Are actively managed mutual funds doomed?

The mutual fund industry is facing an existential crisis that could lead to its demise or at the very least usher in radical changes in its business model and service line. To that end, last week marked a watershed moment: Bloomberg News reported that assets in index-based U.S. equity mutual funds and exchange-traded funds topped those run by stock pickers for the first time in August -- $4.271 trillion invested in U.S. stock index funds, compared with $4.246 trillion in those run by stock pickers. The news reinvigorated the ongoing debate on active versus passive management as an ”either or”, as if these were the only two alternatives and mutually exclusive options to manage money successfully. There is in fact a third alternative which is not only consistent with the evolution of innovative financial techniques, but most to the point yields attractive performance: active asset allocation and its operational aspect of optimal portfolio construction.

It is a widely known secret that over the past 15 years, well over 90% of actively managed stock funds have failed to outperform their benchmarks. According to Bloomberg, fixed-income funds, an active/speculative beast by nature, also did very poorly versus their benchmarks. Despite petulant criticisms, this troubling state of affairs cannot be attributed to a systematic decline of money management skills; it is highly unlikely that active managers have all gone mad at the same time! It is more likely that markets have become much more efficient, rendering stock picking (and hence benchmark outperformance) obsolete. Indeed, there is now an army of analysts whose daily job is to follow in detail a small number of stocks and disseminate instantly their analysis and findings. Technological leaps (or the incredibly powerful combination of fast and immediate connectivity, big data and artificial intelligence/sophisticate software) have made sure that whenever information on a specific stock is published, it gets arbitraged away immediately and globally -- and wait until Quantum Computing comes online! Hence, good luck outperforming by picking specific names in the right proportions in a portfolio!

Meanwhile financial innovation such as ETFs has further facilitated the adoption of passive strategies. There are reportedly more than 8,000 ETFs, or more than the stocks listed in the New York Exchange. These ETFs are now covering ever more granular and specific corners of the global investment universe, e.g. from the US retail sector, banks in the Eurozone, a small frontier market, etc. In the process, the massive influx of funds into these vehicles is flattening and equalizing valuation across similar components of ever more specialized ETFs, thus further reducing the opportunity to outperform by picking a specific stock! As the late Nobel Prize winner Franco Modigliani put it "…markets are quickly becoming micro efficient but will remain macro inefficient". Could it be that outperformance now depends on picking the right ETF?

To be sure, the active manager community has not been silent and has vigorously accused passive managers and ETFs peddlers of distorting the market – i.e. the old argument that passive pushes the investors into the latest best performing (and growing in size) stocks, a form of momentum investment. Michael Burry – the hero of the Big Short who made a fortune shorting the housing market in 2008 – recently went as far as calling the latest flood into passive funds “ a bubble ready to burst”, a farfetched conclusion given that funds and ETFs are simply vehicles, how could they be inflated?! What they hold may be bubbly, not the vehicle itself! Their growth is simply the result of a massive ongoing exodus from actively managed funds.

Despite all the valid arguments against or in favor, however, two wrong do not make one right. Indeed, both active and passive peddlers are overlooking one crucial reality: the scope for active management is not dead at all; it has simply shifted from stock picking to asset allocation and portfolio construction. To be sure, this is nothing new. Successful money management (i.e. beating the benchmark) requires two distinct yet equally crucial functions: idea origination (i.e. stock picking) and portfolio construction (i.e. asset allocation). The trouble is that portfolio construction has traditionally been an afterthought for the active portfolio manager, or at best left to the statistician using the rearview mirror to allocate risk (volatility, actually), instead of actively manage value.

Recalling Prof. Modigliani above, if markets are micro efficient but macro inefficient, then what matters is the right selection of assets, markets, countries, sectors, industries, subindustries, etc., e.g. plenty of opportunities to outperform locally and globally. In the S&P 500 alone there are 11 sectors, 24 industry groups, 69 industries, and 158 sub-industries; with so many options covered by specialized ETFs or index funds, who need to pick stocks anymore and in the process get exposed to idiosyncratic individual stock risk!?!

There is no question that the old model of the actively managed mutual fund, blemished by high fees and poor performances, is on its way of extinction; the watershed news reported by Blomberg last week is an obvious milestone in this trend. The alternative, however, is not simply index funds and ETFs. While there remain opportunities to uncover nuggets in domestic and far away frontier (i.e. inefficient) markets, active asset allocation and proper portfolio construction across an ever more granular universe of global opportunities is rapidly proving to be a crucial ingredient for successful investment.

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