PROFESSIONAL
PENSIONS

On 28 September 2006 Professional Pensions magazine published a feature on active vs. passive management. The editor invited representatives from a leading active equity manager and a leading passive manager to contribute. Dan Gardner of Martin Currie made the case for active equity management. We reproduce his article below.

Dan Gardner of Martin Currie makes the case for active equity management

At Martin Currie our only business is managing specialist active equity portfolios. Our strategies range from benchmark relative (e.g. index +2pc per annum), unconstrained "best ideas", through to absolute return investing that allows "shorting" of stocks. All these strategies are skill-based and are designed to exploit our fundamental belief that markets are inefficient, and offer opportunities for skilled managers to outperform.

So we believe in active management. But that does not mean passive investment strategies don't have a role to play. They can offer pension funds the opportunity to capture the equity risk premium at the lowest possible cost. However investors should recognise them for what they are: rules-based equity strategies with no qualitative overlay or manager discretion. A passive or indexed fund will hold investments that in aggregate track the performance of the benchmark index.

There are three major drawbacks to this approach. Firstly, the strategy is fully exposed to falling markets and, unlike active management, has no flexibility to move into more defensive stocks to protect capital.

Secondly, index funds will typically weight their stock holdings according to the stock"s market capitalisation in the benchmark index. Because the index is biased towards more successful companies (stocks whose prices have increased the greatest have the highest capitalisation, and hence weightings) the passive investor is typically buying expensive stocks and neglecting undervalued ones that may offer greater upside potential.

And thirdly, because indices are market capitalisation weighted, passive investors have an unhealthy concentration of risk in the largest companies. At the current time, approximately 40% of a passive investor's assets in the UK stockmarket is invested in just 10 stocks, headed by the mighty BP at 6.8%.

Active managers can exploit these deficiencies on behalf of their clients. Their greater investment freedom allows them to search the entire marketplace for under-researched investment ideas and manage concentration risk in a more prudent manner.

By accepting the market return ("beta") through passive strategies, pension funds forego the possibility of excess return ("alpha"). How important is this? In an environment of consistent double-digit equity market returns, just capturing beta may be acceptable. But the consensus view is that the equity risk premium over cash is expected to be a more modest 4-5% p.a. over the medium/longer term. Alpha is becoming a more highly prized commodity, particularly as pension funds seek to reduce their funding gaps.

A criticism often levied at active managers is that most will fail to beat the index after costs. This is true, but rather misses the point. Some active managers do outperform persistently over the longer term. Clearly they don"t achieve this by doing the same things as everyone else. In our view the two mistakes most active managers make are:

- They overweight stories relative to statistics - they are misled by behavioural, emotional and intellectual biases more than they realise;
- They underestimate the magnitude and duration of change - they sell their winners too readily and hold on to their losers for too long.

At Martin Currie we focus on the quality, value, growth and change factors that are proven drivers behind long-term share price outperformance. This disciplined approach translates into "running the winners" and "cutting the losers", and means we look for positive dynamics - regardless of whether an investment is classed as a growth or value stock. And we always try to be objective - steering clear of behavioural traps.

So does this approach work? The evidence is that it does, as do a variety of distinctive strategies employed by other successful active managers. But there is one important caveat: in active equity management we believe size is the enemy of performance.

Our research demonstrates a close link between the volume of assets managed and the diminishing ability to outperform. This is based on the premise that the more money you manage, the harder it is to move in and out of stocks without affecting the market price. That is why we have a clear policy on "capping" funds to protect performance for our existing clients. For successful active equity management, size really does matter.

Looking ahead, what are the most efficient ways for pension funds to achieve excess equity returns using skill-based strategies? There is a strong argument for core/satellite approaches that combine low cost beta and high alpha strategies. This represents a case of passive and active management working in harmony for the benefit of pension funds.

Dan Gardner is head of risk management at Martin Currie Investment Management

martin currie