

Active or passive: what is the best investment option?



Information for fund distributors and institutional investors.
Not for circulation to private investors.

Chapter 1



Active or passive:
what is the best
investment option?

Chapter 2



The problem of
finding the
right index

Chapter 3



Conclusion

CEO Commentary



Elizabeth Corley
Chief Executive Officer
Allianz Global Investors Europe

In recent years, through the introduction of index funds and as a result of financial crises, investors' interest in the topic of active versus passive investing has grown substantially. As an active investment manager, we at Allianz Global Investors consider it our duty to provide clients with thoughts concerning this debate.

Chapter 1

Active or passive: what is the best invest- ment option?

The subject of active versus passive management has been a topic of heated debate for many years. Indeed, this is reflected in the wealth of literature that has been produced on this theme, both from professional bodies as well as the academic practice. Unfortunately, there are very good arguments as to why passive is better as well as those that confirm the superiority of active management.

For a start, let us look at the universe of investment options; if we accept that the whole market is divided among active and passive investors then it follows that half of the active players should be outperforming where as the other half would be underperforming (the market). So active investment would be a zero-sum game. Nevertheless one also has to consider the costs of active management. Thus, on balance we can conclude that approximately 40% (rough metric of course depending on total cost and also the type of "market" invested) of active investors are beating the market, after costs.

So yes, we would agree that, on average, more than half of the active managers **should not be** outperforming the market. This statement has been widely held by the passive camp. However this assessment fails to highlight the other



conclusion: that a considerable number of investment managers **should be** out performing.

Having stated what we understand to be the basic facts of this debate, let us now turn to another sub-topic, perhaps most of the time underexplored (and thus underdebated) – should investors opt for passive management, what should be the benchmark for this investment? We think that most market indices are **not suitable** for most investors. Let us explore in more detail why we think passive investment usually isn't the best option because **there is no suitable market index**.

Chapter 2

The problem of finding the right index

- **Equity indices**

The larger part of the financial industry and also the academic community has been promoting the high efficiency, ability to invest and suitability of most equity indices. While we refrain to comment on this, we note that over the last decade there has been

increasingly more evidence of some of the failure of these indices – because, for example, they promote a highly momentum-driven investment approach as well as features of herding behaviour of buying high (and selling low) and of course the promotion of price bubbles. As an alternative to passive investment in equity market indices many options have risen to the surface: fundamental weighted indices, gross domestic product weighted indices, low volatility indices, sustainability indices, and a few others. Whilst we do not judge any of the latter choices one thing is clear: the “good old” equity index might not be the best option. **Active investment**, on the other hand, (subject to the client's guidelines) has, in our view, much more leeway to adapt a portfolio to a more financially efficient basket of securities.

- **Fixed income indices**

Most fixed income market indices pose even greater challenges than equity market indices. Besides the widely known facts of poor liquidity and arguable valuations, they also have other, maybe more severe and fundamental issues: for example, are the larger issuers of bonds necessarily the companies that you want to be invested in? When pension funds adopt a liability driven investment strategy, the assets of the pension fund are benchmarked against a suite of fixed

income securities that matches its liability cash-flow and duration profile. Such a basket of securities can of course not be represented by traditional fixed income indices. **Active investment** is free from these constraints and can implement a fixed income portfolio without regard for any outstanding debt, issuer weighted fixed income index.

- **Other asset classes**

Among other types of investment other than equity or fixed income the scenarios are even bleaker. For real estate, many have already written about the failings of most property indices (mostly for direct holdings as for listed real estate the quality of the indices is somehow better). Commodities are a different story, not only because the underlying construction of the indices relies on spot and roll but also because the weightings and the criteria used have wide differences within the providers. For hedge funds the picture is even worse as at best what can be achieved is an index of actively managed assets! Let's not even mention private equity...

Active investment therefore should be clearly favored for these asset classes as there is no overarching simple, transparent, investable and liquid index available.

Besides these asset class-specific considerations there are other motivations that gently push pension funds away from passive investment towards more active solutions. We have mentioned LDI – Liability Driven Investment, which can be (narrowly) described as a subset of fixed income investing. However, there are many that strongly believe this strategy goes way beyond that (also including, for example, equities and alternative asset classes).



- **ESG**

Another theme which has been supported and advocated by many large institutional investors is ESG – Environmental, Sustainability and Governance. This is such a broad and wide topic in itself that by its very nature struggles to bed down to one single market index. It is true that there are some – mostly themed – indices that provide a suitable (equity) proxy for investing. Still, the engagement and governance guidelines that most large international pension funds abide to go far beyond that.

- **Active Share**

The final piece that has often been neglected is how one should quantify active portfolio management. People have often used tracking error as a measurement for active management, but more recently another measure has been introduced: **Active Share**. It describes the share of portfolio holdings that differ from the benchmark index. These two dimensions are not the same: while tracking error volatility makes sense and is easy to calculate, it only infers what the manager is doing in the portfolio and does not actually look at the underlying holdings. Portfolios can be constructed with a high active share and a low tracking error. This would result in a portfolio of 'diversified stock picks'. Academic research¹ has found out that funds with the highest Active Share significantly outperform their benchmark indices both before and after expenses. Non-index funds with the lowest Active Share underperform. However, one should not interpret these results in a manner that leads to the conclusion that all managers with high Active Share portfolios would beat their benchmarks. It is 'just' an extra toolkit for selecting managers.

Chapter 3

Conclusion

We agree with the bulk of evidence that, on average, an active manager would underperform its benchmark index. Should we accept this then we also accept that for, say, every 3 managers underperforming there should always be 2 managers outperforming.

Still we believe these arguments miss the crucial point: are the current market indices used a suitable benchmark for an institutional investor? If not we strongly believe that this discussion

should be refocused, from the merits of active management towards the merits of market indices.

We might well end concluding that the best way to avoid the so called failings of market indices is to use active investment management, as long as accepted, understood and managed accordingly by its clients.



Contact us

Allianz Global Investors Europe
 Seidlstr. 24–24a
 80335 Munich, Germany
europe@allianzgi.com

¹⁾ Martijn Cremers and Antti Petajisto, 2006 Yale School of Management.

Disclaimer

This document has been issued and approved by Allianz Global Investors Europe GmbH, a subsidiary of Allianz Global Investors AG (part of the Allianz Group). Allianz Global Investors Europe GmbH is a limited liability company incorporated under the laws of the Federal Republic of Germany with its registered office at Seidlstr. 24–24a, D-80335 Munich.

Allianz Global Investors Europe GmbH is licensed in the Federal Republic of Germany as a provider of financial services (Finanzdienstleistungsinstitut); for the conduct of its business activities, Allianz Global Investors Europe GmbH is subject to the supervision of the German Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin). Allianz Global Investors Europe GmbH is also authorised to provide such services under the European Union (EU) Markets in Financial Instruments Directives (2004-39-EC and 2006-73-EC) in the following EU and European Economic Area countries: Austria, Belgium, Czech Republic, Denmark, Finland, France, Greece, Hungary, Iceland, Ireland, Italy, Luxembourg, The Netherlands, Norway, Poland, Portugal, Slovak Republic, Slovenia, Spain, Sweden and the United Kingdom. Allianz Global Investors Europe GmbH has established a branch in Switzerland, which operates under the corporate name of Allianz Global Investors Europe GmbH, Zweigniederlassung Zürich. For the conduct of its investment fund distribution activities, the Swiss branch is subject to the supervision of the Eidgenössischen Bankenkommision (EBK).

In addition, Allianz Global Investors Europe GmbH has established a branch in Italy, which operates under the corporate name of Allianz Global Investors Europe GmbH, Succursale in Italia. For the conduct of its activities, the Italian branch is subject to the supervision of the Commissione Nazionale per le Società e la Borsa (CONSOB).

Allianz Global Investors Europe GmbH has also established a branch in the United Kingdom, which operates under the corporate name of Allianz Global Investors Europe GmbH, UK Branch. For the conduct of its activities, the United Kingdom branch is subject to the supervision of the Financial Services Authority (FSA). Finally, Allianz Global Investors Europe GmbH has established a branch in Spain, which operates under the corporate name of Allianz Global Investors Europe GmbH, Sucursal en España. For the conduct of its activities, the Spanish branch is subject to the supervision of the Comisión Nacional del Mercado de Valores (CNMV). Separately, Allianz Global Investors Europe GmbH has set up a representative office in the Kingdom of Bahrain. For the conduct of its activities, the Kingdom of Bahrain branch is subject to the supervision of the Central Bank of Bahrain (CBB).

Allianz Global Investors Europe has also set up a representative office in Portugal, which operates under the corporate name of Allianz Global Investors Europe GmbH - Portugal - Escritório de Representação.

This document does not constitute an offer to sell securities; it is meant to provide a broad overview for discussion and/or information purposes. Furthermore, this document was not prepared with the intention of providing legal or tax advice.

The duplication, publication, or transmission of the contents of this document to unauthorised persons, irrespective of the form, is not permitted.

While some of the data provided herein is derived from various published and unpublished sources, and is assumed to be correct and reliable, it has not been independently verified; in addition, all the information contained in this document is subject to change. Therefore, Allianz Global Investors Europe GmbH does not guarantee the accuracy or completeness of such data/information and will not accept any liability for any direct or consequential losses arising from its use. Statements made to recipients of this document are subject to the provisions of any underlying offer or contract that may have been, or will be, made or concluded. As with all investment products, no guarantee can be given that past performance will be repeated in the future; consequently, there is no assurance that a portfolio will match the returns shown in this document. In particular, the value of a portfolio of which the assets are invested in the equity securities of companies in emerging markets may fluctuate more than other portfolios, as less developed markets are generally less well regulated than mature markets, may be less liquid and may have less reliable custody arrangements. This also applies to portfolios whose assets are invested in (i) the equity securities of small capitalisation companies, as the latter involve greater risk than large capitalisation companies and the markets for such securities may be more volatile and less liquid; (ii) the equity securities issued by companies active in industries such as biotechnology, information technology and media, due to the volatile nature of such securities; (iii) the equity securities of companies operating in the hard commodities markets, due in particular to the volatility inherent in mining shares and the low level of correlation between the mining sector and equity markets as a whole, with gold bullion and mining shares tending to be counter-cyclical in nature; (iv) the equity securities of companies operating in the soft commodities markets, as the price of such commodities can be highly volatile (such price movements are typically influenced by factors which may affect a particular commodity or industry, such as drought, embargoes, floods, livestock disease, weather, as well as changing market supply and demand relationships, exchange control and tariffs); (v) the equity securities of companies engaged in the real estate industry, because of the special risk considerations associated with this type of securities, such as fluctuations in lease occupancy rates and operating expenses, variations in rental schedules, which in turn may be adversely affected by general and local economic conditions, the supply and demand for real properties, zoning laws, rent control laws, real property tax rates, the availability and costs of financing, environmental laws, and uninsured losses (generally from catastrophic events such as earthquakes, floods, and wars); (vi) high yield fixed income securities, which generally entail increased credit and market risks; and (vii) real estate, because of difficulties or delays in selling the underlying property, and because property valuation is a matter of opinion by an independent valuer rather than fact.

The investment opportunities described herein are not guaranteed by Allianz Global Investors Europe GmbH or affiliated companies within the Allianz Group.

Internet: www.allianzglobalinvestors.eu, E-Mail: europe@allianzgi.com