

Passive Investment or Active Investment?

'Passive Investment and Index Tracking Funds'

Lecture by Professor Simon Keane* to the Members of UKSA (Scotland) on 21 September 2000 at the RSAC, Glasgow

Before a splendid audience of over 50 members and guests Professor Keane delivered a good humoured address in which he attempted to demolish the cherished investment strategies of both fundamentalists and technical analysts present. He distinguished between 'active investment' – where the investor attempted to beat the performance of the market – and 'passive investment' – where a representative portfolio of shares is carefully selected and then left untouched until the money is needed.

He claimed that the 'efficient market' evidence suggests that the performance of the passive investor was likely to be superior, after costs, provided that the comparison was made over the long term, say 7 to 10 years and that the portfolio was reasonably representative of the market as a whole.

Professor Keane explained that the concept of an efficient capital market had been one of the dominant themes in academic literature since the 1960s and Professor Eugene Fama had been particularly active in drawing a body of the theory together. In finance the phrase 'efficient capital markets' has come to have the very specific and stringent meaning that *share prices fully reflect all available information*.

He illustrated the concept by an amusing anecdote of the man who found a £20 note lying on the pavement. Active investors would joke that if the man believed in the efficient market he would not pick it up because in an efficient market such a windfall gain would not occur. However, Professor Keane argued that the efficient market investor would claim no such thing. He would argue, however, that if the man didn't pick it up there would be no point later in telephoning his friend to suggest that he went to collect it! In other

words windfall gains do occur but there is no point in spending time and resources in trying to obtain them.

He accepted that luck could play a part in the short term, possibly to the advantage of the active investor. To prove whether or not anything other than luck influences investment success requires an enormous amount of analysis. Professor Keane presented brief comments on the following results of investment performance tests carried out over many years in the UK and USA to demonstrate whether or not different investment regimes could yield an excess return compared with the market average.

Managed Funds – tests on unit trusts and investment trusts over seven to 10 years showed no consistency in the selection of the best and worst performers; managed funds consistently underperform the market and cannot, by and large, expect to cover their costs; some do worse than others depending on the amount of trading they do.

Smaller funds – often claimed to be more flexible but tend to do even worse because their costs are relatively larger than large funds.

Brokers tips – a study which brought together 50,000 tips published over 50 years showed that they could have made a 2% abnormal gain compared with pure chance *providing that the information had been available before the tip was published*.

Financial press tips – Would have made a 4% gain before transaction costs *again providing that the information had been available before the tip was published*. An important factor here is that sometimes the press gets hold of new information.

Telephone tips – calculated to have made 1% abnormal growth.

Investment newsletters – of 48 investment tipster sheets monitored, only one outperformed the market over five years.

Private investors – difficult to test. Estimates of private investors performance via access to brokers' accounts showed an average excess return of 3% before costs. It is quite possible that some private investors may have inside information.

Professor Keane reasoned from these tests that the advertised ways of seeking superior investment performance could not improve on that of the market average over the long term. He implied that this applied both to stock selection and to timing the market. 'By and large' he said 'the market gets the price right'. On timing he cautioned that you cannot say 'the market is going down' you can only say 'the market went down today'. He pointed out that a major bear market has been thought imminent for several years past but those who got out lost money. 'The market is skilled in reflecting the price,' he said 'and this makes the future unpredictable. However, there is always the matter of luck.' He claimed that Chartists were wasting their time. Fundamentalists also because the market reacts so quickly to fundamental changes. 'A cheap share is bought up very quickly,' he said.

Professor Keane went on to say that in view of the results of these tests it was difficult to understand why the world was full of active investors. He concluded that it could only be because they did not know the weight of evidence against them and because many had vested interests in rejecting the evidence. He also sought an explanation for the many self proclaimed 'winners' – funds, tips, shares etc. – and thought that it would be illuminating to see the corresponding list of 'losers' published! To the question 'Surely it pays to avoid the rogue shares' he said that his reply was that the chance of picking a share that will do badly is not greater than that of picking a share that will do well. Both must be chosen in a representative portfolio, providing that the share price fully reflects both the good and the bad company. He offered the following conclusions:

- You are fooling yourself if you think you can beat the market.
- You like the challenge of trying to beat the market, but it is not necessarily profitable.
- *Over the long term and after costs* passive investment is better than active investment.
- The ideal investment strategy has two golden rules:
 - diversify as much as possible,
 - transact as little as possible.

Moving on to index tracking funds, Professor Keane asked first of all whether such funds truly represent passive investment. He stated that the majority of such funds available in the UK concentrate on securities invested only in the UK thereby ignoring the rest of the world. The US, Japanese and certain European markets are no less efficient than that of the UK and so a UK based fund is not globally representative. 'With a UK based tracker fund, you are effectively betting against the rest of the world' he said. The real need is for a global tracking fund where he suggested that a representative fund should have, perhaps, 50% US stock, 20% Japan, 20% Europe, 10% UK. 'You can, of course, construct your own index as an alternative,' he suggested.

Prof Keane confessed that he did not hold any tracker funds himself preferring investment trusts because they also had low management costs and could generally be purchased at discounted asset value. He considered that a large investment trust with a significant foreign content to be a reasonable approximation to a tracker fund. He thought it unnecessary to replicate the index exactly. A portfolio of 20 shares carefully chosen as representative could give 90% of the tracking effect. He also suggested that it was unreasonable to expect exceptionally high returns. He thought it reasonable to aim for a about 12–15 % annual average return from a portfolio.

The chairman, James Murray, in his vote of thanks to Professor Keane said that he had found the lecture profoundly stimulating. This view was clearly shared by the audience who continued to question the speaker enthusiastically for 30 minutes after his lecture. In the time available it was regrettable that the assumptions, data and methods of the investment performance tests could not be presented in greater detail as this was the crux of the case for passive

investment. As a result, in spite of the speaker's persuasive manner, it is unlikely that the fundamentalists present will give up their forecasts of earnings growth nor the technical analysts their moving averages. As one member of the audience said afterwards of the divergence of views 'This is what makes a market!' ■

*Professor Keane recently retired as the Head of the Department of Accounting and Finance at Glasgow University. In October 1999, writing in the *Financial Times*, the stock market historian David Schwartz advised against index tracking shares as, in his view, they would fare badly in the bear market which he thought was imminent. Writing in the same paper two weeks later Professor Keane profoundly disagreed, stating that index tracking funds were not only here to stay but with a few structural modifications would become the norm. Almost a year later, during which time the stock market has seen pronounced volatility in the share prices of even the largest companies, Professor Keane has not changed his views.

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