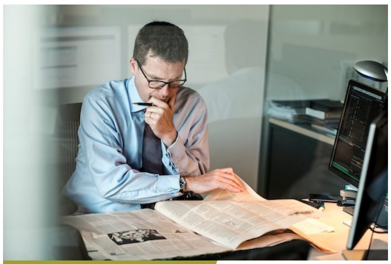
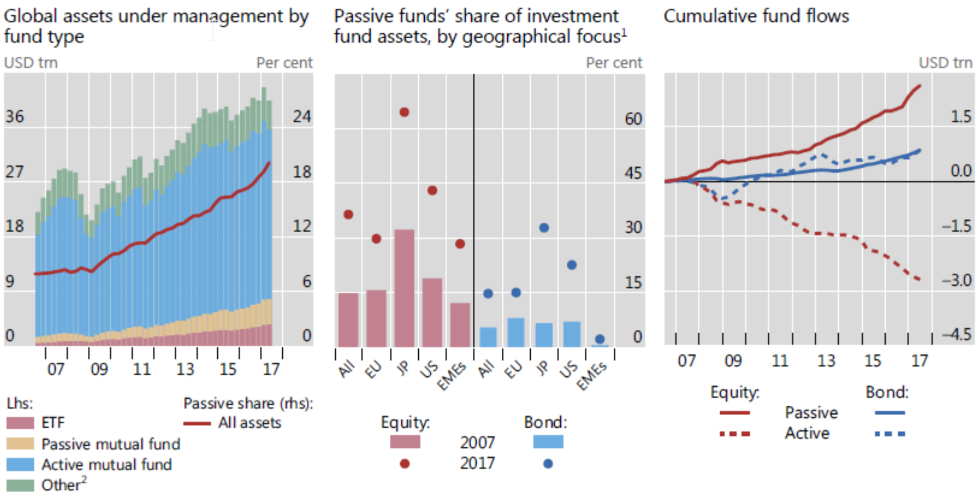


Friday Morning Coffee

Nr. 5 — Active vs. Passive Management: David against Goliath?

The debate about the respective virtues of active and passive management has been intense for years now, and it is obvious that passive strategies are gaining traction, European equities are not immune to this trend.

Graph 1: Passive funds' share of the fund management sector rises



¹ As of end-June for each year. ² Includes investment fund assets of closed-end funds, hedge funds, insurance funds, investment trusts and pension funds.

Source: BIS Quarterly Review, March 2018, The implications of passive investing for securities analysis, Vladyslav Sushko, Grant Turner

The main argument given by the supporters of passive management is the observation that, after fees and over the long-term, very few active managers are able to outperform the market. So, why bother selecting stocks?

For their part, **the advocates of active management explain that their aim is to exploit market inefficiencies that lead, at certain point in time, the stock price of a company to not reflect properly its fundamental value**. Hence, the emergence of passive strategies should consequently increase those market inefficiencies and thus the related investment opportunities for active managers.

Indeed, **stock market dynamics are based on the differences of opinion between buyers and sellers. But, passive management has no opinion**.

Index funds buy when they have subscriptions and conversely sell to face redemption flows, regardless of the fundamentals of the underlying company. In addition, they build their portfolio based on a benchmark that is most often calculated taking into account the market capitalization of the underlying securities. ***By construction, passive management is therefore based on the "momentum": the more a stock price increases, the higher is its weight in the index, and therefore the more it is bought by the passive managers***.

We are here very far from the idea that the price of a stock is nothing more than the price at which a company's property right (a share) is changing hands between a seller and a buyer who each have different views about the value of an underlying good (the listed company). Let's take a concrete example with Europcar' s share. This stock has been highly volatile recently, having climbed up to EUR 11.65 at the end of January to go down lately to EUR 8.75. As active managers, if today, we want to buy Europcar, it is because our view is that the stock is worth more than its current price while the seller from whom we are going to buy the stock thinks that it is worth EUR 8.75 or a little less. **The emergence of ETFs and other passive investment solutions is distorting this crucial relationship between a buyer and a seller**.

Recently one of our investors asked me my opinion on the ability for active managers to counter the negative effects of passive management and thus to force the market to correct valuation errors. In other words, **will active management meet a sad end against markets guided by the flows of passive strategies that will be unable to recognize the under-valuation of companies?**

Considering the extreme case where there would remain only one active manager on the earth, confronted only to passive managers; the only possible exchanges would be linked to the subscription/redemption flows in the passive strategies; the link between the fundamental value of companies and their share price would have totally disappeared.

The only safeguard would be that the valuation of a company falls so low that an industrial buyer decides to buy it back and delist it from the stock market.

Fortunately, we are not there yet, but this subject requires careful attention.

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There is also the fundamental question of the liability of a company's shareholders in terms of, for example, voting rights. If all the owners of a listed company are unaware of the fundamental value of the company and even of the company's business, how can they be able to express a relevant opinion on such crucial issues as the quality of a management team?

We identify an increasing polarisation of the asset management business between the supporters of active and passive management. Many active managers are also tempted and are moving towards semi-passive strategies.

Active management will however **only survive if it assumes its active role, i.e. if it consistently implements long-term investment strategies, characterised by a high active share and supported by strong investment processes aiming at generating alpha.** It is also essential to **have an alignment of the investment horizon of active managers and investors; these managers cannot be judged looking at short-term market developments but must be assessed on sufficiently long periods of time to allow their investment cases to develop, mature and therefore generate returns.**

I wish you a nice weekend,

Léon Kirch, CFA
Partner & Chief Investment Officer
April 6th, 2018