SUCCESS IS BLENDED

Why Passive & Active investing is blended in the Destiny Portfolios

Investors are being persuaded to choose an active or passive investment strategy by clever marketing campaigns but not with strong investment fundamentals. According to Blackrock, the largest asset manager in the world with over $6 trillion under management, "investors should stop thinking in active versus passive terms…but rather in terms of how best to blend".

Ultimately an investor is being told to start their investment construction by asking themselves whether to choose an active or passive allocation in a given asset class. This is the wrong approach.

It is time for investors to accept both approaches and to rather understand how these investment strategies complement each other and to ask how best to blend different sources of return. There is one truth within the investment industry investors should seek varied return sources in cost effective ways depending on their objectives and constraints.

Passive investing leverages off active investing, because active managers make markets more efficient than they would otherwise be. The two strategies are complementary. Markets function best when there is a broad universe of investors with different strategies and time horizons.

The growth in passive strategies actually increases opportunities for the genuinely active manager. It does this by increasing liquidity in the market. It also makes markets less efficient because it steers the investment process away from buying high and selling low. It systematically gives higher weights to overvalued stocks and lower weights to undervalued stocks.

By combining active and passive management in an innovative matrix, GIB has been able to use traditional investment market leaders but has still managed to reduce costs and increase efficiency by using active management in a cost effective manner via a core-satellite approach.

One of the strongest arguments in favour of passive investing is that investors in passive strategies remove stock specific risk from their portfolios and simply get the return of the overall market or market sector, at low cost. This is a compelling argument and it applies in many of the world's more mature markets. Investors in a passive S&P 500 Fund have approximately 3% of their investment exposed to the single largest stock, while exposure to the largest 10 stocks amounts to only 18%. The SA equity market on the other hand is highly concentrated.

The case for a passive product is premised on low fees, which puts pressure on active managers who often charge inappropriately high fees. Active managers should be assessed on the alpha or return they deliver net of fees. Passive management threatens active managers who have not delivered outperformance or who do not produce truly active portfolios (that is, they construct portfolios that hug benchmarks).

The investment returns that are generated by managers beyond a benchmark fall into two buckets:

1) Returns that can be replicated systematically and cost-efficiently by broad market and factor indices; and
2) Returns that are driven by true investment skills and cannot be systematically captured through an index.

The first bucket we call Beta. This is achieved by replicating the market in its totality which produces an average of all possible positive and negative returns of the underlying market.

The second bucket of return is what we call Alpha. This is achieved by security selection, tactical asset allocation across asset classes and market timing strategies.

Without a clear understanding of different return drivers and costs, investors can unintentionally fall short of their risk and return objectives. This can be avoided by analysing underlying factors such as the broader, persistent drivers of return that straddle asset class boundaries, or more simply stated, by blending different investment philosophies and investments styles, be it active or passive, into one consistent alpha generating return.

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