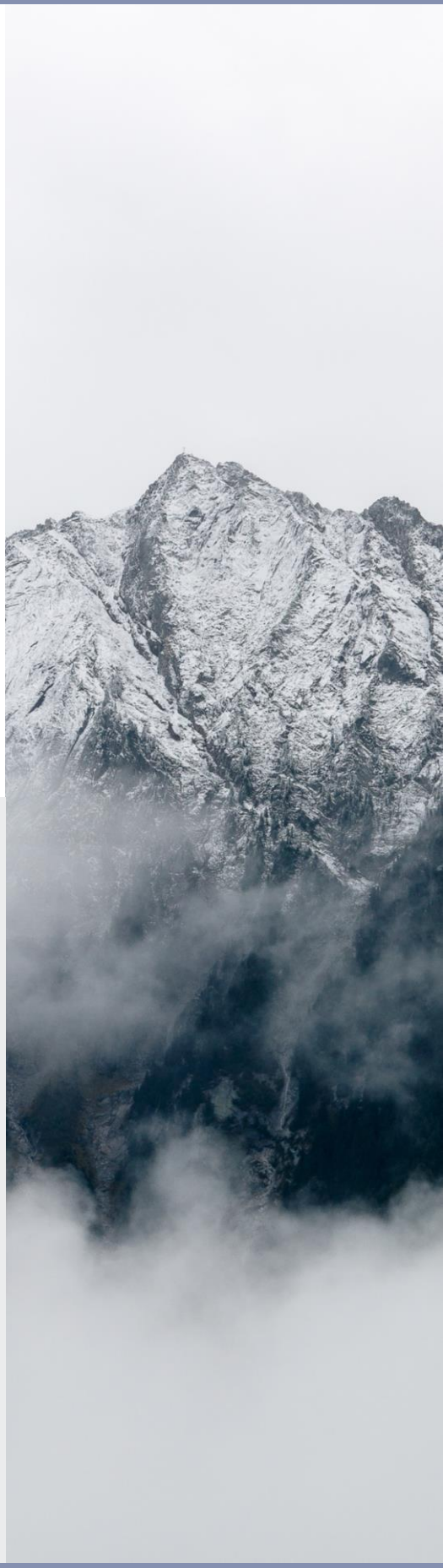
PASSIVE NO MORE?

Why active investment is still beneficial

Sybille Wyss, Chief Investment Officer
Stefan Schütz, Analyst and Head Equity Research

Tareno AG, 2019



The popularity of passivity

The arguments for passive investing seem compelling: low fees, transparency and tax efficiency. The fact that such strategies have in recent years outpaced actively-managed counterparts only adds to their appeal. Across the financial landscape, many now argue that indexing is the best – and only – option for investors, which a growing number have taken to heart. According to research firm ETFGI, global ETF and ETP assets hit a record US$ 5.32 trillion in early-2019 after 61 straight months of inflows.

History suggests, however, that this sort of enthusiasm signals trouble rather than smooth sailing ahead. Indeed, with the crowd increasingly heading in one direction, any contrarian worth his or her salt would likely see this as an opportunity to profit – by going the other way.

Financial markets and the sentiment that drives them have always been cyclical; there is little reason to think this time is different.

The popularity of passivity is not the only reason for caution. The fundamental picture also appears less-than-supportive. Most experts acknowledge, for instance, that equity markets have been among the prime beneficiaries of policies that have fostered unusually low interest rates and volatility.

In an environment where the rising tide of monetary accommodation lifts all boats, an index-based strategy can make sense.

Risks of passive strategies

The economic and financial backdrop is changing, however. Led by the U.S. Federal Reserve, central banks around the world have been gradually moving toward "normalization," suggesting that at least one factor that has propelled markets higher is losing steam. Should conditions revert back to where they were in the past, index investors could be in for a wilder ride than they bargained for.

But even if the economic and financial environment remains stuck in the so-called new normal, the passive approach is flawed. For one thing, it is impossible for such strategies to outperform or even keep pace with relevant benchmarks, unless managers overseeing these assets choose to work for free. More importantly, they expose investors to numerous risks, whether they realize it or not.

The fundamental factors that impact share values and the performance of underlying businesses are largely ignored. Those who invest this way end up owing a collection of good, bad and ugly companies, the relative share of which may owe more to short-term trading momentum than long-term business prospects. Making matters worse, the more capital that flows into such strategies, the greater the risks of owning mispriced securities.

In general, indexing also means having increased exposure to broad market swings. While this may not be such a bad thing when most stocks are rising, the opposite holds true when they are not. This also leaves many investors vulnerable to inherent behavioral biases. Rather than ride out a market storm that may have little to do with prospects for the companies they own, they may decide to cut and run -- at the wrong time.

When investors opt for a passive approach, it can be difficult to ascertain whether the strategy is truly aligned with their long-term financial objectives, personal preferences, and the qualities that influence the success of a business. Index-focused approaches are more about averages than about unique individuals, companies, industries and themes.

Active investing in contrast

By definition, active strategies are not simply a reflection of what the masses are doing. Properly managed, they operate with a clear framework in mind, whether referring to the elements that define a well-run business, valuations, time horizons, the operating environment, or investor needs and requirements, including financial goals and personal preferences.

A hands-on strategy offers other advantages, too. Unlike with a passive approach, investors are not forced to take the bad with the good. An experienced and knowledgeable portfolio manager can discriminate freely, targeting high quality companies with solid prospects and focused strategies and avoiding those where the outlook is unappealing or, in some cases, far worse than many believe.

To be sure, quality does not just refer to those aspects associated with traditional analysis. It also includes environmental, social and governance factors that are increasingly being seen as critical to sustainable success. While investors' ethical concerns undoubtedly kick-started interest in ESG, the fact that well-run firms tend to do the right things means active managers can give it the weight it deserves in the investment decision-making process.

Active management also allows investors to benefit from developments that may not be so apparent when stock prices are being whipped around by earnings reports, economic data, news headlines and assorted random noise. It is true that markets can quickly digest new information, but evidence suggests that investors are not particularly adept at discounting longer-term structural changes.

Take the issue of water, a resource critical to life as we know it. While many investors undoubtedly understand its importance, it is difficult for those who are not actively following developments to identify the clear winners and losers in the space. At the Tareno Global Water Solutions Fund, for example, the investment team spends considerable time ascertaining which firms are best placed to capitalize on demographic, climate change, urbanization and technology trends.

Tailor-made strategies

Active management does not just afford investors the opportunity to capitalize on slow-moving or broad-scale themes. Unlike their passive counterparts, active managers can adapt and react to changing market conditions and new developments. If and when the prices of high-quality companies get knocked by turbulent markets, for example, those who have done their homework can swoop in and scoop up the bargains.

Combined with specialized expertise and a preference for quality, this sort of flexibility gives managers the wherewithal to construct portfolios that are less correlated to broader market moves than index portfolios.

It also allows them to incorporate methods and technologies, including big data and artificial intelligence, that can enhance decision-making and limit the adverse impact that behavioral biases can have on the investment process.

The fact is, despite the apparent advantages of indexing, an active approach enables investors to strike the right balance between risk and reward. While the proponents of passivity are quick to highlight the low fees involved, they tend to underplay important aspects, including being able to invest in defensive, high quality portfolios that offer the promise of above-market returns. At the current juncture, this is not something investors should be taking lightly.

TARENO
Global Water Solutions Fund

Company

Tareno Ltd

St. Jakobs-Strasse 18

CH-4052 Basel

+41 (0)61 282 28 00

Tareno Ltd

Claridenstrasse 34

CH-8002 Zürich

+41 (0)44 282 28 00

info@tareno.ch

www.tareno.ch

Responsible

Sybille Wyss

Chief Investment Officer

s.wyss@tareno.ch

Stefan Schütz

Head Equity Research

s.schuetz@tareno.ch

Annina Tschanz

Head Marketing

a.tschanz@tareno.ch

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