The pitfalls of benchmark investing

Active management is not always 'active'

Active managers have recently come under scrutiny following the release of an S&P report which found that most actively managed funds have underperformed the index over the medium term. In the global equity space, for example, the report identifies that the index outperformed 76% of international equity funds over the last five years. This is hardly a ringing endorsement for so called 'active' management.

The real question for investors is how many of these 'active' managers really *are* active?

How active is active?

Many active managers are in fact closet benchmark huggers, choosing to stick close to the benchmark weights and then charging an active fee. The result is benchmark-like returns, but with a higher fee and, hence, underperformance.

The reason some active managers take this approach is to try and manage the risk of underperforming the benchmark and their peer group. By sticking near the benchmark they are attempting to negate the risk of significantly underperforming it. However, such an approach also negates the possibility of significantly outperforming it as well! You could argue that the industry's fixation with performance tables and the increasingly short term investment horizon of investors has led to a culture of fear among fund managers - a fear of underperforming.

Unless investors are prepared to accept short term underperformance, they cannot hope to outperform in the long term. By definition, in order to outperform the benchmark you have to step away from it. And by stepping away from it, you also have to be willing to underperform.

The problems with benchmarks

The problem with benchmarks is that they are backward-looking; they provide no indication of where the best opportunities will lie in the future. Given investors are looking to generate future returns, why would they want to base their decisions on a retrospective indicator? A benchmark-based approach is one where are "biggest is best" mentality prevails. But in reality the largest component of the MSCI All Countries World index - making up nearly 50% of it - is the United States. The US has been the worst performing country in the index over the last five calendar years. Conversely, the smallest geographical representation in the index is Latin America which has been the best performing region over the last five calendar years. It is a similar story at a sector level, with the largest sector – Financials – also the worst performing sector over the last five calendar years.

Benchmark investing can also lead managers to become momentum driven. This is because, as a sector or individual stock performs, it becomes a larger part of the index. Index funds, or closet benchmark huggers, are then enticed to buy more, potentially driving prices even higher. In effect, they are increasing their weight to stocks that have already outperformed, leading to the very real possibility that investors will be holding maximum exposure just before the inevitable correction comes. Truly active managers do not need to chase markets and potentially overpay for momentum driven stocks; instead they choose to invest in more relatively attractive opportunities.

One final myth is that index investing is a zero risk position. By investing in or hugging the index, the relative risk of underperforming the market is zero or approaching zero. In absolute terms, though, investors are still exposed to the risk of the market. And, as we all know, markets and indexes do go down as well as up. An index approach means exposure to the full impact of corrections, as well as upturns. On the other hand, a skilled truly active manager can help protect investors against the full impact of market downturns. An index approach offers no protection at all.

The advantages of being truly active

Rather than blindly following an index, active investors should rely on first-hand research to find good-quality companies with solid long-term prospects.

In the current environment, it is more important than ever to use a range of appropriate valuation and quality measures. For instance, price-earnings ratios are becoming less relevant given that earnings forecasts are only just beginning to be downgraded and the profit outlook is increasingly uncertain.

Measures such as price-to-book, whereby a stock's market value is compared to its book value, are becoming all the more pertinent.

In terms of identifying company quality, there is no substitute for the ability to make face-to-face contact with company management and to undertake meticulous comparative research, aimed at uncovering those companies with the management track record, competitive advantage, and financial strength to outperform in the long term, wherever they may be located.

Benchmark investors can miss great opportunities. For example, China and India currently constitute a small proportion of the MSCI AC World Index despite both being seen as key drivers of global growth for decades to come.

A truly active, benchmark unaware, concentrated portfolio with low turnover can provide returns above the benchmark over the long term. The Aberdeen International Equity Fund has outperformed the MSCI AC World Index by 5.49% per annum net of fees for the 5 years ending 31 July 2009.

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