

What Astronauts Can Tell Us About Passive Investing

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In brief

- Active management's underperformance stems from suppressed market breadth.
- Suppressed interest rates distorted capital allocation, acting like weightlessness on the economy, inhibiting the natural cycle of "creative destruction."
- Higher costs and increasing market breadth are now creating opportunities for skilled active managers to differentiate themselves.

A recent client meeting raised a common question:

"I have been hearing the bull case for active managers since I started my career, and it has yet to happen. Will active managers ever outperform?"

This sentiment likely resonates with many investment professionals who began their careers after 2008. The current market mirrors this sentiment, with passive strategies now holding over 50% of the US equity market, a significant increase from less than half that level in the early 2010s. The true extent of passive dominance may be even greater when considering the assets within closet index portfolios and other strategies designed with minimal tracking error.

Will active managers ever outperform? If actions speak louder than words, then the broad market has collectively answered "no." If that were true, then a fundamental shift has occurred. The explanatory factor must be one of two notions: Either there has been a permanent erosion of investment skill, or the market inefficiencies that once fueled active management have disappeared entirely.

Defining Alpha: Skill and Breadth

To understand alpha, it is necessary to revisit the Fundamental Law of Active Management. This principle states that a manager's information ratio (a measure of value add) depends on their information coefficient (representing skill) and the square root of investment opportunities (representing breadth of opportunity). Simply, alpha comes from a combination of stock picking and variation in stock performances.





Erosion of Skill or Market Breadth's Absence

Historically, portfolio manager skill, like other human abilities, has followed a normal distribution, with a range of performance around the market average. Beginning in the 2010s, this distribution increasingly skewed, with a scarcity of active managers consistently outperforming their benchmarks. Critics often attribute this to a structural erosion of skill, arguing that technology's advancements have eliminated the informational advantages once held by some.

While this argument sounds plausible, as technology has undoubtedly made information more accessible, I think it's more about coincidence and less about causality. Information is merely an aggregation of data or facts. Wisdom, the primary component of manager skill, is the product of experience and deep knowledge. It represents the ability to synthesize, infer and make sound decisions from aggregated information. As English poet William Cowper penned, "Knowledge is the food of the soul, but wisdom is the flavor." Although the information gap has narrowed and may even have closed, the wisdom gap remains significant. The ability to transform knowledge into actionable insights is more likely still wide, notwithstanding the challenging performance by active managers over the past 15 years.

If not due to the erosion of skill, what about breadth of opportunity? Stock dispersion or market breadth is cyclical. Instead of delving into graphs illustrating lower-than-normal measures of idiosyncratic risk or high degrees of pair-wise stock correlation due to external factors, this concept can be explored through a more intuitive, though perhaps unconventional, lens.

Space Travel and Market Breadth: A Striking Parallel

Consider astronauts in space. In a weightless environment over a prolonged period, their muscles begin to atrophy; their bodies require load, and without it, they lose bone density. The effects of a gravity-free atmosphere are so severe that upon return to Earth, astronauts must be lifted and carried out of the return capsule, followed by weeks of intense training to rebuild atrophied muscles.

Interest rates play a similar role to gravity in the economy. They act as load-bearing resistance, creating performance disparities between the most and least fit enterprises. When demand for capital surpasses the available supply, or when borrowers outnumber savers, the cost of capital rises and elevates the clearing rate for potential investment ideas, weeding out the least viable projects. Conversely, when the supply of savings outweighs capital demand, interest rates fall, increasing the attractiveness of various investment opportunities. This dynamic helps society achieve equilibrium by allocating capital to projects with true economic utility. Without this resistance mechanism, akin to muscle atrophy in a weightless environment, capital is not allocated in accordance with the utility it produces.

While lower-than-average interest rates throughout the 2010s were likely warranted by a glut of savings and weakening demand for productive capital, central bankers distorted the natural capital market rate to all-time lows. This was further exacerbated by trillions of dollars in fiscal stimulus during the pandemic. This frictionless period, orchestrated by policymakers, extended the lifespan of investment projects and businesses that might otherwise have been deemed unsustainable or written off entirely. This artificial prevention of resistance and thus capital loss, we believe, suppressed market breadth. The misfortunes of skilled active managers, in this light, were cyclical and, arguably, artificially imposed.

Looking Ahead: A Resurgence of Opportunities

While the future lacks any facts, several factors suggest a potential shift. Companies now face materially higher expenses for labor, capital and goods compared to the 2010s. Even if central banks attempt to socialize capital losses with further rate cuts, alarmingly high budget deficits and an awakened bond market may act as a new gravitational force this time around.

A lot is different from the 2010s, and with these changes will come divergent economic and operating results from companies. Businesses offering products or services that customers genuinely want and need will be able to better navigate these changes by taking price or market share. However, businesses whose offerings are becoming obsolete due to new competition and artificial intelligence will face a different reality. This divergence is likely to drive market breadth and potentially alter the current skew of active manager performance. ▲

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