The Creation of Added Value in Actively and Passively Managed Investment Trusts

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1. Introduction

As financial liberalization unfolds, one of the most interesting debates regards the fate of 1,200 trillion yen in personal financial assets. Banks and other institutions have quietly begun investment trust sales at the retail level amid optimistic prospects for the asset management business.

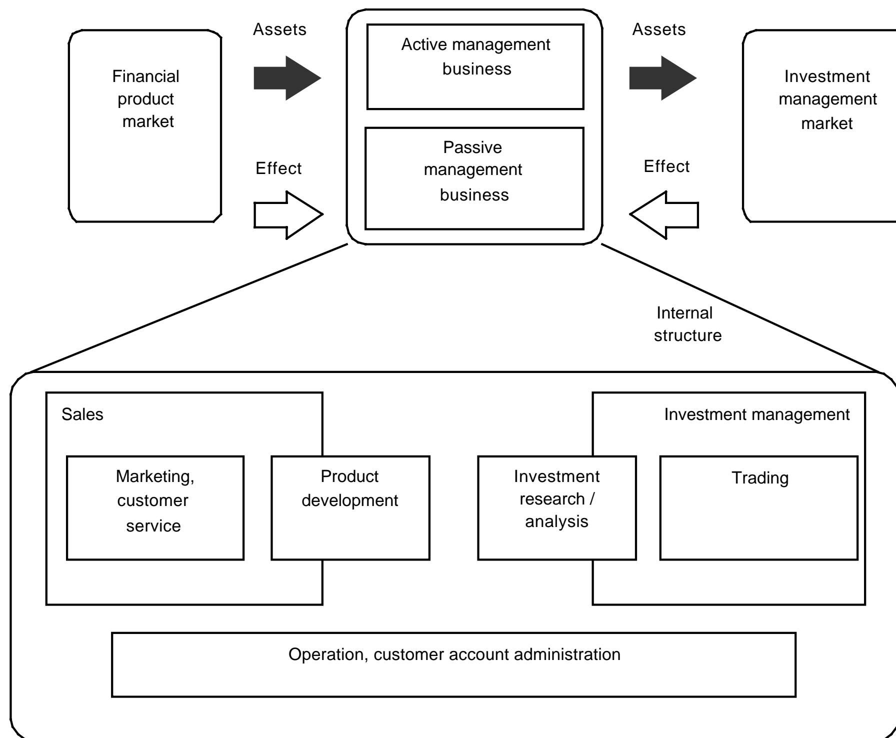
This paper examines the factors that determine how added value is created in the asset management business, with special emphasis on the key words, "two markets" and "active" versus "passive" management. While the viewpoint is that of service providers, service users may also benefit from the following observations.

2. Two Markets

As shown in Figure 1, the asset management business is situated between two markets: (1) the financial product sales market, and (2) the investment management market.

In the financial products market, asset management companies provide financial services to customers by selling investment trusts and other products. On the other hand, the investment management market uses the funds gathered in the financial product sales market to manage portfolios of stocks and bonds. Thus the overall arrangement is for customer assets to flow from the financial product sales market, through the asset management company, to the investment management market.

Figure 1 The Two Markets of the Asset Management Business



3. Active and Passive Management

Active and passive management refer to two distinct methods of asset management. In active management, managers aim to outperform market returns, while passive management aims for returns that track the market average.

While the word "passive" is often assumed to denote inferiority, passive management actually offers several advantages over active management: (1) research, transaction, and other costs are lower due to economies of scale, and (2) ample disclosure enables comparisons with other funds, whereas actively managed funds usually protect their methods as trade secrets.

4. Added Value

The internal structure of an asset management company consists of three areas: (1) investment

management (2) sales, and (3) management and fund administration (Figure 1). Of these, investment management corresponds to the investment management market, and sales to the financial products market.

However, even if they operate with the same internal structure, active and passive management differ significantly in terms of the creation of added value. From the perspective of an asset management company, the following points can be made: (1) active management can set high management fees, and adds much value added per unit of managed assets, while (2) passive management has low management fees, and adds less value per unit of managed assets.

Here we need to point out that a business is not necessarily inferior simply because it produces less value added. While active management has a larger value added, its costs are also higher. The use of analysts and strategists incurs research costs, and a high portfolio turnover rate pushes costs upward. These additional costs do not produce guaranteed results, and may even exceed the large management fees that are charged.

On the other hand, passive management produces less value added, but costs are also lower. Moreover, it is subject to economies of scale, wherein the larger managed assets are, the lower costs fall. Economies of scale also serve as a barrier to entry. For example, while actively managed funds in the U.S. are in constant flux, the major passively managed funds see almost no changes in their net asset rankings. Vanguard Group, whose business is centered around index funds, is a prominent example of a successful passive management business.

5. Strategies for the Two Markets

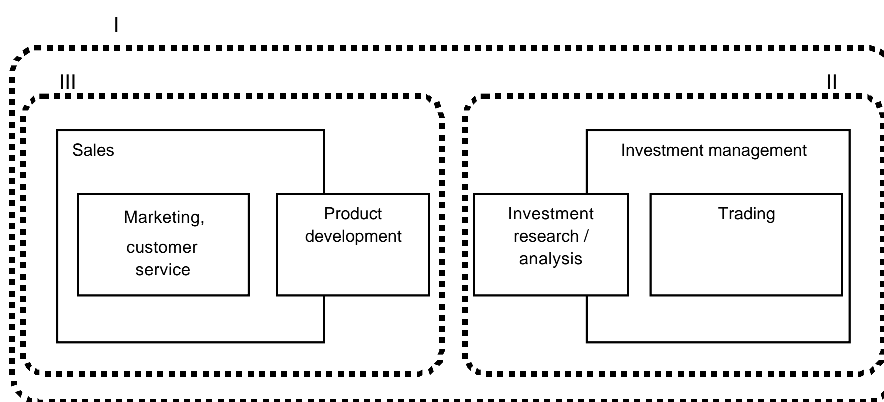
The two markets have a significant impact on the overall industry structure of the asset management business, and on individual companies.

In the investment management market, fund managers may or may not outperform the market. Meanwhile, customers may or may not expect the financial products market to outperform the market. Since customer expectations can differ from the investment management market conditions, four cases are possible. The appropriate strategy of passive or active management differs in each case, as does the source of added value within the investment company. Using Figures 2 and 3, we discuss below how each case affects the industry structure of the asset management business as well as each company's internal structure.

Figure 2 Strategy Matrix for Conditions in the Two Markets

		Investment management market conditions	
		Can outperform market	Cannot outperform market
Customer expectations	Can outperform market	I Active management −Must enhance management capability	III Active management −Must enhance marketing & sales capability
	Cannot outperform market	II Passive management for customer accounts; active management for dealing account	IV Passive management

Figure 3 Source of Value Added and Cost



(1) Case I — Aggressive Active Management

When the investment management market is inefficient, market-beating returns are possible (see left side of Figure 2). Furthermore, if customers expect market-beating returns, the demand for high value added active management increases, and earnings and sales growth can be expected in the financial products market. However, this causes a dilemma for the asset management business overall, since if the share of active management grows, the market becomes more efficient and hence increasingly difficult to outperform.

On the other hand, within the company, added value is created in both areas of asset management and sales (Figure 3). First, asset management creates added value by generating returns in excess of the market. Then since customers condone the high management fee ratios, value is added through sales as well. To create added value, it is important to enhance asset management capabilities (research, analysis, trading, etc.) and sales power (marketing, customer service, etc.), both of which are costly. Since past performance affects sales, it is an appropriate strategy to

concentrate management resources (fund managers, analysts, traders, marketers, customer service, etc.) on a limited product line (the K strategy).[2]

(2) Case II — Active Management of the Dealing Account

If the asset management market is inefficient but customers nonetheless fail to expect excessive returns, added value from the asset management market will be sought in the dealing account. Demand in the financial product sales market will gradually shift from passive to active management if excessive returns in the asset management market can be sustained, causing a shift to the upper left corner of Figure 2.

Within the company, investment management of the dealing account will generate substantial added value (Figure 3). However, since customers who do not expect excessive returns will not condone high fee ratios, value added cannot be expected in the sales market. Thus while a strategy of spending lavishly on investment management is rational, it may also be feasible to invest in sales in anticipation that customers will eventually alter their expectations.

(3) Case III — Downplayed Active Management

If the investment management market is highly efficient, returns are not likely to beat the market no matter what is done (see right half of Figure 2). However, if some customers still expect the market to be inefficient (upper right corner of Figure 2), demand for active management will emerge in the financial products market.

Since customers will condone high fee ratios, added value will come mostly from the financial products market (Figure 3). But contrary to customer expectations, since added value will not be generated through investment management, expenditures will need to be minimized and enough only to support sales. On the other hand, marketing, customer service activities, and product development will gain in importance. To survive intense competition, it will be advantageous to have several product lines (the r strategy).[3]

(4) Case IV — Passive Management

If investment management market is efficient, and customers (the financial product sales market) are aware of this (lower right corner of Figure 2), then passive management, which tracks the market average, will become prevalent in the asset management business, and value added in the business will decrease.

Companies will seek economies of scale because of the small value added per unit of man-

aged assets. Cost cutting will be an imperative in both investment management and sales.

To summarize the above results, passive management is chosen only when excessive returns are not anticipated from the investment management market, and this perception is shared by customers; in the other three cases, active management is preferred.

In cases where customers do not share a consensus regarding possible outperforming returns (both opinions exist in the financial products market), the following choices will be made: (1) if excessive returns can actually be obtained in the investment management market, active management will primarily be chosen (2) if excessive returns cannot be obtained, active management will coexist with passive management.

Thus what ultimately determines the worthiness of active management business is not the investment management market but the financial products market. In other words, regardless of whether the investment management market conditions are efficient or not, as long as there is a demand for active management, such businesses will continue to exist.

6. Strategy in an Efficient Investment Management Market

Weighted by fund size, the return on all actively managed funds falls below that of passively managed funds. Thus active management cannot be credited with improving the industry's returns. A few successful actively managed funds are creating the demand for active management (even then, as top executives of major pension consulting companies say, past performance provides no guarantee of future returns).

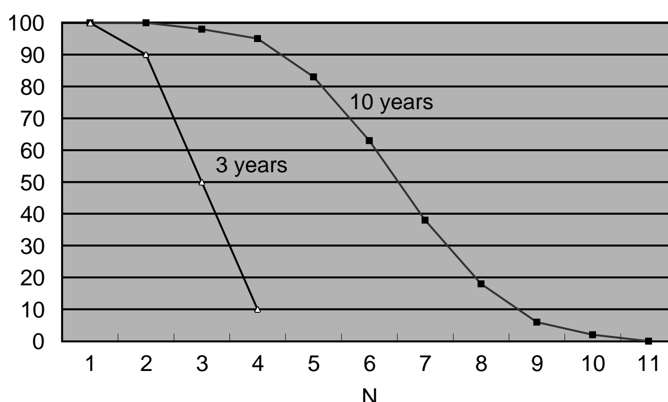
Looking at the successful cases, even at times when the active management business is struggling (because of the efficient investment management market), a certain proportion of actively managed funds should still outperform the market by shear probability. We examine this possibility in Figure 4.

Assume that a particular active fund has an even chance (50%) of either outperforming or underperforming the market. For a 3-year and 10-year period, we count the number of years in which a fund beats the market. To be judged successful, a fund must beat the market in two out of three years, or six out of ten years. Looking at the results, half of the funds beat the market in at least two out of three years, but 38% won at least six out of ten years. Only 0.1% of the funds outperformed the market for the full decade, ensuring a legendary status. However, if costs are also considered (transaction costs, etc.), the proportion of accidentally success-

ful funds declines slightly more.

If the coincidental success of these funds is emphasized, even if the investment management market is efficient, it would stimulate demand for active management in the financial product sales market. In addition, by offering a greater number of funds, active management companies can improve their probability of survival. Richard Ennis (1997) points out that under certain conditions, a company with a single product line has a 38% probability of outperforming the market over the course of a decade, but a company with 10 product lines has an 80% probability that three of its products will outperform the market (Figure 4).[4]

Figure 4 Probability of Beating the Market N Times



7. Conclusion

One of the most intriguing paradoxes of the asset management business is how actively managed funds can thrive despite their poor track record. Despite the prospect of poor returns in the investment management market, it is possible that the probability mechanism described earlier works to stimulate demand for active management (upper right corner of Figure 2). However, it is also true that some managers have consistently beat the market.

Thus customers need to clearly distinguish between the two markets. If they cannot do so, then they should take a conservative approach (bottom half of Figure 2).

This is because customers cannot rest assured that financial professionals will do a good job. Customers need to distinguish between the two markets, and decide which professional to rely on, and how far to rely on active or passive management. Furthermore, customers must continue to keep an eye on their investments, because fund managers can be replaced and fund policies can be changed abruptly.

Notes

1. This paper is excerpted and enhanced from a recently published book by NLI Research Institute's asset management task force, *The Near-Term Future of the Asset Management Business* (Kinzai, July 1999).

2. The "K strategy," a survival strategy suited to a friendly environment, involves having few children and lavishing care on them. In the asset management business, this corresponds to offering a single product line, and concentrating all resources on it to ensure its success.

3. The "r strategy," a survival strategy for harsh environments, involves having many children and providing limited care per child. In the asset management business, this corresponds to offering many product lines through aggressive product development and mergers, and spreading out management resources among them. According to Tadao Matsumoto's introductory biology text (Iwanami Shoten, 1993), r and K are derived from an equation for growth, $dN/dt = rN (1 - N/K)$, where growth can be maximized by increasing the rate of growth r, or by decreasing K, the maximum obtainable amount in a given environment.

4. Richard M. Ennis (1997), "The Structure of the Investment Management Industry: Revisiting the New Paradigm," *Financial Analysts Journal*, July/August 1997.