
# Brent Sheather's RESEARCH

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## FINANCIAL ADVICE AND INVESTOR BELIEFS: ACTIVE VERSUS PASSIVE STRATEGIES – Part 1

A recent article by Robin Wigglesworth, writing in the London Financial Times, highlighted a paper by two academics – Antoinette Schoar from MIT University in Cambridge Massachusetts and Yang Sun from the Brandeis International Business School. Mr Wigglesworth is the global finance correspondent for the London Financial Times and its well worth subscribing for his insightful analysis alone. He has long been fascinated by the active/passive debate, describing himself as "having spent a few years in the active-passive trenches." A few years back Wigglesworth authored "Billions" - a history of the inexorable rise in popularity of index funds. We have exchanged emails a few times and he clearly has little time for the claims of active management. Wigglesworth has no concerns at present that markets will become inefficient due to the increased popularity of index investing as he believes that equity and bond prices can continue to reflect fundamentals due to the stock picking efforts of hedge funds. However he offered no view on the issue as to whether it is the responsibility of all equity investors to pay for price discovery and whether ESG investors in passive funds are abdicating their responsibility to pay for price discovery and thereby acting unethically.

Wigglesworth cynically headlined his review of the Schoar/Sun paper "Smart People Prefer Passive" and his key takeaways from the paper are as follows: "*How do people react to financial advice? It depends on who is receiving it, who is giving it and what it consists of. That is the main unsurprising findings of a randomized controlled trial. Financial literate individuals find passive advice to be higher quality and appear resistant to being persuaded by the active narrative. In contrast, less financially literate subjects struggle to make this distinction and respond with similar magnitudes to both types of advice. This susceptibility potentially makes them vulnerable to lower-quality financial advice*".

In this three part series, we will also discuss the Schoar/Sun paper, perhaps less cynically than Mr Wigglesworth's effort given my view that someone has to pay for price discovery, interpret the results from an NZ perspective, and finally survey some of the latest international research literature on financial advice. First off though we will today set the scene by highlighting the unfortunate reality in the retail financial advice world that the difference between passive and active strategies has become increasingly blurred. A recent paper in the Journal of Beta Investment Strategies, "Casting a Wide Net: Why True Passive Strategies Are Rare Catches" summarises the current ambiguous state of the play as follows: "*With the rapid expansion of index funds, including smart beta and factor portfolios, investors are able to cast a much wider net when selecting the strategies that best meet their goals and risk tolerances. However, what is active versus what is passive has become difficult to discern. Here, we argue that only the theoretical market portfolio is a "purely" passive catch, and in practice only index portfolios that track broad market cap weighted indices can be viewed*

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*as passive investing. Everything else is active. It is well accepted that the boundary between passive and active investing has shifted over the last two decades. Arguably, the driving force behind this foundational shift has been the emergence of increasingly complex forms of beta. Love it or loathe it, smart beta became part of the financial lexicon, first with the emergence of fundamental indices in the 2000s, followed by a proliferation of smart beta and factor indices in the 2010s. More recently in the last half decade, we have seen an explosion in thematic funds such as levered, Bitcoin, and clean-energy-themed etfs to name a few, the growth of which continue to blur the boundary between active and passive investing."*

David Blitz, of Robeco, also despairs at the extent to which the passive investing paradigm has detoured toward active management. In a November 2024 paper for the Journal of Portfolio Management, "Things I Expected Would Have Changed By Now (But Have Not)" he writes *"Most etfs do no, in fact, aim to track the broad market portfolio, but a very specific subset of stocks, such as a single country or sector, or a specific style, such as high dividend stocks. Thus, they provide exposure to all kinds of stock baskets that are really only needed for applying active investment views. Moreover, many investors claim to adhere to a passive approach but exclude all kinds of stocks for ESG (environmental, social or governance) reasons, such as tobacco and thermal coal stocks. Whether one likes it or not, exclusion choices are active underweight decisions that create a gap in the portfolio, which in turn requires other stocks to be actively overweighted (see Blitz and Swinkels 2023). Thus, sustainable investing might be the ultimate death blow to passive investing"*.

These views reflect the mercenary, procyclical asset gathering inclinations of the fund management industry and the retail financial advice world which was well summarised by an industry veteran some years ago as being "if the ducks quack, feed them". By any measure the ducks are being extremely well fed – a recent study by the etf research house, ETFGI, noted that at the end of September, the global etfs industry had a phenomenal 12,843 different etfs available for investors, with 1400 new etfs pumped out in the last year alone. The sector had assets of US$14.46 Tn, with 786 providers feeding the ducks in 63 countries. Whilst this is good news from a "gathering funds under management" perspective the downside of this strategy is that the huge number of etfs available in niche sectors of the market now permits advisors and individuals to eschew diversity, embrace concentrated positions in flavour of the month sectors and thus make bad decisions more cheaply than ever.

That is enough for this week. Next time we will look at how the active/passive advice continuum is interpreted by local retail financial advisors. Hint: as per the international experience it is a lot more active than passive.