

Actively using passive

There is a lot of angst globally concerning the prospects of computers taking away our jobs, and the Investment Industry is no different. Personally, I don't believe this needs to be the case as the name of the game has always been "adapt or die", and this time is no different. Current developments need to be embraced, as this dynamic is part of a natural evolutionary process; to survive you need to establish what your value add(s) is and charge for that, whilst letting technology take care of the rest. Even though there might be some initial expenses to ensure you don't compromise on quality, in the long run it will make any business immensely more cost effective.

To explain from a practical perspective how this can be achieved, it is important to understand that there is a form of beta in everything. An investment process is made up of various steps, each of which has numerous sub-steps.



If you can separate the "beta" from the "alpha" in any one, it means it can be automated to some extent by meticulously structuring a systematic process. This ensures that it is applied consistently, and no discretionary decision making is necessary for that specific function, resulting in a reduction of cost. Discretion can still be taken as and when the need arises, but it affords the opportunity to not have to spend more time than is warranted on a function that is more of a distraction than an area of your specific expertise.

To use a practical example, let's look at passive instruments, as the staggering amount of Index Tracking Funds that have been launched over the past decade is a major contributor to concerns.

In our opinion, this should be viewed as healthy for the market: In an industry that was traditionally quite heavy on accountants, it offers the ability for different kinds of players to get involved, with probably a more appropriate number of analysts scouring through financials to ensure everything is what it claims to be. Don't get me wrong, share analysts will always play a crucial role, as they are essentially the price makers and ensure that we don't blindly follow the terminators into the abyss, but is now part of a much more diverse industry.



As access to very specific area/sector/style Beta is now widely available, when you have a well-researched view that should benefit a very specific segment of the market, you no longer need to pick the stocks to implement your view. This very specific allocation resulting from your research will attribute the bulk of the returns, paying up for a manager that currently has the same view as you will unduly inflate your expense ratio. The time saved also affords you the opportunity to get on with what your real value add is, and work on the next idea. Nothing passive about it really.

The opposite is also true, where for some their value add is a proven track record in picking alpha managers, but they might find it hard to from trade ideas from views. In this case, it is worth spending the time to pinpoint the "beta" in your way of thinking, and build a model which structures your thought processes and converts it to trade ideas before allocating to the appropriate manager.

Not only would this mean you don't have to go through the process every time, it would also ensure consistency in your application of information. This logic can be applied to anything from establishing a consistent investment style to position sizing, and even compliance or reporting. Having a long term sustainable model in Investments is all about risk management, and any process that is not up to scratch is a risk.

