



IMAP Independent Thought Podcast

Episode 33: Blending active and passive

Join Chad Hitzeman (GlobalX), David Wanis (Longwave Capital Partners) and Emily Barlow (Perpetual) discussing:

- Active vs passive
- Is passive and active black & white?
- The impact of ETFs
- Trends, what's here to stay?

Moderated by Emily Barlow

IMAP Disclaimer

This podcast series is not meant for retail investors, but instead is meant for financial advice, and investment professionals. Please refer to IMAP's website <https://imap.asn.au> for more details.

Emily Barlow - Perpetual Private (00:15):

Hello and welcome to episode 33 of the IMAP Independent Thought series, a podcast dedicated to helping managed account professionals stay up to date with views from a range of investment advice experts.

My name is Emily Barlow and I am an investment director at Perpetual Private and your podcast host.

Today I'm joined by Chad Hitzeman and David Wanis.

Chad is head of institutional Sales at Global X ETFs, a provider of low cost ETFs spanning disruptive tech equity income, commodities and digital assets. So, fair to say, not your conventional broad market passive provider.

David is a founder and portfolio manager at Longwave Capital Partners, an Australian based boutique manager specializing in small cap active strategies.

In today's episode, we're exploring a topic that's been discussed for years, active versus passive. The rise of passive investing in ETFs in particular has been astronomical. We've seen huge growth in both funds under management and the range of strategies available.

Their appeal is clear, lower costs, simplicity, and in recent years, strong performance versus many active funds. However, with rates now expected to stay higher for longer and certain asset classes still inaccessible to passive managers and ETF providers, perhaps a blended approach is going to lead to optimal outcomes.

So with that, we'll get started. If we look back over the past 10 years, active managers have struggled to outperform passive managers. David, do you think this is a trend that's here to stay?

David Wanis - Longwave Capital Partners (01:53):

Thanks, Emily, and it's great to be here. I think in areas where active management has struggled the most, for example, Australian or US large caps, then yes, I think this trend is likely to continue.

But there are a lot of areas where active managers have managed to consistently do better. So, for example, in Australian and global small caps, and this is also likely to continue, and this is due to mostly the structural differences between these markets, which I'm happy to go into if you like.

Emily Barlow - Perpetual Private (02:24):

Sure, why not give us a brief overview?

David Wanis - Longwave Capital Partners (02:28):

So if you think about the structural differences why is it that that large cap managers have struggled to beat their indices for so long, and small caps have done quite well?

Think about the nature of the markets in which different groups are investing. And in large caps you have this relatively static mature universe of stocks. Companies that are household names like Commonwealth Bank or Telstra BHP or Woolworths, and they've been like the mainstays of this index for many years.

Statistically, you can actually observe that about 90% of the stocks in the large cap index remain the same over any three year period. In small caps, we have a far broader and more dynamic market. This is where new companies and new industries emerge.

Think about technology, lithium, biotech, those type of industries that that sort of seem to come from nothing.

David Wanis - Longwave Capital Partners (03:16):

And in any three year period, more than 50% of stocks in the small cap index are new. So very structurally, different markets added to this is the competition of the active investors.

In large caps, you probably have 10 to 20 times as many analysts per stock trying to find a mis-pricing. These are highly intelligent, motivated, experienced individuals trying to find you. You know, the mis-priced security can lead to outperformance in small caps, it's very different.

There's fewer analysts, there's a much larger universe of opportunities, and it's always changing. So the chances of finding mis-priced stocks every year is far greater with this dynamic at play. And, and that isn't likely to change.

And that's why we think it'll continue to be hard for those efficient markets to, to, you know, for active managers there to outperform, but why there's plenty of opportunities still in places like small camps.

Emily Barlow - Perpetual Private (04:16):

Great. So one of the things we've often talked about is passive and activism, either or. So Chad, on that, would you say it is black or white or is there more of a spectrum? And how would you describe the approach you are taking at Global X ETFs in the context of that passive and active?

Chad Hitzeman - GlobalX RTFs (04:35):

It's a wonderful question, and thank you for having us from Global X. Firstly I would say that even if evidence-based investing suggests that "broader the better" indices, say global equities and global equities, S&P500, maybe MSCI world,

It's hard to outperform those universes. There's always scope for individual investor preferences that might have a specificity of focus on certain subsections with equity markets. For example, a thematic like artificial intelligence trying to capture companies that have something of a revenue purity, to that of investing for AI capability or maybe the electrification of the economy.

So I think on our side at Global Global-X, we cater to those preferences, those unique areas. All the while very much aware of the benefits of broader the better universes, which we do have in the background as well.

Chad Hitzeman - GlobalX RTFs (05:41):

I'm agnostic. I think we're agnostic between active and passive. Ultimately Global X is actually owned by Mire Asset, a South Korean asset management firm. We do have active portfolio management capabilities but I think it might come down to an individual investor's preferences.

So for instance if you are an allocator who's very much wedded to asset allocation in terms of thinking that that's what drives returns, then perhaps your traditional index-based ETF tools for instance, like the ones I mentioned, the S&P 500, MSCI world for your equity bucket might suffice in filling out your allocation framework.

And then there are investors who like to do fund manager, active fund manager selection and they feel confident that they have an edge in selecting the right managers. They know the portfolio management teams quite well.

Chad Hitzeman - GlobalX RTFs (06:46):

They have a high degree of confidence and they might feel like having an individual PM team on the steering wheel guiding their equity exposure say, which is a good thing.

So choice matters, a broad spectrum of choice matters, and I don't think it's entirely black and white. And lastly, I'll just close by saying that index-based investing itself has come a long way. I alluded to that earlier by saying ETF providers have thematic ETFs which go beyond traditional market cap weighted indexes like your ASX 200.

So there's been an evolution there and you can, through thematics attempt to achieve alpha equity alpha and stepping away diverging from your broader benchmarks. I think it's very interesting, but I don't think it's black and white in answer to your question.

Emily Barlow - Perpetual Private (07:50):

Great thanks Chad. David, we have touched on that active passive and whether there's an approach for both. And I think based on your last question, I would say the answer is probably yes.

So, if we turn to more the performance and why is it that passive has done so well, so this is a broader question around active versus passive but also the low interest rate environment, which has perhaps led to less dispersion between sectors.

So my question to you is whether this transition, because we've seen huge growth in this sector, so a huge amount of fun as well as a potentially new interest rate environment looking forward are headwinds or tailwinds for active managers?

David Wanis - Longwave Capital Partners (08:34):

I think there's never really been a normal market. There's always something going on in markets, which is unusual and the first time ever.

And I think that the model I have is that markets are inherently dynamic in moving from one disequilibrium to another. So it could be bubbles in different themes, it could be different interest rates, it could be geopolitical issues. And that's the nature of, of markets.

And you know, if you go back in time, you'll find people who will give reasons why active is about to outperform, but a lot of those reasons have come and gone because in these highly efficient markets we talked about earlier, indices have still come out on top and none of this is new. You know, active managers have talked about the flaws of indexing for over 50 years.

David Wanis - Longwave Capital Partners (09:25):

Actually there are parts of the indexing market that seems to work quite well for investors. And so in those structurally challenged areas of the market, those really efficient asset classes, I think the headwinds remain.

But I think you can decide where you want to be active, what are the structural drivers of active out-performance in what parts of the market are you being paid to take an active view? And it could be, in our case small caps, it could be emerging markets, it could be emerging market debt.

There's lots of different sort of less efficient markets where being active actually is very valuable. And so to Chad's point, having the choice and being able to build a portfolio from lots of different components, whether they're plain vanilla, passive indices, thematic portfolios, ESG, sustainability type portfolios or active funds.

All of those things allow investors to build portfolios that are better able to achieve their goals rather than this one size fits all. We have to be active everywhere or we have to be passive everywhere all the time.

Emily Barlow - Perpetual Private (10:38):

Great, thanks David. So if we turn more specifically to ETFs, so they've really been disrupting the market for quite a number of years now, but traditionally it has been in the passive space and certainly the largest fund within the ETF sector is passive.

But as you mentioned, Chad, we are starting to see more active ETFs. Now my question is, are we going to see them disrupting other sectors like alternative markets where that's been a pure active play previously?

Chad Hitzeman - GlobalX RTFs (11:07):

It's a great question, because to your point, index-based ETFs are omnipresent across all classes. The one where operationally it's challenging to have an ETF wrapper over would be your unlisted markets such as private equity, private credit, which at the moment are resonating with investors.

So there have been a few attempts to bring in alternative asset exposures through an ETF wrapper, but usually it's done in an indirect oblique way.

So for instance, managers ETF managers have wrapped in an ETF wrapper listed private credit or private equity managers who are listed on public exchanges, and then thereby you hope to achieve something of a proxy exposure to the underlying private assets that that manager has.

There are furthermore index providers that are very systematic and quantitative driven, and they believe that you can perhaps replicate the gross returns of private equity or private credit universes or venture capital universes through listed securities and a little bit of leverage.

Chad Hitzeman - GlobalX RTFs (12:29):

The other thing I should say though also is in fact there are available liquid alternatives through ETFs already, such as Australian dollar Gold.

That might not be your first idea of what an alternative is, but to our minds it does have alternative asset performance properties in terms of non-correlation, it's pushed and pulled by different performance drivers than equities or bonds.

It doesn't give income, for instance, it's a historically persistent diversifier. So you can still incorporate alternative asset performance properties into a portfolio through an ETF.

But to your question about whether or not ETF providers are going to be able to innovate in such a way operationally that we can include in an ETF market to market wrapper, unlisted non-market to market securities we'll see.

Emily Barlow - Perpetual Private (13:31):

So if you were to forecast it or if you were to guess whether or not we were going to do it, would you be hedging towards yes or no?

Chad Hitzeman - GlobalX RTFs (13:40):

It's going to be hard. I think there might be liquidity windows and then therefore you are not necessarily going to have a daily liquidity, just because of the underlying's.

And that's an issue that even unlisted funds have with private credit or private equity is being able to, furthermore service redemption requests or creation requests, there could be limitations in scale.

So I'm a bit neutral. I wouldn't put it past ETF engineers to concoct away to achieve that, but I think there's still work to be done in that space.

Emily Barlow - Perpetual Private (14:26):

Thanks, Chad. That'll be one to watch. And so David, if we take a slight turn now and talk about fees. So I mean, one of the benefits of ETFs is their low cost, although noting not all ETFs are low cost. Is this impacting how active managers are thinking about their fees or are there more important trends that are having an impact on this?

David Wanis - Longwave Capital Partners (14:52):

I think there's quite a few things that are impacting fees for active managers and across the board. You know, it's interesting that there's this thing called fee alpha, which is an observation that a lot of our active equity funds in particular do outperform before fees, but the fees themselves consume all of that alpha.

And so then what's left for the end investor is an under performance versus an index. So there is an argument to say a reduction in the fee charged is the easiest way for a manager to improve their client's net outcome.

Not surprisingly, this isn't where active managers have gone first to look to improve that. The second thing that's been interesting over kind of the last 20 years is that those market access products in ETF or fund format, their fees have fallen more than the active equivalent.

David Wanis - Longwave Capital Partners (15:52):

And so the implied price of active management has potentially even gone up over the past 20 years and not down so that's just one aspect.

You know, not everyone's looking at a fee in comparison to a passive alternative for active management, but there are other trends that are out there that are impacting fees across the board.

So improved disclosure of indirect cost ratios or ICR, which capture lots of rolled up fees such as management fees and performance fees, that's making clients aware of the total cost of all of their funds. Regulatory intervention is also focusing on cost disclosure and transparency.

Choice, competition, transparency, the regulators, they're all working to improve the outcome for the investor, but that perhaps reduces that excess profitability of some of these active participants through lower fees.

I don't think it's just one thing. I don't think it's just passive or just the price of index funds that are putting the market's focus on this. It's really the underlying investors looking at what's the outcome of their investment decisions and they've got more information available to them, or their advisors to make better decisions around that.

Emily Barlow - Perpetual Private (17:11):

Great, thanks David. And Chad, David has just touched on the fee pressure in passive and ETFs and we actually have strategies in the market that are effectively free. So just interested on your thoughts on how this is impacting the market and if we will continue to see those downward pressures on fees for these types of strategy.

Chad Hitzeman - GlobalX RTFs (17:33):

I think we will. It's interesting that we've been in a very inflationary environment, but within the financial services sector, there's been disinflation "the Vanguard effect" I think it's been referred to.

At the end of the day, it's entirely a good outcome for end users. And we're not (as managers to David's point), capturing all of the return, digesting all of the return in terms of novel pricing strategies that ETF providers might have in the sense that maybe you take the headline expense ratio management expense ratio, and bring it to zero in order to commercialize monetise the fund other things are done in the background, so to speak, by the manager to achieve revenue off of the fund.

So it might be lending out the underlying securities. One obstacle there is that that could introduce other risks that an investor would have to consider such as counterparty risk, and the like.

Chad Hitzeman - GlobalX RTFs (18:34):

But even independent of novel pricing strategies, I would say that generally ETF-MER headline fees are going down because of the demand by investors to have index based funds lower in price.

And there's competition of course. The ETF market is rapidly growing, roughly 30% each year, every year. So very outsized growth and within that competitive, challenging environment for the managers, one way to compete is on fees, and there's been a lot of competition there.

I will continue to say that I think ETF fees will be (especially compared to active managers) incredibly attractive. But on the other hand, I should say, active managers themselves are having to bring down fees to some degree, or at least through

rebates, (what I refer to as rebates) and give back of the fee to a client. But at the end of the day, as mentioned, it should be good for investors so that their compounded returns are a bit more magnified on an after-fee basis.

Emily Barlow - Perpetual Private (19:59):

Great, thank you. So to wrap up I'm keen to get your thoughts looking forward. So David, if we start with you, what are you most optimistic about in terms of market opportunities for active management?

But also to add to that question, is there anything that you think investors should be wary of?

David Wanis - Longwave Capital Partners (20:22):

Well, in, in my corner of the market in small caps, active management is still adding a lot of value. So we're taking advantage of the inefficiencies in our market and the volatility that a lot of people are trying to eliminate from their portfolio by investing in private market funds are actually a key advantage that we have.

You know, volatility presents the opportunity every day to make new investments at lower prices or exit current positions at higher prices. As Chad touched on active funds are also evolving.

You know, we are learning from indices, we're learning from systematic approaches, we're listening to clients on fees. A lot of active funds are moving to exchange listed structures.

I mean we started our business in 2018 with a forward looking view of where active management needed to go to deliver better value across a lot of the things that we've talked about today.

David Wanis - Longwave Capital Partners (21:17):

And you know, I think as an industry on the active side, we end up serving clients better with more suitable active strategies and allowing them to take advantage of the opportunities in the corners of the market where active works really well.

But a lot of the inequities or inefficiencies or frictions or lack of transparency that has been there in the past, that starts to sort of improve and so we can provide better portfolios from the active side and then clients can build better overall portfolios from the components available to them.

Emily Barlow - Perpetual Private (21:55):

And Chad, really the same question to you. What are you most optimistic and pessimistic about looking forward?

Chad Hitzeman - GlobalX RTFs (22:03):

Pessimistic firstly just in light of current market volatility, maybe just the market environment, and whether or not there's going to be a deterioration. I know that's not necessarily ETF specific because on the ETF side, I'm entirely optimistic.

The fact that you can devise and curate an entirely asset allocated portfolio with even sleeves for thematic funds for alpha generation, say in your equity bucket across, even fixed income liquid alternatives like gold.

And you can even have a dynamic asset allocation framework as well where you can maybe do a little bit of rotations into mid cap, small cap, or maybe now you think emerging markets might be a destination as well. You can go into India, you can go into South Korea.

I like the fact there that there is choice and then on our side as an ETF provider, we need to assist users of the funds to devise something of a best practice playbook.

Chad Hitzeman - GlobalX RTFs (23:12):

And just understanding, especially for thematic ETFs, the way in which you are stepping away from a benchmark. So in other words, active share risk in items like that. But I think I'm excited. There's a lot of innovation and coverage of previously inaccessible areas are being made accessible through ETF vehicles, which is great.

And actually in fact, hopefully they buy as the markets overall have more price efficiency because you have more participants in theory. So I am a little optimistic, more than optimistic, which is a good thing.

Emily Barlow - Perpetual Private (23:50):

Great. Well that just about wraps us up for time and so thank you so much David and Chad for joining us on the episode for today.

And we've explored the debate that between active and passive investing is no longer an "either or" question, but rather finding that right balance between what now is a spectrum of approaches.

Join us next time for more insights on investments advice and portfolio construction.

Thank you.

<<<<< ENDS >>>>>