WHY I BELIEVE IN BOTH ACTIVE AND PASSIVE MANAGEMENT

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I recently found myself on a panel debating the merits of passive investing versus active management at an investment conference populated by mostly active investors and traders. In the spotlight and fending off objections from the audience, I felt like the lone defender of a passive investment approach.

As a prelude to the debate, the moderator showed a chart illustrating the cyclicality of active management, and an overwhelmingly large (like 90%+ large) number had trailed their respective benchmark over the most recent five-year period. The implication was that we are nearing an inflection point in which passive investors are about to be on the short side of a swinging pendulum that's moving back in favor of active management.

It was an odd moment for me to be the principal defender of the low-cost market cap-weighted indexing world, given I also believe investors can improve upon a pure cap-weighted indexing approach.

But it is hard to look at the data and see the growth of passive investing as being anything but positive. There has been a transfer of wealth back to investors' pockets, as investors are keeping more of their returns by paying less in fees and active managers are having to get by on lower fees. That is a very positive market development.

Passive Investing Won't Be the Downfall of Capitalism

At this panel discussion a few months ago, a former manager at one of the world's largest mutual fund companies objected and told me I did not realize how detrimental the rise of passive investing was going to be. He argued the rise of passive investing was both distorting market prices and going to be the downfall of capitalism—echoing the argument I've heard that passive investing is similar to Marxism and will lead to disastrous results for both companies and investors in passive products.

I don't see it that way—I think we'll continue to see passive investing taking market share, and investors overall will be better off paying less for investment management services.

I also don't think the rise of indexing is causing bubbles in certain areas of the marketplace. If anything, I think a number of private transactions and some of the bitcoin and cryptocurrency investing taking place show that exuberance and a herd mentality can exist without passive management present.

We've also heard the rise of passive investing is going to push stock correlations in the market to one due to indiscriminate buying and selling of stocks. However, when you look at the data, we've actually seen the reverse—with some of the lowest cross-correlations in the market in a decade, despite the rise of passive investing, as my colleague discussed in a blog post, "Is the Current U.S. Equity Market Rally Sustainable?".

I don't mean this defense of passive investing to imply that investors should flock only to the lowest-cost beta managers.

I believe there are strategies that can outperform pure market beta over time.

Can We Do Better? Pushing the Innovation Frontier with Active Equity Exchange-Traded Funds (ETFs)

WisdomTree was founded over a decade ago on the premise that investors can do better than beta, and we launched a suite of fundamentally weighted Indexes that reweighted equity markets according to income streams—both earnings and dividends. I would describe these Indexes as relatively low tracking error strategies that tilt toward factors WisdomTree believes will be rewarded over time—all while managing valuation risk of the market, a feature we believe anchors investor returns.

We believe these strategies are becoming increasingly important for the current environment, as my colleague Chris Gannatti recently wrote about the growing P/E ratio discounts that can be achieved given expanding market multiples.

WisdomTree strives to be *the* low-cost[1] ETF innovator. While one might describe all of WisdomTree's quantitative and rules-based Index strategies as employing an active—or systematic active—approach, we are about to embark on a new frontier for our equity ETFs by launching our first active equity ETF before the end of the year.

WisdomTree believes active management can add value in equities. But until now, WisdomTree's equity ETFs have only been active in pursuit of alpha with strategies that are packaged into an Index.

Over time, WisdomTree plans to launch active equity ETFs that will aim for higher alpha targets. Our approach to active equity ETFs will be based on quantitative research that my team will oversee—having established a more than 10-year track record of managing more traditional passive-alpha Indexes.

We will be marrying our new, more active approach with the benefit of the ETF chassis to take advantage of the tax-efficient ETF structure.

Unlike fund managers who are looking to launch non-transparent actively managed ETFs, WisdomTree's actively managed ETFs will be very transparent, with daily portfolio holdings revealed and a clear description of the investment process and philosophy motivating our strategies.

We will strive to drive down costs for traditional actively managed portfolios, and we can leverage the same infrastructure and operational procedures WisdomTree used to build our traditional Index business to run these new active equity ETFs.

To sum up: WisdomTree's quant team is challenging the traditional thinking around active and passive management. Our pursuit of passive alpha is evolving into the pursuit of alpha. Stay tuned for more…

[1]Ordinary brokerage commissions apply.

For standardized performance and the most recent month-end performance click here NOTE, this material is intended for electronic use only. Individuals who intend to print and physically deliver to an investor must print the monthly performance report to accompany this blog.

For more investing insights, check out our Economic & Market Outlook

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You cannot invest directly in an index.

DEFINITIONS

Passive : Indexes that take a rules-based approach with regular rebalancing schedules that are not changed due to market conditions.

Active : Funds that attempt to outperform the market by selecting securities a portfolio manager believe to be the best.

Market capitalization-weighting : Market cap = share prices x number of shares outstanding. Firms with the highest values receive the highest weights in approaches designed to weight firms by market cap.

Correlation : Statistical measure of how two sets of returns move in relation to each other. Correlation coefficients range from -1 to 1. A correlation of 1 means the two subjects of analysis move in lockstep with each other. A correlation of -1 means the two subjects of analysis have moved in exactly the opposite direction.

Beta : A measure of the volatility of a security or a portfolio in comparison to a benchmark. In general, a beta less than 1 indicates that the investment is less volatile than the benchmark, while a beta more than 1 indicates that the investment is more volatile than the benchmark.

Fundamental weighting : A type of equity index in which components are chosen based on fundamental criteria as opposed to market capitalization. Fundamentally weighted indexes may be based on fundamental metrics such as revenue, dividend rates, earnings or book value.

Dividend : A portion of corporate profits paid out to shareholders.

Tracking Error : Can be discussed as both the standard deviation of excess return relative to a specific benchmark, or absolute excess return relative to a specific benchmark.

Valuation risk : The risk of buying or over-weighting a particular stock that has appreciated significantly in price relative to its dividends, earnings or any other fundamental metric.

Alpha : Can be discussed as both risk-adjusted excess return relative to a specific benchmark, or absolute excess return relative to a benchmark. It is sometimes more generally referred to as excess returns in general.