



## THEORETICAL ARGUMENTS FOR A PASSIVE INVESTMENT STRATEGY

Jens Wingenfeld, University of Latvia, Latvia /  
Fachhochschule Kufstein, Germany<sup>1</sup>

**Abstract.** One main classification of portfolio management strategies is the differentiation between active and passive approaches. Proponents of an active investment management strategy believe that capital markets are inefficient, and therefore it should be possible to achieve above-average risk-adjusted returns via stock selection and/or timing. On the other hand, passive investment managers do not believe in such opportunities. Next to diverse empirical quantitative studies, there are developed some theories that can support a passive investment strategy by a distinct sequence of logical arguments. Aim of the depiction is to elaborate these existing theories and create a better understanding of employing passive investment management strategies. The paper presents these theories and evaluates their utility for an application of a passive investment approach. Altogether, five specific qualitative arguments could be found which are eligible to be a theoretical proponent for passive portfolio management. The validity to the active versus passive debate is critical interpreted. The novelty is that the detected research models are able to find an adequate answer to the question which investment style is preferable under diverse presumptions by the methodology of a qualitative approach. Other studies often employ tests with success-measurement figures. The weakness of these single quantitative scientific models is their reference only to the past. With the help of an entire qualitative theory, the commitment to one of the above mentioned basic investment strategies can receive a more profound appreciation. The research is embedded in view of the fact that public pension schemes will not be able to guarantee an adequate living standard for the coming pensioners in Europe. The result is that some of the presented theories are indeed very suitable to gain a sophisticated decision for a special investment approach, although some assumptions are not fully congruent with the reality on worldwide financial markets.

**Key words:** *passive investment approach, indexing*

**JEL code:** G11

### 1. Introduction

By the end of October 2012, fund management companies of German provenience governed assets under management (AuM) with a volume of more than 715 billion Euros in mutual funds open to the general public and more than 952 billion Euros in specialised funds (open to institutional investors only)

---

<sup>1</sup> Corresponding author – e-mail address: jens\_wingenfeld@hotmail.com, telephone: ++49/177/2962958



# New Challenges of Economic and Business Development – 2013

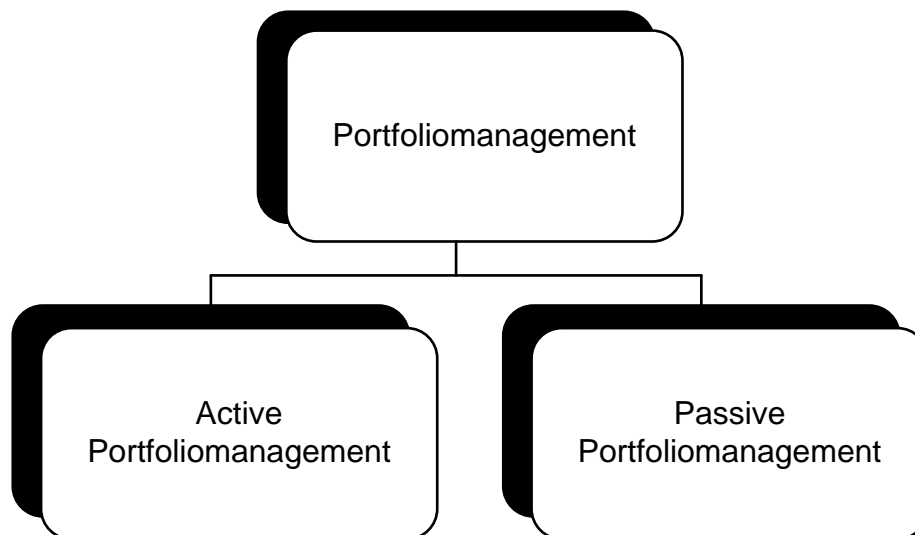
May 9 - 11, 2013, Riga, University of Latvia

(BVI, 2012). In the United States of America, the most important capital market in the world up until now, the combined assets of the nation's mutual funds were US-\$ 12.71 trillion in October 2012, according to the Investment Company Institute's official survey of the mutual fund industry (ICI, 2012).

Considering these huge amounts of money alone, both the importance of the portfolio management process and its responsibility in terms of the global economy become obvious. It has to be stated that public pension scheme is not, nor will it ever be able to guarantee an adequate standard of living for its citizens in our society. In this regard, it is essential for nearly any citizen to provide for their retirement on their own. Hence, the question should pertain to specific methods that are intelligent and rational.

Therefore, mutual funds are a popular investment vehicle. A mutual fund can be described as a financial intermediary that pools the savings of various investors who share a common financial goal (Achleitner A., 2002, p. 657). Because an investor has a huge choice of mutual funds, the question is which of these investment vehicles are preferable or – concerning the view of a fund company – what is the best way to manage a fund or portfolio in general. This problem is also one of the dominant themes in modern finance, both for institutional investors and also for private investors.

One fundamental approach to categorize portfolio management is on the one hand an active approach and on the other hand a passive one:



Source: Own.

Fig. 1. **Basic categorization of the Portfolio Management Process**

Few topics have generated more engaging discussions between academics and investment professionals than the debate over active versus passive portfolio management (Harlow W.V., 2005, p. 1).

A lot of definitions exist for both kinds of investment styles. Basically, an active portfolio manager tries to outperform a given benchmark; whereas within a passive management strategy, the objective is to track a given benchmark as accurately as possible.

Active and passive portfolio management approaches are often seen as the two main and opposing investment styles (Malkiel B. G., 2003, p. 2). The following remarks should provide an answer to the question if the employment of passive investment management tools, like Exchange Traded Funds (ETFs), is to justify by diverse theoretical and universal appropriable chain of thoughts.



## 2. The Single Specific Qualitative Arguments for a Passive Investment Strategy

### 2.1. Sharpe's Arithmetic of Active Management

Sharpe (1991, pp. 7-9) published a short but remarkable article about his point of view of a basic axiom of investment management. His theory does not invoke and is independent from efficient markets or any other financial theory, but relies only upon the laws of addition, subtraction, multiplication and division. Sharpe was prompted to implement his theory by often used statements of investment professionals like the following ones (Sharpe W. F., 1991, p. 7):

“The case for passive management rests only on complex and unrealistic theories of equilibrium in capital markets.”

“Any graduate of the Business School should be able to beat an index fund over the course of a market cycle.”

Sharpe countered these statements by introducing his laws of arithmetic which are based on the all over accepted assumption that the entire capital market is composed of active investors and passive investors; or put another way, the average performance of all investors (either active investors and passive investors) will be the same as the market performance, because from a superior point of view, at any one time, the holdings of all investors in a particular market make up that market. For his model, Sharpe postulates that a certain market like the S&P 500 or anyone else has to be selected. Furthermore, a clear distinction between an active and a passive investor has to be carried out. The latter one holds every security from the market (as defined above), with each represented in the same manner as in the market. By implication, an active investor is simply one who is not passive. Market return is defined as a weighted average of the returns of all securities within the market, using beginning market values as weights (Sharpe W. F., 1991, p. 8). Sharpe's laws of arithmetic are the following ones (Sharpe W. F., 1991, p. 7):

“If “active” and “passive” management styles are defined in sensible ways, it must be the case that:

- (1) Before costs, the return on the average actively managed dollar will equal the return on the average passively managed dollar, and;
- (2) After costs, the return on the average actively managed dollar will be less than the return on the average passively managed dollar.”

Sharpe enunciates that these assertions will hold for any time period. Moreover, no exception is possible to this mathematical necessity which is casually named as the “Zero-Sum Game of Dispersion of Return” or also “Equilibrium Accounting”. Ferri (2011, p. 28) describes this issue in the context of explaining Sharpe's introduction of the Greek letter beta ( $\beta$ ) for representing market risk: “In summary, there's only one market risk and one market return. No excess return or excess risk exists in this market. This makes all non-market risk a zero-sum game: For every non-market risk winner (i.e., for any active investor) there must be a non-market risk loser at the same time in the market. Another way of stating this is that the asset weighted performance of all investors, both positive and negative, will equal the overall performance of the market. However, no one invests for free. After fees and expenses, most non-market risk takers must underperform the market by the costs they incur. It's simple arithmetic.”

It is, of course, possible that individual active investors add value. But if they do, it is at the expense of other active investors. Because of the fact that some existing studies are convinced that active strategies gain advantage over passive strategies in their context, Sharpe (1991, p. 7) presents three practical occasions why these false observations can occur:



# New Challenges of Economic and Business Development – 2013

May 9 - 11, 2013, Riga, University of Latvia

- 1) Not all passive managers are passive in a true sense. Hence, not all index managers hold all securities in market proportions, rather they often sample the market of their choice; often to charge high enough fees to bring their total costs to an equal level or exceed those of active managers.
- 2) This group of investors who is labeled in some studies as “active investors”, do not fully represent all “non-passive” investors in the market. Often, the active part is applied to institutional investors only; thus, the retail investor who pays the added costs for the active managers via inferior performance, is not counted within this context. Another example that will tend to produce results that are better than those obtained by the average passively managed dollar, is connected with survivorship bias. The latter is the tendency for failed funds to be excluded from performance studies due to the fact that they do not longer exist.
- 3) As possibly most important reason, Sharpe claims that there are often wrongly applied statistics, because it is necessary to compute the performance of an average actively managed dollar versus a passive one. Some comparisons use a simple average of all large and small managers or e.g. the median active manager. A consequence of such an approach is that certain empirical regularities of a superior active investment strategy persist.

Sharpe (1991, p. 9) accentuates that by a proper measurement, the average actively managed dollar must underperform the average passively managed dollar, net costs. If empirical analysis arises which refutes this principle, these studies will be guilty of improper measurement. In Sharpe’s opinion, the return advantage gained by one active fund can only be at the expense of another active fund that underperforms the market, hence we can describe it as an entire zero-sum game.

## 2.2. Thorley’s Drop-Out Argument

In contrast to the Efficient Market Theory and its implications for a passive investment strategy, Thorley (1999, p. 11) argues in his article “The Inefficient Market Argument for Passive Investing” in favor of a passive investment strategy even under the assumption that the stock market is not efficient. The author does not explicitly postulate an informational efficient capital market for a functioning passive investment strategy, in fact he states quite the opposite; he presents a logical line of arguments which leads to the following conclusion (Thorley S., 1999, pp. 6 et seq.):

1. In a perfectly efficient stock market, advantages of skill don’t matter, rather it is all luck, and less skilled players have the same one in three chance of beating the market like anyone else. Thus, market efficiency is a protection for less-skilled participants taking wrong decisions.
2. If the market is not informational efficient, successive thoughts are valid:
  - In a competitive market, all participants with superior knowledge and abilities will reach superior investment results. Vice versa, such traders with low skills will reach below-average results.
  - Traders with below-average results will realize their failure, because it is easy for them to compare their trading results with public index returns (roughly, this is the average result, before expenses).
  - As Sharpe points out, an alternative to reach better returns for all below-average traders is to use a passive strategy, e. g. investing in an Index Fund or ETF instead of “financing” the above-average returns of the superior traders (Sharpe W. F., 1991, p. 9).
  - The market becomes more competitive the more inferior participants leave and switch to the fraction of passive investors. This way, the number of inferior participants who stay in the market becomes smaller. Hence, fewer financiers remain manifesting superior returns for the high-skilled traders.



- Due to the number of inferior participants quitting the market, the level of competence in the remaining market increases. It becomes harder for all skilled traders to reach superior investment results compared to the former situation with more low-skilled traders present. The longer this process persists, the greater the hurdle for the remaining participants to achieve adequately superior returns.

As a result of the above given argumentation line by Thorley, only such rational investors who deny an informational efficient capital market and concurrently claim an above-average level of trading-skills for themselves, will remain in the market.

### 2.3. The Influence of Asset Allocation on the Portfolio Management Performance

Rather than focusing on risk-adjusted returns, practitioners often simply want to ascertain which decisions results in superior or inferior performance (Bodie Z. et al., 2011, p. 874). Active investment strategies can be categorized in many respects. Referring to Statmann (2000, p. 17), any active investment strategy consists at least of market timing or stock-picking or a mixture between these approaches, whereas a passive investment strategy only consists of asset allocation.

Table 1

The Three Items of the Investment Management Process

↓	↓	↓
<p><b>Asset Allocation</b>  <u>Alternative Expression:</u>            Strategic Asset Allocation, Static Asset Allocation, Fixed Weight Asset Allocation, Investment Policy, Portfolio Policy</p>	<p><b>Market Timing</b>  <u>Alternative Expression:</u>            Tactical Asset Allocation, Dynamic Asset Allocation</p>	<p><b>Stock Picking</b>  <u>Alternative Expression:</u>            Security Selection</p>
<p><b>Purpose:</b>            Universal sharing of the Portfolio to the diverse asset classes, in which exposure is required. There is no possibility to realize an outperformance with this kind of choice. Asset Allocation does not cause avoidable costs.</p>	<p><b>Purpose:</b>            Exploiting deviations of the valuation of single assets-classes (markets) to achieve outperformance. Success of Market Timing implies prediction skills. A Market Timer accepts additional but avoidable costs.</p>	<p><b>Purpose:</b>            Exploiting deviations of the valuation of single securities to achieve outperformance. Success of Stock Picking implies prediction skills. A Stock Picker accepts additional but avoidable costs.</p>
<p><b>Note:</b>            A passive investor only works with this kind of investment decision and does not care about the other two elements. He adapts his asset allocation only for the case if his risk exposure or his liquidity requirements change, but not for the purpose to achieve an outperformance.</p>	<p><b>Note:</b>            Market Timing means active investing, but a Market Timer can also take an asset allocation decision, if it constitutes a minimum range of assets. If this is not the case, Asset Allocation is only a negligible side effect of Market Timing.</p>	<p><b>Note:</b>            Stock Picking means active investing, but a Stock Picker can also take an asset allocation decision, if it constitutes a minimum range of assets. If this is not the case, Asset Allocation is only a negligible side effect of Stock Picking.</p>

Source: Statmann M., 2000, p. 16.



## New Challenges of Economic and Business Development – 2013

May 9 - 11, 2013, Riga, University of Latvia

Brinson et al. (1986, p. 133) define asset allocation within a portfolio management process as investment policy which identifies the long-term asset allocation plan (including asset classes and normal weights) selected to control the overall risk and meet fund objectives. For a practical implementation of a portfolio of assets, the first two of a total of four steps are:

1. Deciding which asset classes to include and which to exclude from the portfolio.
2. Deciding upon the normal, or long-term, weights for each of the asset classes allowed in the portfolio.

For Brinson et al., market timing means the strategic under- or overweighting of an asset class relative to its normal weight, for purposes of return enhancement and/or risk reduction, while security selection is the active selection of investments within an asset class. As a consequent resumption of the two steps above, this means for the portfolio management process:

3. Strategically altering the investment mix weights away from normal in an attempt to capture excess returns from short-term fluctuations in asset class prices (market timing).
4. Selecting individual securities within an asset class to achieve superior returns relative that asset class (security selection).

Brinson et al. developed an arithmetic framework which can be used to decompose total portfolio returns in the sense of a performance attribution. They used data from 91 pension plans for a complete 10-year (40-quarter) period beginning in 1974. They computed that the mean average annualized total return was 9.01 per cent. The contribution of market timing accounted for a loss of 66 basis points per year, while security selection caused a loss of 36 basis points per year. Thus, they found out that within their sample the two main active portfolio management approaches even contributed to a negative performance over time. Furthermore, with the help of the time-series R-squared they found out that on average 93.6 per cent of the total variation in actual plan return was explained by policy, vice versa, less than 10 percent of variation of returns could be ascribed to active portfolio management. In a further study, Brinson and Gilbert (1991, pp. 40 et seq.) regenerated together with Singer their first study from 1985. They examined data from 82 large pension plans over the 10-year period December 1977 to December 1987 and found out that 91.5 per cent of the variation in quarterly total plan returns could be explained by investment policy.

Ibbotson and Kaplan (2000, pp. 26-33) expanded the Brinson et al. study, because the applied performance attribution of funds was only measured over time; which means that they examined how much of the variability in the monthly returns of each fund can be explained in a fund's policy benchmark. Thus, the authors wanted to answer the following questions:

- a. How much of the variation in return among funds is explained by policy differences? The question is whether there is a tendency for policy to differentiate performance across funds.
- b. What is the ratio of the policy benchmark return compared to the fund's actual return (explaining the level of returns)?

For answering question a), the authors compared funds with each other through the use of cross sectional regression analysis R-squared. If all funds were invested passively under the same asset allocation policy, there would be no variation among funds. If all funds were invested passively but had a wide range of asset allocation policies; however, all of the variation of returns would be attributable to policy. Ibbotson and Kaplan (2000, p. 32) demonstrated that asset allocation explained about 40 per cent of the variation of returns among funds. On average, across funds, asset allocation policy explains a little more than 100 per cent of the level of returns.

Drobetz and Köhler (2002) conducted a study on simple monthly returns of 51 Swiss and German balanced mutual funds. They followed the research approach of Ibbotson and Kaplan (2000), which means that they also distinguished exactly the same three research questions like them. Drobetz and Köhler found out that more than 80 per cent of the variability of returns in a typical fund over time is



# New Challenges of Economic and Business Development – 2013

May 9 - 11, 2013, Riga, University of Latvia

explained by asset allocation policy, roughly 60 percent of the variation among funds is explained by policy, and more than 130 per cent on the return level, on average, is explained by the policy return level. The latest study in this field comes from Kinniry et al. (2006). They tested a sample of 214 US domestic equity funds over a very long time period from 1966 to 2003. Table 2 gives a synopsis of the above presented research results to the question what impact asset allocation has for portfolio performance:

Table 2

**The Impact of Asset Allocation for the Portfolio Performance**

	<b>Brinson et al. (1986)</b>	<b>Brinson et al. (1991)</b>	<b>Ibbotson/Kaplan (2000)</b>	<b>Drobetz/Köhler (2002)</b>	<b>Kinniry et al. (2006)</b>
<b>Number of Analyzed Funds</b>	91 US-Pension Funds	82 US-Pension Funds	94 US-Equity Funds	51 German and Swiss Equity Funds	214 US Equity Funds
<b>Time Period</b>	1974 – 1983	1977 – 1987	1988 – 1998	Up to 12/2001*	1966 – 2003
<b>Share of Return and Risk Parameter Determined by Asset Allocation</b>					
<b>Return Variation of a given Fund over Time</b>	93.6% (Avg.) Med. n. a.	91.5% (Avg.) Med. n. a.	81.4% (Avg.) 87.6 % Med	82.9% (Avg.) 85.7% (Med.)	18.9% (Avg.) 15.0% (Med.)
<b>Return Variation across Funds Time</b>	n. a.	n. a.	40.0% (Avg.) Med. n. a.	65.0% (Avg.) Med. n. a.	81.6% (Avg.) 85.5% (Med.)
<b>Return level</b>	112% (Avg.) Med. n. a.	101% (Avg.) Med. n. a.	104% (Avg.) 100% (Med.)	134% (Avg.) 131% (Med.)	122% (Avg.) 106% (Med.)
<b>Return compared to Benchmark p. a.</b>					
	-1.1% (Avg.) Med. n. a.	-0.1% (Avg.) Med. n. a.	-0.3% (Avg.) 0.0% (Med)	-2.4% (Avg.) -2.0% (Med.)	-0.5% (Avg.) Med. n. a.

\*no exact time period given

Source: Author's Composition of Cited Studies.

## 2.4. The Mean-Reverting Effect

Berk and Green (2004) derived a theory of portfolio management which focusses on the relationship between fund flows and performance. Their model suggests that fund flows are one key mechanism that prevents a persistent outperformance, but also removes a persistent underperformance. An economy is assumed in which investors and managers are fully rational. It follows a brief description of the model:

There exist skilled active investment managers with differential ability to generate positive risk-adjusted excess returns. A further assumption is that managers and investors alike know who these managers are. Thus, in the market exists at least one active managed fund which achieves a performance above-average. Investors recognize this as an evidence for replicable skill rather than luck. They expect also an above-average performance in the future with a probability of more than 50%. As a result, the amount of assets under management of the superior fund grows very strong. It is a generally accepted fact that the greater the funds' size, the expected return of the portfolio as a whole becomes lower (negative fund size effect), see e. g. the elaborations of Zheng (1999), Finn and Sawacki (2001), Chen et al. (2004), Pollet and Wilson (2008) or Bessler et al. (2010). Referring to Bogle (1999, pp. 265 et seq.), basically there are three reasons why an increasing cash-inflow results in a negative fund performance:



# New Challenges of Economic and Business Development – 2013

May 9 - 11, 2013, Riga, University of Latvia

- A decreasing investment universe

In many jurisdictions there are limitations concerning the maximum share of a single asset a fund is allowed to invest, see e.g. section 52 German Investment Act (InvG). Despite this, a fund with big cash reserves relative to its investment target is only able to purchase small tranches of light capitalized securities. Even if such a tranche will produce a good performance, it will not affect the funds' performance very well because of its small weighting within the fund. Costs of analysis for the single asset are independent from this matter of fact. Hence, investments in light capitalized stocks will not pay for the big fund, although *ceteris paribus* these stocks can be a worthwhile investment for a small fund. Because of this phenomenon it can be observed that funds with high cash-inflows have a tendency to focus their policies to high capitalized securities and therefore mimic more and more a benchmark index, because high capitalized stocks in most indexes have a higher weight than lower ones. As described in number 2, investment universe also constrains to higher capitalized assets the more a fund attracts money from investors. This means the respective investment universe diminishes. In correspondence with Peter Bernstein, Warren Buffet explains: "We have always known that huge increases in managed funds would dramatically diminish our universe of investment choices. (...) Obviously performance would be much diminished if we had only 100 securities available for possible purchase compared to, say, 10,000 available when our capital was microscopic (Bogle J., 1999, p. 270).

- Indirect Transaction costs

Another important, but not always very obvious reason for a shrinking investment entirety arises due to the market impact of purchase and sale. These implied costs emerge from the deviation of the realized transaction price and the price which would develop if no transaction would occur (Keim and Madhavan, 1997, p. 272). However, these kinds of costs are not easy to measure. The higher the single transaction volume, or the more urgent it is, the higher the costs. This relation becomes stronger if the certain stock is less liquid. On the other hand, if the fund manager divides his order into smaller shares to minimize implied transaction costs, it will emerge higher direct transaction costs. A manager of a small fund who has to execute relative small-size trades is not concerned by indirect transaction costs.

- Organizations' Costs of Hierarchy

Bogle (1999, p. 270) contends that with the growing of an investment company the influence of the single manager recedes. He claims that a fund manager cannot work best in an environment with high hierarchical and bureaucratic structures. In his view, the superior skills of an excellent manager are repressed.

"Picking stocks, like writing stories, is a one-at-a-time endeavor. It is done best by individuals or small groups of people sharing their ideas and buying only the very best. A small fund family managing selective portfolios (...) can succeed as a group, but no large institution (...) can order dozens of managers to outperform. The image can be branded, but not the talent. The people matters more than the name."(Bogle J., 1999, p. 270).

Chen et al. (2004, pp. 1278 et seq.) bring forward the argument that hierarchy costs may be especially relevant for mutual funds. The basic premise is that in large organizations with hierarchies, the process of agents fighting for (and potentially not having) their ideas implemented will affect agents' *ex ante* decisions of what ideas they want to work on. Thus, small organizations ought to outperform large ones on tasks that involve the processing of soft information (i.e., information that cannot be directly verified by anyone other than the agent who produces it). If the information is soft, then agents have a harder time convincing others of their ideas and it becomes more difficult to pass this information up the organization.

If we confess that funds' performance decreases the more resources the fund has, investors will allocate their money into this fund until it has reached the performance of the second best fund. At that point, investors will be indifferent between investing with either manager, so money will flow to both managers until they have reached the performance of the third best fund. This cascade effect persists until





# New Challenges of Economic and Business Development – 2013

May 9 - 11, 2013, Riga, University of Latvia

the performance of all former outperformer funds declines to the performance of a passive benchmark fund.

In the contrary, all funds with an inferior performance successively have cash-outflows until they reach the performance of a passive benchmark fund.

The result is that in equilibrium all funds have the same expected return than the passive benchmark. In this equilibrium all managers, regardless of their skill level, have the same expected return.

## 3. Research results and discussion

### 3.1. Evaluation of the discussed qualitative theories to the research question

Beside quantitative arguments that sometime support and also sometime do not recommend the application of passive investment strategies, the above presented arguments are a strong argument to implement a passive strategy **in general**, which means unconnected and independent of special market movements. The author agrees with the argumentation line of Sharpe (1991) in a strictly theoretical perspective. But it has to be stated that even today it is not possible to buy “the market” in a convenient and cost efficient way, especially for retail investors. Sharpe claims the market has to be selected. With this approach, it is necessary to make an active decision which defines his model down. Referring to the World Federation of Exchanges, a total number of 46,514 stock exchange listed companies are available to an investor (WFE Monthly Report, 2012). This number is only the amount of listed companies of such states that are a member of the World Federation of Exchanges. This given figure consists of very heterogeneous companies which are not all covered by index funds, exchange traded funds, or other passive investment tools. Thus “to buy the market” is a very theoretical approach, especially for a private investor. For the latter, it is simply impossible to invest into the entire market by buying all assets in the same weight as the market prescribes due to occurring fees relative to the investment amount.

However, if we apply Sharpe’s Arithmetic of Active Management *ceteris paribus* to an established investment universe like German DAX or US S&P 500, all assumptions of Sharpe’s model can be transferred into reality of investment and it can be considered as “fundamental law”. In such a case, it is very easy for a passive investor to transfer his strategy and to buy “the market” by only purchasing a few standard products. Thorley’s thoughts seem to be coherent and also a strong proponent of applying a passive investment strategy. But one should notice that this theory – like the Efficient Market Hypothesis – requires a strictly rational investor which is a paradigm in traditional finance. In this context of neoclassical finance science, the theoretical model of the “homo economicus” is a key assumption in terms of positive economic theory. Homo economicus refers to a greatly simplified model of human behavior where an individual is characterized by perfect self-interest, perfect rationality, and free access to perfect information regarding a specific condition. But a growing number of economists have come to interpret diverse anomalies described in literature as consistent with several irrationalities that seem to characterize individuals making complicated decisions. These irrationalities fall into two broad categories: first, investors do not always process information correctly and therefore infer incorrect probability distributions about future rates of return; and second, even when given a probability distribution of returns, investors often make inconsistent or systematically suboptimal decisions (Bodi et al., 2011, p. 210). Insofar, Thorley’s arguments are a self-contained theoretical assumption which should be accepted as a piece of advice for any market participant who does not have an overwhelming conviction about his own research and trading abilities. In this context Barber and Odean (2001) provided an interesting example of overconfidence in financial markets. They compared trading activity and average returns in brokerage accounts of men and women and found out a general greater overconfidence of men versus women which is also well documented in the psychological literature.



# New Challenges of Economic and Business Development – 2013

May 9 - 11, 2013, Riga, University of Latvia

Overall, it is obvious that asset allocation has an overwhelming influence on the risk/return tradeoff within the portfolio management process. All studies arrive at the conclusion that active investment decisions in terms of selecting and timing did little to improve performance. “Extra returns seemed to be unrelated to the level of active management.” (Brinson, G. P. et al., 1991, p. 48): Nearly all surveys show that active management has not even been neutral to fund performance, but “rather destroyed a significant portion of investors’ value.” (Drobetz and Köhler, 2002 p. 233) respectively “reduces return and increases volatility.” (Kinniry et al., 2006, p. 53) Kinniry et al. underline that dynamic asset allocation (i. e. all non-passive portfolio management methods) can enhance portfolio performance only if investors have the ability to consistently predict expected returns in financial markets. But it is a well-known fact that it is nearly impossible to forecast expected returns in a persisting manner in a sustainable above-average quality. Bernstein (2001, p. 80) summarizes this with the following sentence: “For a retail investor the likely conclusion do draw from this research is restricting investment process to asset allocation and to abstain from active fiddling with the portfolio, that could reduce long term return and does not have a clearly positive effect on portfolio risk.”

Hence, if asset allocation has such an important impact on the outcome of an investment strategy and other methods do only contribute little or even a negative share to investment success, this finding is possibly the strongest theoretical proponent of a preference of a passive portfolio management strategy. If passive management is implemented by investing in one or a few broad market indexes via Index Funds, Exchange Traded Funds, or Investment Certificates, asset allocation is automatically realized with nearly no additional expenses.

For Berk and Green (2004), the fact that investments with active managers do not outperform passive benchmarks is a consequence of the competitiveness in the market for capital investment. For them successful funds capture excess returns. Therefore, all the economic rents generated using managers’ ability by raising fees, thus investors do not participate on superior managerial skill. The managers themselves benefit from their skills. The arguments of Berk and Green are very coherent, the effect described by the authors can regularly be observed in the field. In conclusion, the authors give a further strong qualitative support for an application of a passive investment strategy.

## 3.2. Proposal for further research activities

Altogether, it has to be stated that there exist some interesting, but not very well known theories which do recommend passive investment portfolio management eminently. Although they are a strictly theoretical approach and base on diverse assumptions which cannot be observed in reality all the time, the theories contribute to a better understanding of a rational and prescient portfolio management style. They conduce to justify a special portfolio management approach by scientific arguments which are applicable in any market environment and therefore can be seen as statements with a universal validity, detached from a certain market movement and situation. Further research activities should be done in this field of international finance, because it is crucial for any citizen to provide for their retirement in a self-reliant way.

## Bibliography

- Achleitner, A. K., 2002. *Handbuch Investment-Banking*. Wiesbaden: Gabler.
- Barber, B. & Odean T., 2001. Boys Will Be Boys: Gender, Overconfidence, and Common Stock Investment, *The Quarterly Journal of Economics*, 116(1), pp. 261-292.
- Berk, J. & Green, R., 2004, Mutual Fund Flows and Performance in Rational Markets. *Journal of Political Economy*, 112, (4), pp. 1269-1295.



## New Challenges of Economic and Business Development – 2013

May 9 - 11, 2013, Riga, University of Latvia

- Bernstein, W. J., 2001. *The Intelligent Asset Allocator. How to Build your Portfolio to Maximize Returns and Minimize Risk*. New York: McGraw Hill.
- Bessler, W.; Blake, D. P.; Lueckoff, P.; Tonks, I., 2010. *Why Does Mutual Fund Performance Not Persist? The Impact and Interaction of Fund Flows and Manager Changes*. Finance Meeting EUROFIDAI AFFI. Paris.
- Bodie, Z.; Kane, A.; Marcus, A. J., 2011. *Investments*. New York: McGraw-Hill/Irwin.
- Bogle, J. C., 1999: *John Bogle on Investing. The first 50 years*. New York: McGraw Hill.
- Brinson, G.; Beebower, G.; Hood, R., 1986. Determinants of Portfolio Performance. *Financial Analysts Journal*, 42(4), pp. 39-48.
- Brinson, G.; Beebower, G.; Hood, R., 1991. Determinants of Portfolio Performance II: An Update. *Financial Analysts Journal*, 47(3), pp. 40-48.
- Bundesverband Investment und Asset Management e.V. (BVI), 2012. *Investmentstatistik*. [Online] Available at <http://www.bvi.de/de/statistikwelt/Investmentstatistik/index.html> [accessed 08 January 2013].
- Chen, J.; Hong, H.; Huang, M.; Kubik, J., 2004. Does Fund Size Erode Mutual Fund Performance? The Role of Liquidity and Organization. *American Economic Review*, 94(5), pp. 1276-1307.
- Drobtz, W. & Köhler, F., 2002. The Contribution of Asset Allocation Policy to Portfolio Performance. *Financial Markets and Portfolio Management*, 16(2), pp. 219-233.
- Ferri, R A., 2011. *The ETF Book. All you need to know about exchange-traded funds*. Hoboken, N.J: John Wiley & Sons.
- Finn, F. & Sawicki, J., 2001. Smart Money and Small Funds. *Journal of Business Finance and Accounting*, 29(5, 6), pp. 825-846.
- Harlow, W. V. & Brown, K. C., 2005. The Right Answer to the Wrong Question: Identifying Superior Active Portfolio Management. *Journal of Investment Management*, 3(3), pp. 1-21.
- Ibbotson, R. & Kaplan, P. D., 2000. Does Asset Allocation Policy Explain 40, 90, or 100 Percent of Performance? *Financial Analysts Journal*, 56(1), pp. 26-33.
- Investment Company Institute (ICI), 2012. *Investment Company Fact Book*. [Online] Available at [http://www.ici.org/research/stats/trends/trends\\_11\\_11](http://www.ici.org/research/stats/trends/trends_11_11) [accessed 08 January 2013].
- Kinniry F.; Tokat, Y.; Wicas, N., 2006. The Asset Allocation Debate: A Review and Reconciliation. *Journal of Financial Planning*, 19(10), pp. 53-63.
- Malkiel, B. G., 2003. Passive Investment Strategies and Efficient Markets. *European Financial Management* (9), pp. 1-10.
- Pollet, J. & Wilson, M., 2008. How Does Size Effect Mutual Fund Behavior? *Journal of Finance*, 62, pp. 2941-2969.
- Sharpe, W. F., 1991. The Arithmetic of Active Management. *Financial Analysts Journal* 47(1), pp. 7-9.
- Statman, M., 2000. The 93.6% Question of Financial Advisors. *Journal of Investing*, 9(1), pp. 16-20.
- Thorley, S., 1999. *The Inefficient Markets Argument for Passive Investing*. Brigham Young University. [Online] Available at: <http://marriott-school.net/emp/SRT/passive.html>. [Accessed 10 January 2013].
- World Federation of Exchanges, 2012. *WFE Monthly Report*. [Online] Available at: <http://www.world-exchanges.org/statistics/monthly-reports> [Accessed 6 January 2013]
- Zheng, L., 1999. Is Money Smart? A Study of Mutual Fund Investors' Selection Ability. *Journal of Finance*, 54(3), pp. 901-904.