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sifma asset management group

ASSET MANAGEMENT FUNDAMENTALS

Index v. Active v. Activist – Three Different Approaches to Investing

Introduction

Asset managers help investors meet their economic goals and objectives. They provide investing advice and guidance. Asset managers invest on behalf of their clients through individual accounts or funds.

There are many assets and financial instruments and many approaches for how to make use of those assets. Clients with different needs, objectives, and risk tolerances establish their individual investing goals. An asset manager works on behalf of the client to carry out the client's objectives within the client's set parameters.

Clients often retain different asset managers to carry out different parts of their investment plan. Asset managers across the industry offer varying strategies that address different objectives and often different philosophies in seeking returns. Those strategies make distinctions of where to invest, such as asset classes like equity or fixed income, specific geographies, or specific industries.

A different question is the investing approach utilized to make investments. There are variations, but three common approaches to investing are index, active, and activist.

Terminology and the Use of the Term "Passive"

The term "*passive*" can be confusing because it is used differently in different contexts.

In the investment style context, "*passive*" is often used to describe index investing, which is contrasted with "active" investing. "*Passive*" and "*active*" are two different approaches to making investment decisions.

To avoid confusion, this document uses "*index investing*" to describe investment styles that seek to track an index. In the corporate governance context, however, "*passive investing*" is often used to describe those investors who do not invest to "control" a company or to influence the day-to-day management of the companies in which they invest. In this context, both active and index investment strategies can be passive (*i.e.,* not investing for control or to influence management).

"*Activist*" investors are not passive — they invest with an intent to control or influence management, which distinguishes them from both active and index investment approaches.

INDEX INVESTING

What is an Index or a Benchmark?

An index or benchmark collects a group of securities together and allows tracking of the performance as a group. Well known examples are the Dow Jones U.S. Total Stock Market Index, which measures the entire U.S. stock market, and the Standard & Poor's 500, which tracks 500 companies listed on U.S. stock exchanges. Examples from outside the United States include the Nikkei 225, which tracks 225 stocks listed on the Tokyo Stock Exchange, and the Financial Times Stock Exchange 100 Index, which tracks the largest issuers on the London Stock Exchange.

In each case, the index provider, typically a third-party separate and distinct from an asset manager, defines the methodology and criteria for including companies or securities, determines the proportion of each holding in the index, and adjusts the index, usually at regular intervals (*e.g.,* quarterly). Over time, certain securities or issuers may no longer meet the criteria or new securities or issuers may meet the criteria and are removed or added to the index accordingly. Both require ongoing maintenance by the index provider.

An index represents the market where its issuers operate (*e.g.,* a specific country, sector, and/or stated market capitalization). Equity indices that track a group of equities give a sense of how the market the index represents is performing. Likewise, fixed income indices track a group of fixed income instruments and give a sense of how the fixed income market is performing. Broader indices measure broader markets and more narrow indices focus on more specific sub-groups.

An index or benchmark is often used to set expectations for portfolio management decisions, risk, and returns. As described further below, typically an index investor seeks to closely track the returns of a stated market, whereas an active investor would be striving to outperform the returns of the market.

What is "Index" Investing?

Index investing refers to an investment strategy that seeks to track an index. Asset managers offer index investing options to clients through mutual funds and other types of products, including exchange traded funds ("ETFs") in the U.S. The asset manager seeks to track the performance of the index as closely as possible, often by buying all (or a representative sample) of the stocks or bonds in the index it tracks. The asset manager generally maintains the same holdings in the same proportions as the index, mechanically tracking the index. Deviations from these holdings or proportions would be reflected in a measurement referred to as "tracking error."

An asset manager invests new money from clients to align the holdings and proportions with the index. When they sell to raise money to meet investor redemption or withdrawal requests, they do so in the same manner. With more inflows, funds and strategies inherently grow their holdings of individual securities in a mechanical manner consistent with the composition of the index. Buying and selling activity and corresponding holdings depend exclusively on client demand and index composition.

An index fund allows investors to efficiently target a desired part of the market, enabling investment in a single fund rather than buying individual instruments to track an index. An index fund with a long history gives investors an idea of historical returns and the manager's ability to track the index. The asset manager's role is to deliver the return of the selected index. A single asset manager can offer multiple funds or strategies that each track their own index and the investment decisions for each are based on the composition and client demand for each.

Indexing appeals to investors looking to easily invest in a particular market segment. It also appeals to investors who believe that holding all or a representative sample of a market segment is a better approach than attempting to pick individual winning instruments that will outperform the market. Index funds typically appeal to investors who seek a low-cost means of investing in desired asset classes and diversifying their investments. Index funds also typically have reduced portfolio turnover and ease of tracking due to the publicly available nature of the indexes they track. Managers of index strategies compete on their ability to track an index closely and cost efficiently, the ease of investing mechanics for the investor, and the scope of products offered.

An index investment approach is passive from a corporate governance standpoint. An index strategy has no intent or desire to become involved in managing a company's business or assuming control of a company. An index strategy is exclusively focused on making investments that track the specified index.

ACTIVE INVESTING

What is "Active" Investing?

The practice of actively managing holdings and making decisions on investment opportunities is a key contrast from directly tracking an index. By exercising decision-making, active management strives to produce better returns than the index with a portfolio that has the same or less risk than the index.

Active investing involves decisions about where to invest, when to invest, and how to invest. Managers apply judgment and invest (or decide not to invest) as they seek economic returns and manage associated risks.

An active manager does not invest to directly track or mirror an index but instead looks for investing opportunities and makes their own investing decisions. If a manager believes a security is significantly undervalued relative to its price and risk, it buys that security, consistent with the investment objectives of the portfolio. Likewise, a manager may choose not to invest in a security because it believes there is little upside or presents other investing risks.

In addition to deciding whether to buy, sell, or hold, the manager thinks about timing and sizing. How much should it buy? When should it buy? When should it sell? How does the holding relate to others in the portfolio to create an overall investment program? Does it add a different risk? Does it duplicate risk? Does it mitigate risk? Are portfolio holdings diversified?

Active strategies employ varying degrees of connection to a benchmark. An active manager might use an index as a starting

point for investing possibilities. Rather than letting the index dictate what the manager buys or sells, the active manager makes its own decisions in an effort to outperform the returns of the index. Depending on specific guidelines, active managers can maintain holdings within a certain range of index weightings or invest beyond the instruments or issuers included in the index. These practices are often known as "underweighting," "overweighting," and "going out of benchmark."

The more latitude the guidelines permit, the more likely portfolio returns will diverge from the returns of the index. The less latitude the guidelines permit, the more likely portfolio returns will be similar to returns of the index. In both cases, the management would be considered "active," but an investor's expectations for over-and under-performance should differ. The benchmark should be reasonable for the stated strategy of the manager because it will impact how a portfolio is managed or what results are expected. Referencing an index in guidelines gives a client or investor comfort that the asset manager will maintain a strategy that focuses on a particular aspect of the market. For example, a strategy using a fixed-income index as a reference point gives clients and investors comfort that the manager is investing in fixed-income assets and not in other asset classes.

An active manager might also offer a strategy that does not utilize an index at all. Unconstrained or total return strategies have no constraints that require the manager to make investments based on index composition or weightings. There may be other limits or requirements, but managers have a wider range of investment opportunities without an index constraint.

Even if an index plays no role in making day-to-day investment decisions, managers and clients sometimes use a relevant and comparable index to judge the performance of the manager. For example, a client and investor might agree that the performance objective for that client is to produce returns above a selected index. The index may not drive portfolio construction, but both parties can agree to judge the active manager's performance by comparing results to an index that represents a relevant part of the market.

Passive Investing - Corporate Governance Without Exercising Control

Both active and index strategies are "passive" when it comes to corporate governance. When matters of corporate governance involve a shareholder vote, equity holders have the right to vote. Acting on behalf of their clients and investors, both index and active funds may vote proxies, consistent with their fiduciary duties. Active fund managers often take this a step further and consider proxy voting and engagement with managers to be a part of their investment process. When there are shareholder votes, fund managers evaluate the issues and vote in the best interests of their clients. The way in which investors exercise their rights as equity holders does not mean that they are exercising "control" or trying to influence the company's day to day business decisions.

For example, asset managers, in their capacity representing investors, can decide to engage with company management to

share views about a company's corporate governance practices and discuss how it can help produce value or manage risks to investors. Active managers may offer their perspectives, but almost always take steps to remain passive investors and do not make management decisions, act as an active part of management, or serve on Boards of Directors. In the rare case that an active manager has a control intent, it must make that intent known to regulators and the public through required filings with the Securities and Exchange Commission (SEC).

Active managers develop their own investment philosophies and processes for making investing decisions. An active manager seeks to earn returns for clients and investors that aim to outperform a stated market, with an approach of balancing risks and rewards. Different managers have different approaches to make these decisions. Investors assess these investing approaches, and managers compete with each other for clients on the basis of their investment process, resulting performance record, and their outperformance relative to costs.

ACTIVIST INVESTING

What is "Activist" Investing?

Some managers seek to create value for their clients by pushing for changes in the way a company operates. Activist investors not only make dynamic decisions for what to buy, sell, and hold, but they typically take meaningful ownership positions of an issuer's equity and utilize that position to advocate for a different approach to running the company than the current management takes.

Specific tactics vary but can include direct dialogue with company management to provide recommendations, holding Board seats or supporting others who run for Board positions, proposing matters for companies to put to shareholder votes, actively advocating for or against particular votes, and pushing for company restructurings, mergers, acquisitions, or divestments. They may also push for changes in the way the company handles its financing needs and the interests of equity holders, such as changing dividend policies or buying back shares in the open market. Activist investors may also coordinate with other investors and solicit support through media campaigns or proxy voting contests.

Instead of maintaining a broad portfolio of holdings, activists often focus on a smaller number of issuers and holdings where they believe they can make an outsized impact. An activist typically has an appetite to pursue litigation, defend a position, or advocate against an issuer's actions. Where others might shy away from bankruptcy or reorganization scenarios, an activist investor may be willing to participate in hopes of a positive outcome. Activist investors rarely intend to acquire a majority stake or the entire company.

SEC rules require a public filing when ownership of a publicly traded company exceeds five percent. Section 13 of the Securities Exchange Act of 1934 and associated rules establish the framework and make distinctions to identify investors who are acquiring and holding securities for the purpose or effect of changing or

influencing the control of the issuer or having a “control intent.” “Passive” investors (*i.e.,* investors who do not have a “control intent” like the managers of index and active strategies discussed above) make an abbreviated filing on SEC Schedule 13G, while activist investors make more robust disclosures on SEC Schedule 13D. Activist managers typically are directly involved with corporate management. When they build sizable positions in an issuer, public SEC filings enable issuers, the market, and regulators to know of their presence and intentions. Those that do not meet this standard are typically called “*passive investors*.”

Terminology for Section 13 filings can be confusing. While “passive” investing is often informally used as a synonym for “index” investing in personal finance literature and the financial press, “*passive*” in this specific context means investing with no intent to control or influence control. “*Passive investors*” in the context of Section 13 filings can include both “index” and “active” investors. As noted above, managers of both “index” and “active” strategies make SEC Schedule 13G filings because neither acquires shares of an issuer with intent to control or influence control.

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About SIFMA and SIFMA AMG:

SIFMA is the leading trade association for broker-dealers, investment banks and asset managers operating in the U.S. and global capital markets. On behalf of our industry’s one million employees, we advocate on legislation, regulation and business policy affecting retail and institutional investors, equity and fixed income markets and related products and services. We serve as an industry coordinating body to promote fair and orderly markets, informed regulatory compliance, and efficient market operations and resiliency. We also provide a forum for industry policy and professional development. For more information, visit http://www.sifma.org.

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