Let's talk about actual investing.

Investing should be about working constructively with inspiring individuals and companies on behalf of our clients, says Stuart Dunbar.

Equity investing, the process of funnelling capital towards projects in the search for profitable returns, has been a root cause of societal progress and individual wealth creation since the 19th century. For most of this time the investment industry concerned itself with actual companies and actual projects. Nowadays though our industry is obsessed by abstract concepts – such as regional allocations, sector positions, factor exposures and over/underweights – which have little to do with our fundamental purpose.

The vocabulary we use makes us sound like speculators. More importantly, investment managers' collective failure to focus on actual investment lets clients down in the long run, contributes to the malaise in which the active investment industry finds itself, and likely contributes to the lacklustre levels of productivity growth that many developed economies suffer from.

It is high time for the actual investors among us to explain why actual investing is important.

Active? Passive? We Prefer Actual.

This conversation should not be reduced to a simplistic active-versus-passive debate, as if these things were equally valid approaches to the same activity. They are not. Active investing itself is not a single activity, and much of what is called active investing does not fit that description. The fundamental purpose of investing is to use available capital from those who have surplus to fund the ideas and projects of entrepreneurs and company managers who see an opportunity to generate profits. Our job as professional investors is to weigh up the risks associated with those ideas and projects, the range of possible outcomes and their probabilities, and thereby put a price on the equity or debt that is being used as funding. As an industry, we focus too little on that fundamental purpose.

Passive investing is different. It has a place – cheap market access is better value than poor active management – but allocating capital with no reference to the underlying purpose isn't really investing in a pure sense. The main reason that a passive approach has often fared well against its more fundamental rivals is that far too much of what passes for active management is simply second-order trading of existing assets, with the main focus being to try to anticipate the behaviour of other investors. This has little to do with actual investing, and it creates huge amounts of over-trading and volatility. It also serves no useful purpose other than for those who make a very handsome living from transactional activity, or those who confuse their clients into thinking that short-term volatility is skill.

We need a secondary market in securities to provide occasional liquidity between investors but, beyond that role, we should essentially ignore it. Instead we have arrived at a point where analysis of secondary markets now dominates our fundamental purpose. Moreover, the financial industry now describes its value in terms of market-referencing data points. Everyone is trying to outsmart everyone else by buying and selling existing assets: this is the zero-sum game that is so unthinkingly referenced by commentators and practitioners alike. It has little to do with wealth creation, either for our clients or for society.

How (almost) nobody selects a manager.

If actual investing is the bedrock of wealth creation, a more pertinent question should be, what is it that you should look for when selecting an investment manager? 'Average' is not going to serve you well in an industry where so few remain focused on the right things. The good news is that there are some useful shortcuts: independent research shows that managers who have very high active share (i.e. those who ignore benchmarks) are more likely to outperform. This, however, is not sufficient - high active share in the presence of high turnover is still likely to underperform a market cap-weighted index. However, managers who combine high active share and low turnover on average outperform market cap weighted indices (between 1995 and 2013 by 2.3% p.a. net of costs*). This is not exactly rocket science, though it did require the authors to gather a huge amount of difficult-to-find data, so one wonders why manager selection is apparently so difficult to consistently get right. To offer a view:

There are so many managers that some will have seemingly statistically significant outperformance even if they lack investment skill. This is just the law of big numbers. In the absence of further analysis, historic performance means little. Unfortunately, historic and (even worse) short-term performance still figures highly as a search criterion. So by definition the good are mixed with the lucky. Do not use historic performance as a filter in isolation.

Good fundamental managers stick to their approach through thick and thin. All too often managers who have done a good job through fundamental analysis are blown off course by the investment industry's incessant need to build assets, grow profits, merge together and generally put their own interests ahead of those of clients'. Ownership and motivation – performance, not assets under management – really matter. Pick the right firm.

Back to basics.

The task in hand is to remind our clients what investing actually means. Actual managers need to demonstrate that we act on behalf of clients to identify and back fundamental investment ideas, not just try to outsmart other investors. We need to talk about the progress and risks involved with those investments, not about short-term share price performance which means nothing in a market dominated by speculators. By doing this we can refocus the discussion on the central and important role we play in the progress of society, and perhaps start to restore the investment industry's social license.

*Active Share and Mutual Fund Performance, Antti Petajisto, 2013 and Patient Capital Outperformance: The Investment Skill of High Active Share Managers Who Trade Infrequently, M. Cremers, A Pareek, 2014.

All investment strategies have the potential for profit and loss, your or your clients' capital may be at risk. Past performance is not a guide for future returns.

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