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Active Management Still Has An Important Role – September, 2025

There have been two major developments in financial markets over the past couple of decades that have impacted the average investor: first was the introduction of the index fund and second the introduction of exchange traded funds, otherwise known as ETFs. These innovations became known as “passive” investing. In recent years there has been ongoing debate in financial circles between the merits of ‘passive’ vs “active” management.

Passive management, through index funds and ETFs, offers investors broad market exposure at relatively low costs, as these funds typically have lower fees and require less frequent trading. This approach aims to replicate the performance of a benchmark index, which can be appealing for those seeking simplicity and steady, long-term returns. However, passive investing does not attempt to outperform the market or respond to changing market conditions, which may limit opportunities during periods of volatility or in inefficient markets.

On the other hand, active management involves a hands-on approach, with portfolio managers making investment decisions based on research, market trends, and economic forecasts. The primary merit of active management is the potential to outperform market indices, especially during periods of market dislocation or in niche sectors where skilled managers can identify undervalued opportunities. While active management may lead to higher returns, it generally comes with higher fees and the risk that the manager may not consistently beat the

market. Ultimately, the choice between passive and active management depends on an investor’s goals, risk tolerance, and investment philosophy.

It would be useful to take a step back to view these developments in a larger context of the transition from defined-benefit to defined-contribution saving pension plans.

Historically, many governments and corporations provided defined-benefit pension plans, guaranteeing employees a specific retirement income based on salary and years of service. Over the past several decades, however, there has been a significant transition toward defined-contribution plans where individuals contribute to their own retirement savings and bear the investment risk. Hong Kong was a late adopter with the introduction of the Mandatory Pension Fund (MPF) in 2000, whereas the US established their retirement savings plan in 1978 and Canada introduced theirs in 1957. This shift has been driven by factors including changing demographics, increased longevity, and the desire of organizations to reduce long-term financial liabilities, fundamentally altering the retirement landscape and placing more responsibility on individuals to manage their financial futures.

In addition to this shift in pension funds, U.S. brokerage commissions were deregulated in 1975 which led to discount brokers to emerge. Previously brokerage commissions were fixed and high but the lowering of costs spurred competition and innovation in financial products and services, particularly in North America. Further regulatory changes and tax incentives, along with demographic shifts added to the pace of this evolution.

The introduction in the 1970s of the efficient market theory (EMT), where asset prices supposedly reflect all publicly available information, provided more fuel to the passive vs active management debate.

In the world economy today radical shifts in economic approach by the current US administration will change norms, behaviors of corporations and governments globally. This will have a strong impact on investors as they navigate these new and unknown waters.

However, let's go back to last year when we were still the traditional post-war global economic order and the passive vs active management debate centered mostly around the EMT. Within that context let's explore why active investment management is as relevant today as ever.

1. Uncovering Nuances and Information Advantages:

While EMT posits that all *publicly* available information is instantly incorporated into prices, active managers can still seek to exploit informational advantages through diligent research and analysis. This involves:

- **Deep Sector Expertise:** Developing specialized knowledge in specific industries or asset classes allows managers to understand complex business models, competitive landscapes, and regulatory environments more thoroughly than the broader market. This deep dive can reveal subtle insights not immediately apparent in headline news or broad market data.
- **Proprietary Data and Analysis:** Active managers often invest in gathering and analyzing non-traditional data sources, such as alternative datasets, social media sentiment, or expert network consultations. By processing this information through sophisticated analytical tools and proprietary models, they might identify trends or signals before

they become widely recognized and priced in.

- **Qualitative Analysis and Due Diligence:** Beyond quantitative data, active managers conduct in-depth qualitative research, including management team assessments, corporate governance evaluations, and understanding strategic direction. This nuanced understanding can provide a more holistic view of a company's long-term prospects than purely relying on historical financial data.

2. Exploiting Behavioral Biases:

Even if markets are informationally efficient, they are populated by human investors who are susceptible to behavioral biases. Active managers can potentially generate value by:

- **Identifying and Capitalizing on Systematic Errors:** Behavioral finance highlights predictable patterns of irrationality in investor behavior, such as herding, anchoring, and loss aversion. Skilled active managers can identify situations where these biases are likely to create temporary mis-pricings and strategically position their portfolios to benefit.
- **Providing Emotional Discipline:** Market participants often react emotionally to short-term news and volatility, leading to suboptimal investment decisions. Active managers, acting as rational agents, can provide a steady hand, rebalancing portfolios and taking advantage of opportunities created by panic selling or irrational exuberance.

3. Enhancing Portfolio Construction and Risk Management:

Active management extends beyond stock picking to encompass crucial aspects of portfolio construction and risk management:

- **Dynamic Asset Allocation:** In an efficient market, the optimal asset allocation might still evolve over time due to changing

macroeconomic conditions or investor preferences. Active managers can adjust asset class weights strategically based on their evolving outlook and risk tolerance, potentially enhancing risk-adjusted returns.

- **Factor Investing and Thematic Allocation:** Active managers can construct portfolios based on specific investment factors (e.g., value, growth, momentum, low volatility) or thematic trends (e.g., technological disruption, demographic shifts). While these factors might have long-term risk premia, active implementation allows for dynamic adjustments based on market conditions and factor valuations.

4. Facilitating Market Efficiency and Price Discovery:

Paradoxically, the very existence of active managers contributes to market efficiency:

- **Continuous Monitoring and Analysis:** Active managers constantly scrutinize companies and markets, seeking information and analyzing potential investment opportunities. This ongoing research and trading activity helps to ensure that new information is quickly disseminated and reflected in asset prices.
- **Price Correction Mechanisms:** When active managers identify perceived mispricings (even if these are transient or due to behavioral factors), their trading activity can help to correct these anomalies, pushing prices towards their fair value.

5. Providing Tailored Investment Solutions:

Active managers can offer customized investment solutions that cater to the specific needs and constraints of individual investors or institutions:

- **Liability-Driven Investing (LDI):** For pension funds and insurance companies, active managers can construct portfolios specifically designed to match their long-term liabilities.
- **Socially Responsible Investing (SRI) and ESG Integration:** Active managers can incorporate ethical, social, and governance factors into their investment process, aligning portfolios with client values while still aiming for competitive returns.

While the efficient market theory presents a significant challenge to traditional active management focused solely on outperforming the market through stock picking, it doesn't render active managers obsolete. Their roles have evolved to encompass sophisticated information analysis, the exploitation of behavioral biases, proactive risk management, the facilitation of price discovery, and the provision of tailored investment solutions. In a complex and ever-changing world, the nuanced insights and adaptive strategies of skilled active managers can still add considerable value for investors, even within the boundaries of a relatively efficient market.

In conclusion, if active management had an important role to play in the pre-2025 post war global economic order, it is even more vital today we enter a new economic era and American exceptionalism takes on a new meaning.

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