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The Brandes Center

ACTIVE & PASSIVE INVESTMENT MANAGEMENT

ASIA-PACIFIC FOCUS

by Navya Khurana

In November 2024, Brandes Center Asia-Pacific Advisory Board members David Iverson and Daniel Rupp, CFA shared their thoughts on active and passive investing and the Asian investment landscape. Moderated by Brandes Center Executive Director Bob Schmidt, the full video of the discussion is available here at The Brandes Center YouTube channel.

Iverson is Chief Investment Officer at New Zealand's roughly $50 billion Accident Compensation Corporation (ACC). Rupp is founder and Chief Investment Officer at Hong Kong-based Parkway Capital Ltd.

Executive Summary

Iverson made three, key points about active and passive investing:

1. the active vs. passive debate is not binary; it's "more of a continuum"
2. investors need to understand their alpha sources—how they are generating alpha; and
3. they need to know how those alpha sources behave

He added that most organizations aren't aligned according to a clear understanding of how they intend to deliver alpha—and which *type* of alpha. He also acknowledged the last 10-15 years have been difficult for active managers due to the investment landscape, especially low return dispersion, high concentration and the outperformance of the Magnificent 7 in the United States. He said, "Abandoning a strategy where, if you think you can find these [outperforming] managers, is probably not the right thing to do."

Rupp said passive investing in Asia has been difficult due, in part, to the construction of Asia-based indexes. He has had success as an active manager looking for companies with consistent earnings growth—that are attractively valued—and avoiding others. With over 15,000 listed companies in the region, Asia offers a rich opportunity set.

Rupp's comments on potential tariffs imposed by the Trump Administration have proved prescient: "So, it seems like a head scratcher that [the tariff] policies Trump is talking about will be inflationary. I think he does care about his popularity. It's going to be really hard for him to implement high tariffs and remain popular." Ultimately, he said "some sort of deal is likely."

The Conversation

Iverson opened the discussion by highlighting various theories and approaches toward active and passive investing. After, Rupp built on that theoretical framework and shared ideas on the Asia-Pacific markets. Both often compared and contrasted Asia with Europe and the United States. Here is a summary of the discussion.

Panelists:

- David Iverson is Chief Investment Officer at New Zealand's roughly $50 billion Accident Compensation Corporation (ACC)
- Daniel Rupp, CFA is founder and Chief Investment Officer at Hong Kong-based Parkway Capital Ltd.

Iverson's Remarks on Active and Passive Investing

Iverson started by making three, key points:

1. The active vs. passive debate is not binary; it's "more of a continuum"
2. Investors need to understand their alpha sources—how they are generating alpha; and
3. They need to know how those alpha sources behave

The third point may give investors the mettle to stick with an active strategy—even when it may be out of favor for years.

Iverson said his views on the active/passive continuum have been shaped by other investment thinkers, including Don Ezra, fellow Brandes Center Asia-Pacific Board member Dr. Geoff Warren and Nobel Prize winner Bob Merton.

Iverson defined passive as using a capitalization-weighted benchmark. Of course, he recognized the range of passive products; passive is not binary either. But the cap-weighted index definition set the foundation for the thought process he follows when considering active managers.

Three alpha sources investors may seek:

1. **Transactional alpha**
2. **Dimensional alpha**
3. **Traditional alpha**

"Passive may not always be suitable," he said. "There may be reasons why an indexing strategy doesn't fit your objectives."

He offered protection from inflation as an example. "Buying an off-the-shelf market-capitalization weighted listed infrastructure benchmark may not give you what you're after." In addition, he said gaining exposure to micro-cap stocks was another example where an index product may not be the best option.

Beyond these examples, Iverson said there may be areas where an investor believes active management could outperform the index.
Here, he shared three alpha sources an investor may seek:

1. Transactional alpha
2. Dimensional alpha
3. Traditional alpha

He said many investors "think about the index and jump straight to traditional alpha, but there are all these other reasons in between." He said transactional alpha may be more prevalent when investing in fixed income, but he shared an example using equities.

"Let's say that you are constrained in some way by a regulator—and the regulator is going to charge you 20 basis points for investing in physical equities," Iverson said. "But you find a hedge fund that can act as a financial intermediary and it only charges 10 basis points. This type of alpha is a positive sum game; both parties are better off for having done the transaction."

Iverson said dimensional alpha reflects a concept developed by Bob Merton. “There are factors such as large versus small, value, growth, profitability, low volume, momentum—there are many sorts of factors out there. Not all of them are risk premia. There are other dimensions essentially to the market factors—that’s why Merton calls it dimensional alpha.”

Dimensional Alpha is the name of the investment management firm where Merton is listed as a “resident scientist.”

In an interview posted at the firm’s website, Merton described dimensional alpha in more detail. He said the Capital Asset Pricing Model (CAPM) identifies market risk as the only source of systematic risk. “In my model, investors face non-diversifiable risks caused by unpredictable changes in the future investment opportunity set, including real interest rates, expected returns, and volatilities not reflected in the single-period CAPM. Consequently, investors demand compensation for exposures to these additional sources of risks, causing differences in equilibrium expected returns across securities along multiple risk dimensions.”

Merton added, “I label the premiums associated with these risk dimensions beyond the market risk as ‘dimensional alpha.’” He also noted that while these sources of alpha are related to the company he works with (Dimensional Alpha), they are not exactly the same. Click this link to read the entire interview.

Iverson ended his comments on the types of alpha with a mention of where the conversation about active and passive tends to start—traditional alpha. “That’s a zero-sum game before fees,” he said. “This is where you have to hire a smarter manager than other investors to earn a better return from them.”

Given the broader framework for the discussion that Iverson shared, he moved to his second key point: understanding the source of alpha and its cost.

He added that most organizations aren’t aligned according to a clear understanding of how they intend to deliver alpha—and which type of alpha. “You look at liquidity requirements, capacity constraints and the skill sets within an organization—they are all very different.” The consideration of alpha generation is “usually traditional, long-only type manager selection.”

Schmidt asked Iverson how an organization can best assess whether it has the ability and temperament to pursue an active, alpha generation path.

“There are two areas you need to focus on,” Iverson said. “First, before you deal with the competence of the team, you have to review your set of investment beliefs. You need to know what they are. And that's largely: how do you think financial markets work? Given that, what kind of investment philosophy works well with the way you think about the world? And what types of managers fit within your investment belief set?”

He added that ACC's competitive advantages are proprietary. But he admitted that the organization's time horizon "exceeds most others" which he described as a "huge advantage."

Iverson then switched his focus to the rise of passive investing in the United States. He claimed market-capitalization weighted indexing has only two components: the number of shares outstanding and current price.

While passive investors accept current prices, active managers don't. "An active manager is thinking about the future price—using whatever investment strategy and philosophy they have."

Market-Cap Weighted Indexing

Schmidt asked about cap-weighted indexes and their construction methodology.

Rupp shared the story of Orient Overseas Limited (OOL) (Hong Kong: 0316). A shipping company, OOL was a roughly $2 billion company for about a decade before Covid. During the pandemic, as shipping rates soared, the stock price followed and it became a $20 billion company.

"Because of the way in which the Hang Seng and MSCI China indexes are constructed, it was added in June 2022. Earnings dropped 83% in 2023. As a passive investor, you basically bought, thanks to index rebalancing, peak earnings. For most people who have some common sense, buying into a cyclical industry like shipping *after* a 10x move is probably the wrong thing to do"

Schmidt reiterated that index products reflect a continuum, so it's not simply a "cap-weighted index" or nothing. "But they tend to be backward looking. And understanding how the index is constructed and how it's rebalanced is vital."

"Yes, in terms of index construction," Iverson said, "the market-capitalization weighted one is rooted in theory. What underpins it is that passive investors are free riders. They're assuming someone else is doing the work for them to bring the price in line. What if it's not? Then it doesn't become a riskless strategy. It's very risky."

Iverson added that when the market is completely mis-valued, passive investors won't care. "They don't care about current price," he said. "It's the only thing driving market cap. He also said the cap-weighted indexes, especially in the United States, have become more concentrated. "But that doesn't mean the market's overvalued." (Market concentration would be addressed in more detail later in the discussion.)

Iverson acknowledged that active managers have struggled. "It's been 15 years of a tough environment—and it's partly the reason why there has been a switch from active to passive. This is why I talked about understanding the sources of alpha. For active managers, there are only three components: skill of the manager; the number of positions—and that's really leveraging that skill across the portfolio; and the other is the tracking error of the portfolio. And that's driven by the cross-sectional spread of returns and the size of the positions.

So, what's happened over the last 15 years? Has skill disappeared? Or is something else going on? Iverson argued the environment for active managers has been difficult for a few reasons:

1. Stock dispersion has been unreasonably low—across most markets, including the United States, in Europe, the United Kingdom and Japan. If all stocks go up 10%, he said it doesn't matter which ones you pick; you can't outperform. (Here, stock dispersion refers to cross-sectional volatility or the standard deviation of stock returns at a point in time.)

He added that strong gains from the Magnificent 7 also have created a tough environment. "Essentially, it's been a combination of the amount of breadth in the market and the amount of dispersion—which is largely hidden—has also been low." He said stock-selection skill hasn't disappeared. Instead, these backdrops are why alpha has been hard to produce. See Exhibit 1.

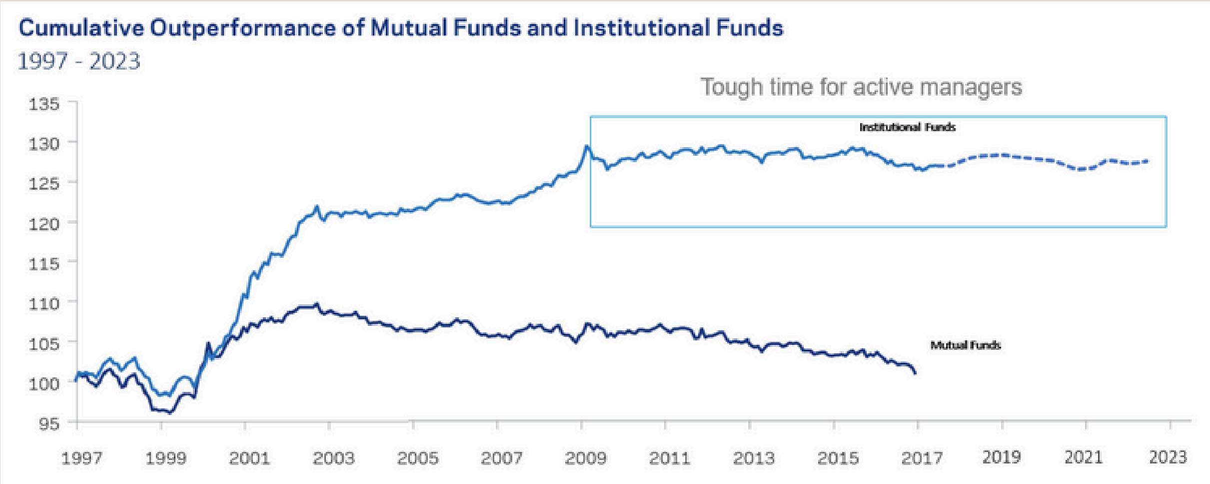
2. Iverson added, "Going back about five years ago, you can see this rally. The blue line is the Mag 7. They're up 6.4 times (since 2020). Everything excluding the Magnificent 7 is only up 1.7 times. It's astronomical." Exhibit 2 shows the Magnificent 7 outperformance since 2013. He noted that PE ratios for some of the Magnificent 7 stocks, like Apple, have climbed from about 14x to "north of 30."

He also shared Exhibit 3 and said, "This is the more worrying one. You're getting levels of concentration in the index which is what you saw in late sixties and into the Nifty 50 period." Iverson added the US market now was more than 70% of the MSCI World Index and asked, "How long can this be sustained?" (It was 71.9% as of June 30, 2025.)

"If all stocks go up 10%, it doesn't matter which ones you pick; you can't outperform."

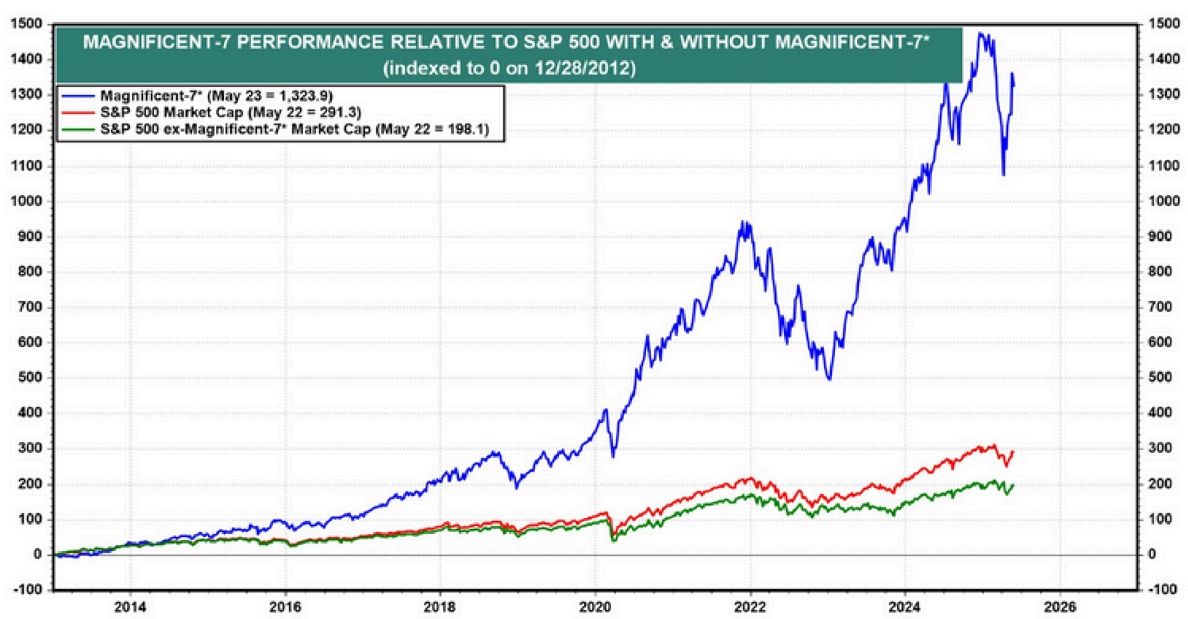
- David Iverson, CIO at ACC

Exhibit 1 | Cumulative Outperformance of Mutual Funds and Institutional Funds (1997-2023)



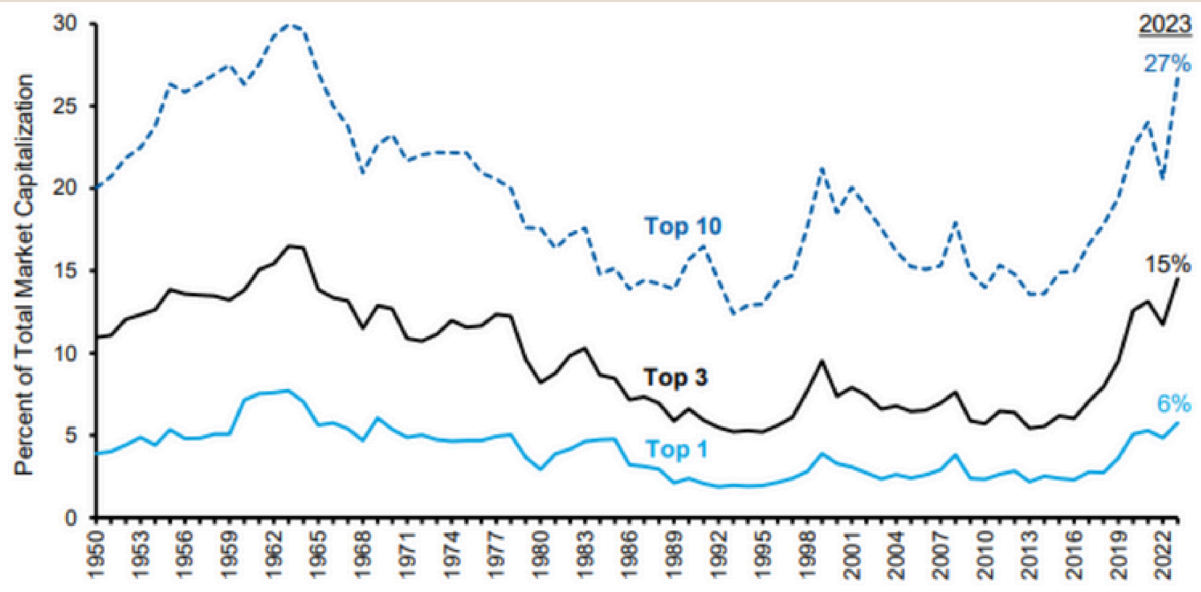
Source: AQR, eVestment

Exhibit 2 | The "Magnificent 7" in the United States Have Delivered Significant Gains Since 2013



Source: Yardeni Research, IBES and LSEG Datastream. https://yardeni.com/charts/magnificent-7/ Dec. 28, 2012 to May 23, 2025
*The Magnificent 7 stocks include Alphabet (Google), Amazon, Meta (Facebook), Microsoft, NVIDIA and Tesla. Both classes of Alphabet shares are included.

Exhibit 3 | US Stock Market Concentration (1950 to 2023)



Source: edwardconrad.com, FactSet, Compustat, U.S. Securities and Exchange Commission, Annual Reports (see www.sec.gov/reports, Counterpoint Global.) The universe includes companies listed on the New York Stock Exchange, Nasdaq and NYSE American stock exchanges, including American depositary receipts. Market capitalization reflects calendar year-end.
https://www.edwardconard.com/macro-roundup/last-year-the-top-10-equities-made-up-27-of-market-capitalization-but-69-of-total-economic-profits-historically-increasing-concentration-has-been-associated-with-above-average-sp-500-returns-mjma/?view=detail

Rupp acknowledged there has been an element of fundamental strength accompanying US stock market gains. “There’s also an element of expectations from AI that's going to drive the next leg of earnings. But,” he warned, “if that doesn't come through, then there's potentially trouble in the US.” Rupp said we need to see some “trouble” in the United States for investors to start looking at Asia and other markets around the world.

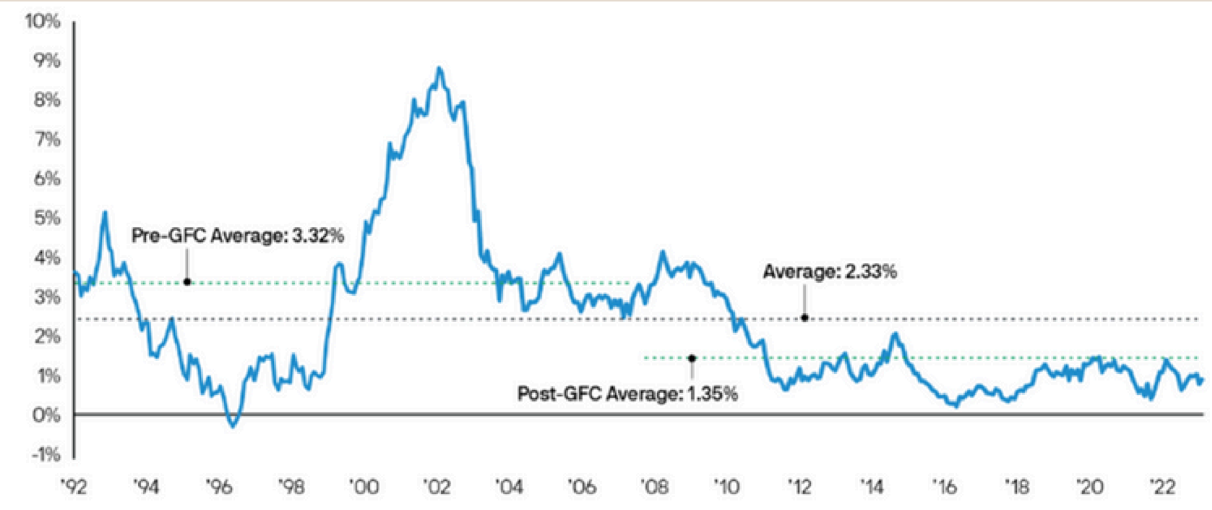
“Looking back, it’s around 2009 where the average managers really produced roughly zero above the benchmark,” Iverson said. “So, there has been a shift in the environment. The best managers are still there, but the environment's been a tough one for them. And so, knowing your alpha drivers, it isn't necessarily that skill has disappeared.” See Exhibit 4.

“So abandoning a strategy where, if you think you can find these managers, is probably not the right thing to do. That’s essentially the point I'm making.”

Schmidt said, “I’ve heard value investing described as time arbitrage. It’s taking the short-term pain for the long-term gain. But you’ve got to have the organizational discipline and buy-in across the shop to make it happen.” Iverson agreed.

“But,” Schmidt added, “For my students who take classes in valuation and risk measurement and management, I tell them that over the last 10 years or so, at least in the United States, the biggest risk in the market has been being *out* of the market. I don’t think that can continue. At some point, it’s going to come back to bite us. I just don’t know when that is.”

Exhibit 4 | Average Top Quartile Large-Cap Core Manager Excess Returns vs. SP 500



Source: eVestment, as of December 2023. Based on annualized returns. Excess return calculated against the S&P 500 Index.

Rupp on the Asia-Pacific Region and Passive Investing

Rupp acknowledged, “David’s had a lot more experience across different asset classes. For me, I’ve spent about 20 years in Asia focusing on equities. And in Asia, passive investing has been really difficult—and that’s been a source of a lot of frustration.”

Rupp said he thinks about the different components to equity returns to help identify alpha opportunities. The main ones are:

- Consistent portfolio-level earnings growth
- Dividend yield

There’s also a miscellaneous element which, effectively, reflects changes in multiples. For investors not based in Asia, there is also a component of F/X gains/losses associated with being invested in unhedged Asian equities. Over the last ~20 years, a basket of currencies (ASIADOLR Index on Bloomberg) that broadly represents Rupp’s Pan-Asian mandate has lost about 70 basis points per year against the USD. That being said, in years where the Asian currencies outperform the USD, the average equity returns have been over 23%. Said another way, in years where Asian currencies gain against the USD, investors generally do very well. (First half 2025 performance of ASIADOLR: +4.2%.)

These components apply to indexes and individual stocks, as well. He shared an example for the S&P 500 Index. “If you were to have bought the S&P 500 35 years ago and held it, the entry multiple and exit multiples would have grown slightly, but the performance comes from earnings compounding at a little over 7% for 35 years.

“That means almost 70% of your return [7.2% divided by the 10.6% total return over the period] came from earnings.” Using these components, he broke down index returns in

Exhibit 5 | Index Returns and Breakdown (in US$): January 2004 to Nov. 2024

	S&P 500	Euro Stoxx 50	MSCI Asia
EPS Growth	6.6%	3.1%	5%
Dividend Yield	2.1%	3.9%	2.9%
Miscellaneous	1.6%	-0.4%	-1.3%
Total Return	10.3%	6.6%	6.6%

Sources: Bloomberg; additional analysis by Parkway Capital

Exhibit 6 | U.S. Companies Have Shown Greater Earnings Stability (2004-2024E)

	S&P 500	Euro 50	MSCI Asia
EPS CAGR	7%	3.3%	5.3%
Standard Deviation	16.2%	22.9%	84.1%
Years of Negative Growth	5	9	9

Sources: Bloomberg.

the United States, Asia and Europe over the last 20 years. See Exhibit 5. (He noted the returns were in US dollars, so the "miscellaneous" category outside the United States reflects, again, multiple expansion/ compression and foreign exchange effects.)

He also shared Exhibit 6 which shows that earnings in the United States have been more stable for the last 20 years through Nov. 2024. For Asia, Rupp said, "This is not an earnings profile that you want to own—whether it's in a single stock or an index. This is the fundamental problem with passive investing in Asia."

He shared Exhibit 7 and noted technology companies have had higher returns over the last 20 years—and the US has a greater weighting in these firms. Financials, on the other hand, have had lower returns vs. tech stocks—and these firms have a greater weight in Asia.

Rupp added, "The skeptics and those who aren't looking for active management could rightly say that I'd rather pay 24 times for the S&P 500 than pay 15 or 16 times for Asia given the history and the volatility of the return stream. For the S&P 500, the median ROA and ROE are 12 and 31, respectively, so it's a pretty high quality group of companies at the top of the market cap spectrum."

Rupp said, "If we go to Europe, we see the same types of dynamics. Healthcare is the leading sector. But in Asia, financials are dominating the top of the market cap spectrum and, because of that, we've got much lower ROAs and ROEs."

The headline multiples alone don't necessarily paint a strong enough picture for people to really want to jump into Asia. "People would have done better historically if they knew which sectors or stocks to avoid and," he added, "really keep a concentrated portfolio. That's been my experience—and for the other funds that have done well in our orbit."

However, he noted that there are about 9,000 companies in Asia with greater than $100 million market caps and more than $1 million in daily trading activity vs. about 3,000 in the United States. He said those dynamics show the United States is a more mature market that reflects more consolidation. He added, “There are too many listed companies in Asia. A lot of them are family run, poorly governed, and should have remained private.” He added that more than half of those 9,000 companies have either no analyst coverage or fewer than five analysts following them. The US and Europe are much better covered markets. Looking at the top 100 companies in each region, Rupp noted how much larger the US market is, how many US companies are buying back shares and paying dividends. These statistics are summarized in Exhibit 8. But he also looked at median fundamental traits for the top 100 companies in each region and noted, “The US is a slightly more expensive market, but tends to have higher quality companies in their top 100, evidenced by their ROE.”

Exhibit 7 | The S&P 500: Greater Weighting in Technology Stocks vs. Europe and Asia

	S&P 500	**Euro 50**	**MSCI Asia**
Top Sector	Info Tech	Healthcare	Financials
Weighting	47%	31%	34%
Median ROA	11.7%	7.4%	5.3%
Median ROE	31.2%	19.8%	13.9%

Sources: Bloomberg, as of Nov. 2024

Exhibit 8 | Breaking Down the US, European and Asian Equity Markets

	US	EU	Asia
# of companies >100m USD Market Cap	3,486	2,671	12,688
# of companies >100m USD Market Cap and >1m ADTV	2,758	1,129	9,015
With fewer than 5 analysts covering them	664	126	4,714
With 0 analysts covering them	64	8	2,163
Sum of top 100 companies' market cap ($b)	37,689	9,404	9,647
# of top 100 companies buyback LTM	90	86	51
# of top 100 companies that pay dividend	82	97	94
Median of top 100			
PE	26.4x	20.1x	18.9x
PB	5.7x	2.4x	1.8x
ROE	20.5%	15.0%	13.0%
Dividend Yield	1.9%	2.7%	2.6%

Sources: Bloomberg; additional analysis by Parkway Capital, as of Nov. 2024

So what does that all mean?

"Asia is dominated by financials—and those financials have led to more earnings volatility, especially downside volatility," he said. He added that Iverson talked about a range of strategies along the active/passive continuum. "In Asia, one enhanced passive strategy might be to avoid financials. That would get you higher quality metrics in terms of ROAs and ROEs."

With respect to earnings, while the largest companies in Asia may have struggled to deliver consistent growth, Rupp said he has been able to find such consistent earnings growers in the region over the last 20 years as the opportunity set is much larger and less well covered.

Given his strong belief in earnings growth as a driver of stock returns, he compared the US and China. "US earnings, as noted, have been fantastic. And this goes to the strength of the US market and the strength of the S&P 500 Index. But let's look at China."

GDP and Stock Market Returns

He said in 1992, GDP per capita in China was $420. Today, it's about $13,000. "So, if you saw that growth coming and you put $100 into the MSCI China Index, it would be worth only $143 today. There's clearly a disconnect. It's really a failed index—and this gets to the problems of passive investing in Asia," Rupp said.

"You just reminded me of a study that Dimson, Marsh and Stanton did years ago on the relationship between GDP and stock market returns," Schmidt said. "You may see things going really well on the economic side in China, but you're not seeing that translate to equities—at least with the index. People tend to think the relationship between [GDP and stock market returns] should be hitched—but it often isn't." He added this relationship underscores the need to do "your homework and look at some of the companies in a region" and not simply make a bet on a country or region with an index. [Visit The Brandes Center website to read a summary of the original research here.]

Debt Levels for Asian Companies?

Schmidt asked Rupp if he were worried about debt levels with companies in Asia. Rupp said no. He added that, generally, Asian companies keep more cash on the balance sheet than in the United States due to "long memories." He said management tends to recall Asian crises where companies were not bailed out by the banks or government.

Of course, he added that too much cash may reflect management not running the business to return capital to shareholders. "You've got to be careful," he warned. "Too much cash could be a sign of poor governance."

Tariffs

Schmidt asked about, at the time, potential tariffs and their consequences. Trump had won the US Presidential election at the time of the discussion, but had yet to take office. Rupp said management teams in China, for example, likely were thinking about the issue. “They likely would have already moved some manufacturing out of China.”

Rupp added that the Trump campaign attacked Biden and Harris on rising inflation in the United States.

“So, it seems like a head scratcher that [the tariff] policies Trump is talking about are hugely inflationary. And even though he's going to be a lame duck President, I think he does care about his popularity. Tariffs could lead to even further problems for the middle class. So, I think it's going to be really hard for him to do what he what he says he's going to do.” Ultimately, he said “some sort of deal is likely.”

In Conclusion

“You have very high-quality companies in the US,” Iverson said. “But the question is: ‘What are you paying for them?’ The risk premium has shrunk; it is razor thin.”

He reiterated his “zero-sum game” comments about active and passive investing. “Trying to stick with your strategy during this [environment] is very, very hard to do. And so, ultimately, we see the capitulation of the institutional investor who gives up on their strategy. And that's when the market turns. This was a classic in the tech boom around ’99.”

Iverson said, “Once they've left the market, that leaves a lot more other investors around who are probably less capable at pricing these stocks. That gives you an opportunity. The price may look wrong, and it's hard to stick with it. But if you can, there is gold at the other end.”

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