THINK
Pieces
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Research Portfolios –

Strategic choice or “buying the index”?

Despite all remaining differences, the task of taking funding decisions on a portfolio of research projects is fundamentally similar and comparable to the task of investing in different assets on the financial markets. This text points at some possibly challenging consequences from exploring this analogy.

Portfolio Theory tells us not to put all eggs in one basket – and to optimize the risk-return ratio of investments through a clever mix of different assets. This is common practice not only for investing decisions on the financial markets, but also for organising research programmes across a wide range of themes, disciplines and laboratories.

For decades, it was common sense that the highest returns on the stock market could be generated by following a strategic approach – and public debate was dominated by the question which bits of analysis would contribute to such a winning strategy. Still today the business model of most investment funds is based on the marketing of either some sophisticated analytical techniques, or the particular experience and competences of the fund manager. Needless to say that both the fund manager and the analytical artillery do not come for free, so there is a (sometimes quite hefty) price to pay for following such a strategic approach.

In recent years, however, the historical success story of this “active” investment approach has somewhat faded away – as a far more simplistic approach might turn out to be more successful: Instead of spending important parts of the investment revenue on the costs for different forms of analytical and strategic efforts, it seems more rewarding to just invest in the entire market or “the index” without any differentiation between the various stocks – at a cost close to zero. The emergence of Exchange Traded Funds (ETF) has made it possible to apply this new logic not just in theoretical experiments, but in real life investments – and the steadily increasing market share of ETFs seems indicates that this “passive” investment approach is rapidly gaining ground.

At this stage, I would like to draw three rough conclusions out of these developments:

- Since uncertainty on the future developments is at the end of the day much higher than top analysts make us believe, the chances for a sustainable outperformance of an “active” investment over a “passive” one are very slim – on average, the index is performing better than the gurus …

- One key factor in this analysis are the differences in the costs for the fund management, which are rather substantial for most “active” investment funds and very low for the “passive” investment based on the market index.

- Finally, one should admit that “active” investment is far more fun than the rather dull and boring “passive” investment strategy – and hence it is a bitter lesson for many investors that the brilliant strategic analysis of future global trends did not translate into any real added value.

While it is certainly not appropriate to translate these observations directly from the stock market to the management of research portfolios, it seems interesting to explore the analogies a bit further:

- Contrary to the stock market, there is no easy way to measure the “performance” of an “active” management (based on strategic agendas and broadly agreed priorities) against a “passive” management approach, where funding is provided to (positively evaluated) research projects of whatever nature. This is an old debate, but surprisingly there seems to be no empirical evidence to illustrate the supremacy of the “strategic” approach in programme management

- The costs for establishing all kind of strategic documents, research agendas, and specific selection criteria are quite important. At the same time the quality of all this analytical efforts needs to be substantiated. Whereas on the stock market there is a natural selection process for those analysts who are persistently wrong, there might not be anything similar (yet?) for the strategic development of research priorities.

- Finally, again, one has to admit that as soon as politics comes into the game, it is extremely difficult to defend a “passive” or “hands off” approach – whereas the number of high level meetings, press releases and forward looking declarations one could generate from a “strategic” approach is truly appealing from the perspective of a politician.

In times where there is a tendency to emphasise the political importance of research, these reflections invite to a somewhat more critical look at the “active” or strategic approach for managing research portfolios.

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