Active vs. Passive Investing

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Index (Passive) investing has produced multiple benefits for investors

The growth of index-tracking funds and exchange-traded funds (ETFs) has forever altered the investment landscape for millions of investors. From a mere 80 funds with a combined $66 billion in assets in 2000, ETFs have grown to represent nearly $2 trillion in assets invested across more than 1,400 funds on behalf of 5.2 million U.S. households. At the same time, the share of equity mutual fund assets represented by index funds has more than doubled, to nearly 20%, according to the Investment Company Institute *(Investment Company Institute 2015)*.

The use of these passive strategies has been most pronounced in market segments such as large-capitalization U.S. stocks, where market efficiency and the abundance of information about those stocks make outperforming a given benchmark more challenging. This makes perfect sense, and investors have voted with their dollars—so much so that funds tracking the large-cap S&P 500 Index represented a third of all index fund assets at the end of 2014 *(Investment Company Institute 2014)*. However, the index investing revolution has done more for investors than merely provide inexpensive market exposure, or beta, to U.S. large-cap stocks.

Lowered fund expenses for all funds - One of the unexpected benefits of index investing is the effect it has had on expenses across all funds. As index funds and ETFs have attracted a growing share of investor dollars since 2000, expenses paid by investors in all equity mutual funds have dropped by nearly 30%. This is due in part to investors flocking to lower-cost options; however, competition from passive strategies has also pressured providers to lower costs of actively managed funds, which fell by 19% on average across bond and stock funds over the past 15 years *(Investment Company Institute 2014)*.

Raised the performance bar for active managers - The rising popularity of passive strategies, along with the steady drumbeat of financial news coverage on the percentage of U.S. large-cap funds that underperform their benchmarks, has sent a clear message to active managers: Earn your fees, or else.

As with the beneficial effect of fee competition, the focus on performance relative to passive strategies can only be good for investors, ensuring they get the value they expect for the fees they pay.

Refocused attention on investor outcomes - Apart from helping to lower fees and raise the bar on fund performance, competition that active strategies face from index funds and ETFs has refocused attention on investor outcomes, such as tax efficiency. Consider portfolio turnover, which creates higher expenses through trading costs. The asset-weighted average turnover rate among mutual funds has dropped to 43% from as high as 80% in the 1980s as more and more investors choose lower-turnover funds that generate fewer taxable distributions *(Investment Company Institute 2015)*.

Not all index-based approaches are the same

All passive strategies involve some active decision in their initial construction. While passive approaches have clearly benefited investors through lower costs and improved tax efficiency, it is important to recognize some of the more common shortcomings of indexes and ETFs.

Most passive approaches are capitalization weighted - Whether the proxy is the S&P 500 Index, the Russell 3000 Index, or the Wilshire 5000 Index, the composition of most indexes is proportional to the capitalization size of their component companies, so bigger companies get a proportionately bigger weighting in the index. One flaw in this approach is that, by definition, the largest-capitalization stocks have already experienced the greatest amount of price appreciation. The proportionate weighting of these stocks in most indexes is the equivalent of thinking that past performance will predict future results. For example, Apple is the largest holding in all three of the indexes mentioned. Investors in these strategies who believe Apple's best days are behind it have no choice but to own it as their largest holding. Conversely, capitalization-weighted indexes relegate the smallest—often younger, faster-growing—companies to proportionately smaller weightings.

Membership rotation creates unintended consequences - The composition of an index changes frequently, based on the index's guidelines and the changing dynamics of the markets. Index providers typically announce changes to composition in advance of implementation—for example, announcing on the 15th of the month additions and deletions that will go into effect on the first of the following month. Index funds cannot make any changes to their portfolios until the index is officially changed, but other investors often buy the new additions and sell the deletions right away to take advantage of the anticipated change in price. This front running creates an unavoidable performance drag for passive strategies as additions are bid up prior to inclusion and deletions begin to sell off before formally exiting the index.

Strategic beta strategies seek to address some of these issues - Strategic beta, or smart beta, strategies seek to combine the low-cost appeal of index investing with a selection, weighting, and rebalancing strategy that differs from traditional capitalization-weighted indexes. One common example is equal weighting the S&P 500 Index to give more weight to the smaller, undervalued names at the expense of the larger names that have already experienced significant appreciation. In doing so, the equal-weighted version seeks to eliminate the past performance bias inherent in capitalization-weighted indexes. While the variety and popularity of strategic beta funds have grown in recent years, all are defined by transparent methodologies that eliminate the need for ongoing research and portfolio management.

Many active managers outperform, even in efficient markets

The traditional argument against active management has been made using U.S. large-cap equity funds with the assertion that, on average, these managers fail to beat their benchmark indexes in any given year. While this is often true, it is a mistake to conclude that all active managers underperform. A growing body of research has begun to segment the universe of U.S. large-cap funds in order to demonstrate that, in fact, many active managers outperform their benchmarks over long periods of time, even in a market as efficient as that of U.S. equities, where companies are widely researched and information is readily available. One recurring measure that stands out as a characteristic of successful managers is high active share.

Active share as an indicator of performance potential - Active share measures how different a fund is from the benchmark it is measured against. A recent study by Invesco examined the performance of roughly 3,000 equity mutual funds over five market cycles that took place during the past 20 years and found that high active share funds (>60%) outperformed their benchmarks after fees, on average, in three of the five market cycles *(Think Active Can't Outperform, Think Again. Invesco, 2015)*. Active share is only one indicator of performance potential, and it is not without its critics; however, it is clear that a fund must be different from its benchmark in order to outperform it.

Outperformance over time does not require outperformance every year - The Invesco study and others suggest that active management may thrive in certain market conditions—those that include higher volatility, for example. As a result, the yearly reporting cycle of relative performance can fail to capture the value of active strategies designed to deliver performance over a full market cycle. For example, some managers employ disciplined strategies that involve seeking to protect assets in declining markets while keeping pace in rising markets. The full benefit of such an approach cannot be appreciated by looking only at periods when markets are strongly positive; rather, it becomes more apparent when viewing a combination of weak and strong markets.

Many markets provide opportunities for active managers to add value

The benchmark against which active managers are often measured—the S&P 500 Index—is an anomaly when viewed on the global stage: It includes a relatively small number of large, highly liquid companies about which information is readily available. In contrast, most areas of the global investment universe are considerably more complex, include illiquid securities, and are not widely covered by Wall Street analysts. As a result, most markets are less efficient than large U.S. stocks, have a wider dispersion of returns, and represent areas where research and active management can provide outperformance (or alpha).

Down markets - Large-cap U.S. stocks have experienced losses in 22 of the past 90 years; intra-year market pullbacks are even more common *(Morningstar)*. Market corrections are often characterized by emotional selling in which correlations increase and prices of high-quality stocks decline alongside those of low-quality stocks. Active managers have the ability to raise cash levels during these periods and sidestep some of the declining stocks. Typically, the percentage of active managers who historically outperform their benchmarks spikes during market declines.

Small-capitalization stocks - More than 15,000 small- and micro-cap stocks trade in the United States alone on various exchanges and in the over-the-counter market. Yet the entire capitalization of the Russell 2000 Index of small company stocks represents just 8% of the U.S. equity market's total capitalization. This compares with the S&P 500 Index, which represents 78% of U.S. equity market capitalization *(Russell Indexes)*. Given the sheer scope of the universe and the small size of its many constituents, the majority of small companies are not widely covered by Wall Street research, and the dispersion of returns is significantly wider than that of the S&P 500 Index, providing opportunity for active managers.

International equities - The breadth of opportunities and the dispersion of returns are even greater outside of the United States. In fact, researchers at the Rotterdam School of Management, working with Robeco Investment Management, found that performance persistence among active managers is strongly correlated with market breadth, and that global equities and emerging-market equities in particular possessed the greatest degree of market breadth *("Mutual Fund Performance Persistence, Market Efficiency, and Breadth," J. Huij and S.D. Lansdorp, 2012)*.

Fixed income - Outside of government sectors, fixed-income markets possess a number of characteristics that make them unsuitable for indexing, including illiquidity and a lack of reasonable bid/ask spreads. Varying market liquidity and a diversity of market participants driven by non-total-return motive (e.g., liability hedging, capital requirements, tax status, etc.) give an astute active manager an opportunity to add value over passive indexes.

Blending active and passive approaches offers the best of both worlds

The debate over whether one should choose an active or passive approach is ultimately misguided because investors can benefit greatly by combining both approaches in the same portfolio. There is ample evidence of how complementary these two approaches can be. Passive strategies can achieve market exposure cheaply and efficiently in certain markets. Active strategies can extend the reach of that portfolio and add risk mitigation or performance alpha, depending on the investor's goals. While high active share strategies have demonstrated their ability to outperform over time, beating a benchmark is too narrow a lens through which to view a well-rounded portfolio.

Potential applications for active and passive strategies

Passive: gain low-cost exposure to certain markets - For investors looking to accumulate wealth, index-based passive strategies can offer low-cost exposure to markets where active strategies have historically had a more difficult time outperforming. This is particularly true of U.S. large-cap equities. The weighting of index strategies in a portfolio is a necessary function of investor need and suitability, but may be influenced by the degree to which the investor wishes to reduce expenses and increase tax efficiency.

Strategic beta approaches may improve this dynamic further by focusing on proven factors that drive stock returns and by reducing the market capitalization bias of traditional indexes.

Active: pursue objectives beyond pure market beta

Portfolio stability - One of the outcomes of the 2008 crisis was a desire for portfolio-stabilizing strategies that would provide a buffer against volatility while also earning more than cash. As a result, many investors began incorporating absolute return strategies into their portfolios. Employed for several decades in the hedge fund world, absolute return strategies put aside the traditional benchmark-centric approach and instead seek to deliver positive returns across all market environments with significantly less volatility than equities. Some varieties target specific levels of absolute return, but all employ a wide range of portfolio tools, such as raising cash and short selling, to pursue their objectives.

Deeper diversification - A related outcome of the crisis was the realization that traditional asset classes can become highly correlated in the midst of a severe market event. Alternative strategies have proliferated in the intervening years, providing investors with a wide variety of non-correlated investment approaches, including currency, market-neutral strategies, real assets, and more. When employed alongside traditional asset classes, alternatives have the potential to deepen the level of portfolio diversification while also pursuing market-like returns.

Niche alpha - While risk mitigation was the driving force of product innovation after the financial crisis, a number of opportunistic strategies also had their origin in that time period. In fixed income, for example, the dramatic decline in risk-free rates of return spurred the development of strategies that pursued additional drivers of return, including mortgages, emerging-market debt, and high yield.