Actively vs. Passively Managed Funds

The opportunity for market outperformance has long encouraged investors to take advantage of professionally, actively managed funds. On the other hand, the low fees associated with passively managed funds also attract investors. The question is whether the higher potential returns or lower associated fees are more advantageous for investors. Over the long run, however, a combination of both strategies by asset class may be the most appropriate for the long-term investor.

The Advantages of Active Management

Actively managed funds are comprised of individual securities selected by a manager or a team of investment managers based on fundamental research and quantitative methods. Actively managed funds provide the opportunity for investors to outperform a benchmark. Investors have the ability to take on additional risk in exchange for the opportunity of obtaining higher-than-market returns. Additionally, actively managed funds allow managers to potentially reduce volatility. By investing in less-risky, high-quality companies rather than in the market as a whole, the portfolio could be less volatile than a market index. Also, the ability to choose investments that are not highly correlated to the market provides customized diversification and reduces overall portfolio volatility. Furthermore, managers can overweight or underweight sectors compared to the market as a whole to have the opportunity to outperform the general market indices. Therefore, actively managed funds are used to customize funds for different client goals with the potential to outperform the market.

The Advantages of Passive Management

In contrast, passively managed portfolios mirror the components and returns of a market index. An example is the Vanguard 500 Index fund, which is invested in the 500 stocks of Standard & Poor's 500 Index. Capital in an index fund is automatically invested proportionately into individual stocks or bonds according to the percentage of their market capitalizations represented in the index. Passive investing can also be accomplished through exchange-traded funds (ETFs), which track an index but trade like a stock. Passively managed funds give investors exposure to broadly diversified segments of the market. Less buying and selling of securities also equates to fewer transaction costs and lower management fees than actively managed funds. In addition, passive funds give investors predictable performance relative to a benchmark, while eliminating concerns about human error or management tenure. David Swenson, former Chief Investment Officer of Yale University's endowment fund, explains, "Most individual investors lack the specialized knowledge necessary to succeed in today's highly competitive investment markets…passive index funds are most likely to satisfy investor aspirations." Swenson goes on to say, "Unless an investor has access to 'incredibly high-qualified professionals,' they should be 100 percent passive."[1]

The Drawbacks of Active Management

While the opportunity for outperformance of actively managed funds is appealing, the argument against actively managed funds is that management fees and transaction costs cut into the investor's profit. Barry Ritholtz, Chief Executive Officer and Director of Equity Research at Fusion

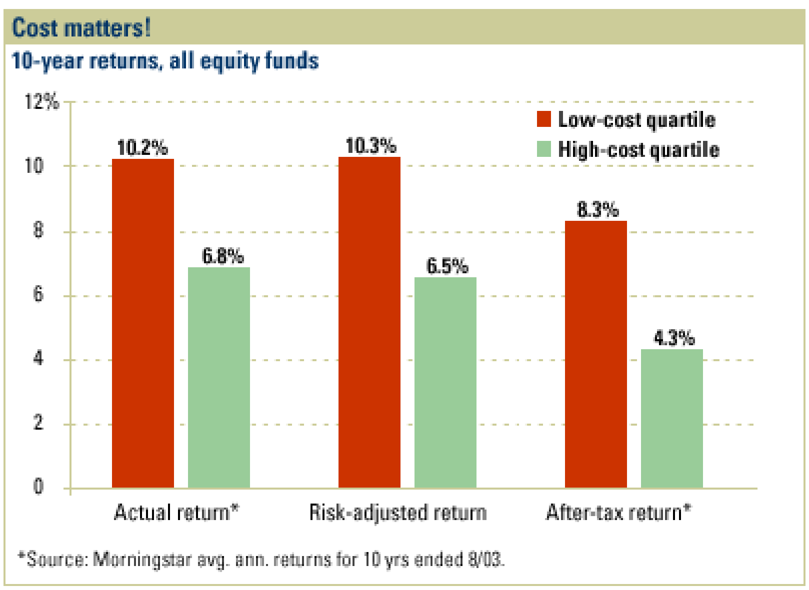
[1] "John C. Bogle Legacy Forum," Bloomberg, 2012

IQ, conducted a study quantifying the relationship between the total costs of equity funds and their returns.[2] The study analyzed the costs and returns of all 803 diversified U.S. equity funds in the Morningstar database over the ten-year period ended August 30, 2003. The average expense ratio for these funds was 1.3%. In addition, the average portfolio transaction costs were estimated to be 0.7%, for a total cost of 2.0%. (The study conservatively assumed that transaction costs totaled 1% of turnover, or ½% on each side of the trade).

The results were that the high-cost quartile of funds, which had expenses of 3.4%, earned an average annual return of 6.8%. The low-cost quartile, with expenses of 1.0%, earned an average annual return of 10.2%, surpassing the high-cost quartile return by 3.4% per year. Therefore, the study evidenced that as costs decrease, returns increase. On a fund-by-fund basis, the inverse correlation between cost and return was notable: negative 0.60%.

Moreover, the study found that the funds with the highest costs also took on the highest risks. The high-cost quartile of funds had a standard deviation 30% higher than the low-cost quartile funds. The high-cost funds also generated the highest turnover, 160% compared to 22% turnover of the low-cost funds. Finally, the high-cost quartile of funds was least tax-efficient as well. As a result, the low-cost quartile of funds had an even greater advantage over the high-cost quartile: 3.8% per year in risk-adjusted return, equating to an advantage of 4.0% per year in after-tax return. Exhibit 1 displays the results of the relationship between fund costs and fund returns.

Exhibit 1



The investment implication is clear, according to Mark Kritzman, President and Chief Executive Officer of Windham Capital Management of Boston. "It is very hard, if not impossible," he wrote in the New York Times, "to justify active management for most individual, taxable investors, if their goal is to grow wealth."[3]

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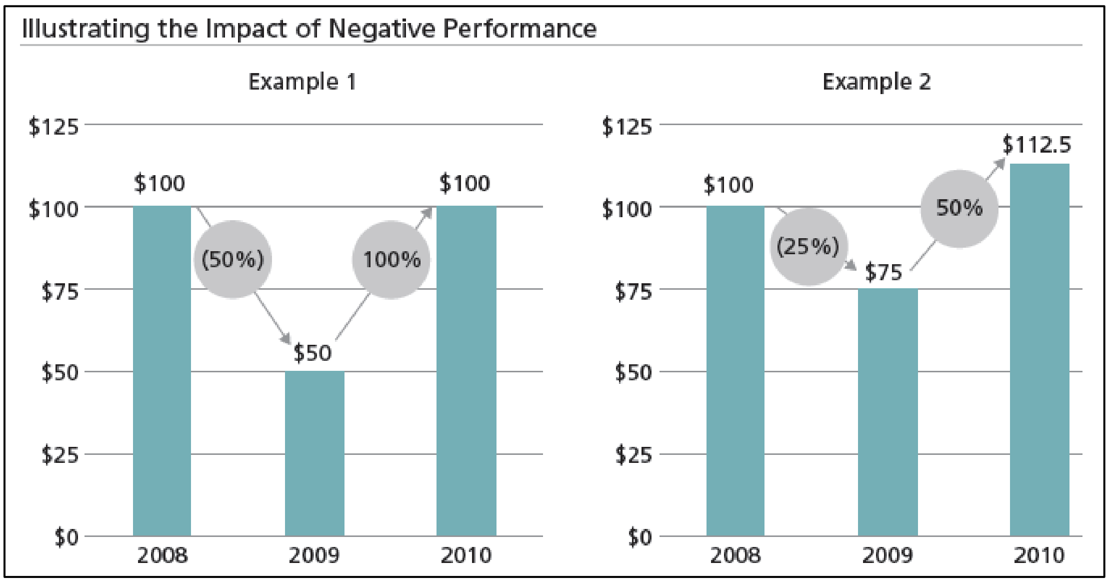
[2] "Bogle on Active Management," Barry Ritholtz, 2012
[3] "The Index Funds Win Again," The New York Times, 2009

The Drawbacks of Passive Management

The argument against passively managed funds is that in market downturns, the passively managed funds follow the overall market, missing the opportunity to customize investments for the specific market environment. Matthew Rubin, Director of Investment Strategy at Neuberger Berman, writes, "Passive strategies attract investors with low fees and — when the market is performing well — market-like returns. The flipside is that during a downturn, the value of passive investors' portfolios fall in sync with the market, often experiencing significant volatility along the way."[4] Whereas passive strategies are inhibited by investment policy to remain fully invested, active managers have the flexibility to protect on the downside by reallocating a portfolio to hold more defensive stocks or higher cash levels until the investment environment improves. Exhibit 2 illustrates that successful downside protection improves the average returns of a portfolio over a full business cycle by shortening the path back to a break-even point.

Exhibit 2



Source: Neuberger Berman

In Example 1, a significant market downturn leads to a 50% loss on an unprotected fund, bringing the portfolio balance from $100 to $50. Example 2 is an actively managed portfolio with successful downside protection that limits the loss from the market downturn to 25%. In the active portfolio, the balance is only reduced to $75 as a result of defensive management actions. In order to breakeven and bring the portfolio value back to the original $100, the unprotected fund must increase 100%. However, if the actively managed portfolio only returns 50%, half of the unprotected portfolio return, the active fund already surpasses its breakeven point reaching a value of $112.50. Thus, the flexibility of active management to customize portfolios for specific market conditions is a valuable tool for investors not found with passive management.

[4] "Active Portfolio Management: An Attractive Option for Today's Market," Neuberger Berman, 2010

Mixing Active & Passive Management

The best option for investors may be to mix active and passive investments, benefiting from the advantages of both fund styles. Since there are instances when one type of fund management outperforms the other, allocating a portfolio between actively managed and passively managed funds could provide additional returns to investors.

Academic studies and literature are split on the active/passive management debate in the highly efficient large cap and fixed income asset classes. From 1992 to 1998, the S&P 500 outperformed 95% of large cap equity core managers and also prevailed for the ten years ending in 2006.[5] However, between 1998 and 2007, more than half of large cap active managers beat the S&P 500.[6] Active managers also outperformed the S&P 500 Index from 1999 through 2006.[6] Thus, different time frames lead to different conclusions.

With regard to fixed income, John Bogle, founder of Vanguard, sites that passive funds beat 85% of active competitors in 2008 and also for the preceding four years.[7] On the other hand, Bill Gross, founder of PIMCO, promotes active management for fixed income as a result of his company's success in actively managed bond funds. PIMCO writes, "Active bond managers can tactically position their portfolios for changing rate environments by using a range of strategies, including duration management and the flexibility to invest in sectors that can both defend against and potentially benefit from rising rates."[8] In 2012, the environment allowed active bond managers to capitalize as 58% of actively managed fixed income funds beat their benchmark.[9]

Longer-term results calculated by Callan and Rogerscasey cover 20 and 25 year time frames, respectively.[10] According to both organizations as well as others, active managers have been more successful than passive styles in small cap, international equities, emerging markets, and real estate investment trusts (REITs). Callan's performance analysis is summarized in Exhibit 3.

[5] "When Indexing Really Shines," Wall Street Journal, 2009
[6] "Active Versus Passive Investing," Wells Fargo, 2012
[7] "A Discussion with John Bogle," Index Universe, 2009
[8] "Active Management Strategies for a Complex Rate Environment," PIMCO, 2013
[9] "Active Versus Passive Bond Funds," Forbes, 2013
[10] "Active Versus Passive Investing," Wells Fargo, 2012

Exhibit 3

Median Active Manager Average Performance

Annualized Excess Return for Twenty Years Ended March 31, 2012 Excluding Fees

Large Cap Core vs. S&P 500 Index	0.08%
Large Cap Growth vs. Russell 1000 Growth Index	0.31%
Large Cap Value vs. Russell 1000 Value Index	-0.63%
Mid Cap Broad vs. Russell Midcap Index	0.36%
Mid Cap Growth vs. Russell Midcap Growth Index	0.76%
Mid Cap Value vs. Russell Midcap Value Index	-0.18%
Small Cap Broad vs. Russell 2000 Index	2.08%
Small Cap Growth vs. Russell 2000 Growth Index	3.01%
Small Cap Value vs. Russell 2000 Value Index	1.01%
Global Equity vs. MSCI World Index	2.39%
International Broad Equity vs. MSCI EAFE Index	2.14%
International Small Cap vs. MSCI EAFE Small Cap Index	0.89%
Emerging Markets vs. MSCI Emerging Free Index	1.43%
Core Bond vs. Barclays Aggregate Index	0.25%
Core Plus Bond vs. Barclays Aggregate Index	0.70%
High Yield vs. Barclays High Yield Index	0.54%
Non US Fixed vs. Citigroup Non-US Gov Index	0.40%
REITs vs. NAREIT Index	2.00%

Source: Callan Associates presentation "Historical Active Management Premiums by Asset Class & Style"- March 31, 2012

Conclusion

Both actively managed funds and passively managed funds have outperformed the other in certain asset classes in the past. As a result, incorporating both active and passive investments by their asset class strengths in the current environment may be the best strategy to increase the probability of yielding superior returns. If passively managed funds are more likely to outperform active funds in large cap and fixed income asset classes in the future, investors should take advantage of the low expenses associated with passive funds in these asset classes. Conversely, if actively managed funds are more likely to beat passive funds in small cap asset classes, international equities, emerging markets, and real estate investment trusts (REITs), the flexibility and customization of actively managed funds often lead to greater returns in these asset classes. However, which management style will outperform in each asset class in the future is subject to even more debate than so in the past. Therefore, giving the participant the option of both actively and passively managed funds may be the best fiduciary decision.