Averages aren't the Answer in the Active vs. Passive Debate

New Research Alludes to Stronger Active Returns

The debate over active versus passive management styles is years in the making with strong proponents on each side. As we cited in our September 2014 article, [Active vs. Passive Management](), there are advantages and drawbacks of each. At the end of each year, the industry is flooded with headlines citing which management style came out on top. In recent years, average returns show passive investments outperforming active management, but are averages indicative of the best opportunity for an investors' portfolio?

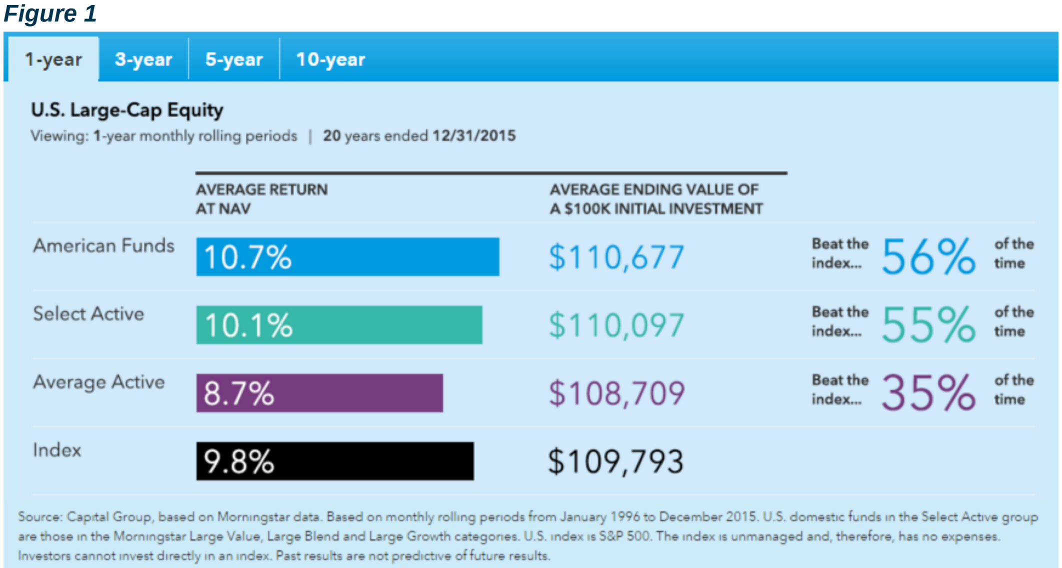
American Funds Active Scorecard

For the last decade, there has been a trend of investors moving money from actively managed funds to their indexed counterparts. A recent research project conducted by American Funds urges investors to consider two key factors before making the leap to an index-only investment strategy.

Can a select group of actively managed funds consistently beat their index? According to American Funds, "research proves that two simple screens can uncover a group of funds that, when taking the average for the group, has beaten the indexes over one-, three-, five- and 10-year rolling periods." To compile this group, referred to as "Select Active Funds", American Funds searched the Morningstar database of large-cap, actively managed funds for those that were in both the lowest quartile for expense ratios and the highest quartile for manager ownership at the firm level. Their results conclude that, on average, this group delivered higher results compared to market indexes over time.[1] Figure 1, below, compares U.S. large-cap equities for the 20 years ended 12/31/2015 with 1-year monthly rolling periods.

For more information on the methodology used by American Funds, please visit the [American Funds website]().

Figure 1



[1] American Funds from Capital Group. The Active Scorecard. https://www.americanfunds.com/advisor/insights/the-active-advantage/active-scorecard.html

While it may seem like a no-brainer to focus on funds in the lowest priced quartile, the reasoning behind the manager ownership requirement may not be as evident. As Steve Deschenes, Sr. VP in Client Analytics and Research at American Funds, explains, “Portfolio manager ownership goes to stewardship and having interests aligned with investors. Having some skin in the game is an indirect signal of good stewardship.”[2]

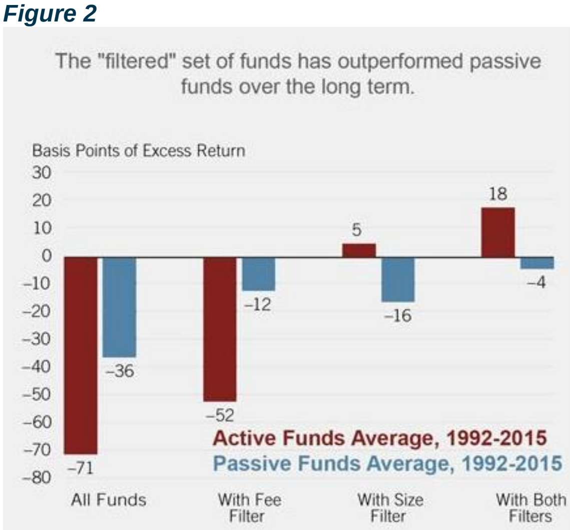
Fidelity Filters for the Best

Following the release of American Funds’ research, Fidelity Investments published similar results of their ongoing research on the debate of active versus passive management. As the Fidelity Viewpoints team identifies, many industry professionals and news outlets reported that 2015 was a challenging year for active managers, with the average actively managed fund falling short of its index and U.S. large-cap stocks underperforming, in particular. They pose an important question, however. “What if those overall averages were not really representative of the active funds investors tend to favor?”[3]

Similar to the screens applied by American Funds, Fidelity uses two filters to compile a more selective group of the top actively managed funds. Based on the previous year’s research, Fidelity applied filters to select funds in the lowest expense quartile from the five largest fund families[4] including American Funds, Fidelity, JP Morgan, T. Rowe Price, and Vanguard. As shown in Figure 2, they found that, on average, this smaller, select group outperformed both the respective benchmark and the industry as a whole.

For more information on the methodology used in Fidelity’s research, please read this [article](#) by the Fidelity Viewpoints Team on Forbes.

Figure 2



Source: Morningstar, Fidelity Investments, as of Feb. 9, 2016.

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[2] Benjamin, Jeff. American Funds says low fees, manager ownership can save actively managed funds. Investment News. 18 March 2016.

[3] Fidelity Viewpoints Team. Some Active Funds Rise Above A Tough Year. Forbes Brand Voice. 24 March 2016.

[4] These fund families are considered the largest based on having the most assets under management (AUM) for U.S. large-cap equities.

The Bottom Line

There will always be proponents of only active management and proponents of solely passive management. The significant takeaway from this research is to look at the specific funds you are investing in. The average returns for the passive or active sectors as a whole may not be indicative of the funds you are invested in or those you may be considering. Several studies outside of these have shown that well managed, low cost fund alternatives tend to perform better than funds without those criteria.

Another key takeaway is to not be reactionary to media commentary. News headlines are designed to elicit strong emotions and quick responses. The educated investor should feel secure in their long-term investment strategy and the funds within it and stay the course.

Allowing plan participants to choose from investment alternatives including both actively and passively managed funds may be the best fiduciary decision. This allows investors to take advantage of the benefits of both management 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.