The ongoing debate between active and passive investing is not as simple as it may seem. There are many variables to consider and it may not be wise to make an all-or-nothing decision since one approach is not necessarily better in every case. Fortunately, active and passive investments are not mutually exclusive, so investors don’t have to choose sides. It may make sense to use a passive index fund in one asset class, but hire an active manager in another. Active management tends to be cyclical, so managers can produce a wide range of outcomes, especially in the short run. However, the passive universe includes a huge mixture of investment products with meaningfully different characteristics, so passive products can also produce vastly different outcomes. Because of this, a rigorous due diligence process is needed for both active and passive manager selection.

Starting Behind - Does It Matter?

Active managers face several challenges when it comes to outperforming passive alternatives. Since they tend to charge higher fees than their passive counterparts, they have to outperform by the amount of their additional expenses just to get back to benchmark level returns. Another obstacle they face is a cash drag. Running an active portfolio usually requires at least a small cash position to maintain flexibility and liquidity, and that cash is a burden on returns since the market rises more than the interest earned on cash a majority of the time. In addition, the nature of the markets requires there to be a buyer for every seller and vice-versa, so there can only be so many winners among active managers. Because of these hurdles, the average active manager will likely underperform the average passive manager over the long run. However, no one expects to hire an average active manager. From an investor’s point of view, if there is a high likelihood of both identifying and sticking with a skilled manager who can add value in a particular asset class, it doesn’t really matter how the rest of active managers perform. Conversely, if the odds of picking a winning manager are slim and the value that manager can add is minimal, it may be wise to implement passive exposure in that area.

The Benefits of Passive

There can be several advantages to using passive investments. The expense ratios of passive mutual funds and ETFs tend to be relatively low, often below 0.10% for products that broadly track traditional asset classes. Most of the larger passive managers have become proficient in tracking indices to the point that the difference in returns between the investment vehicles they manage and the indices they follow is negligible, so investors can get their targeted exposure. In addition, many index providers have adjusted their methodology in order to make their indices more investor-friendly as they consider the implications of trading. Passive products tend to be tax-efficient, since they often have low turnover and are mostly self-rebalancing if weighted by market capitalization. They do not carry the same key-man risk of strategies run by one or a few skilled managers, and they generally don’t have capacity constraints, style drift, or cash drag. Because of these benefits, passive investments should be given strong consideration in asset classes that haven’t historically provided a good opportunity set for active managers.

Choosing Sides

Active managers have had much more success in certain asset classes than others. Looking at the long-term rates of outperformance for active products serves as a good starting point for deciding whether or not it is practical to expect a manager to add value in a particular category. In order to validate the rationale for these results, it is also important to look at structural reasons for efficiency or lack thereof in the market segment under scrutiny. Since active management can be cyclical, as illustrated below, it may be helpful to look and see if a time period contains conditions that provide a more favorable environment for active managers in general, which can include bear markets, extreme valuations, and low stock correlations for equity managers. Taking a look at style and factor exposures, which tend to go in and out of favor, is also an important step for setting proper expectations and gaining insight into the chances of long term success for active managers. If the outlook still looks grim, the next step is to examine which passive products are attractive alternatives.
The Subjective Side of Passive

Rather than trying to pick the best stocks or bonds, passive funds usually aim to own all (or most) of the stocks or bonds in a certain category, while providing this pool of assets at a low cost. However, there is no such thing as a completely objective passive fund. By definition, passive investment products track an index, and that index is designed and maintained by people. Those people have to make subjective decisions when creating the rules for that index. Given the growing interest in passive products and the virtually unlimited combinations of variables in play for designing an index, there are now more indices than individual US stocks. Between ETFs and open ended mutual funds, there were 2,428 index-linked investment products as of this writing. The massive assortment of passive vehicles that track these indices can look very different from one another, so a close look at the nuances within these products is needed to avoid unwelcome surprises from a passive allocation.

INDEX FUNDS

<table>
<thead>
<tr>
<th>Category</th>
<th>ETFs</th>
<th>Mutual Funds</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Alternative</td>
<td>468</td>
<td>102</td>
<td>570</td>
</tr>
<tr>
<td>Equity</td>
<td>1227</td>
<td>333</td>
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</tr>
<tr>
<td>Fixed Income</td>
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<td>59</td>
<td>298</td>
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<tr>
<td><strong>Total</strong></td>
<td></td>
<td></td>
<td><strong>2428</strong></td>
</tr>
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</table>

Many index funds are weighted by market capitalization, but some are equally weighted, others are fundamentally weighted, and a few are price weighted. Some are essentially all inclusive, but others have much stricter criteria. Indices can hold just a few securities or hold thousands. These differences can be illustrated using some of the more
widely known indices. The Dow Jones Industrial Average is a price weighted index of 30 stocks that are picked by a committee based on very broad guidelines. The S&P 500 is a market cap weighted index with approximately (but rarely exactly) 500 stocks that are also picked by a committee after meeting a few restrictions. Meanwhile, the Russell 2000 is a market cap weighted index that compiles roughly 2,000 stocks using a rules-based methodology.

When it comes to tracking an index with an investment vehicle, it is often impractical to hold every security in the index. For example, the stocks towards the bottom end of the Russell 2000 tend to be fairly illiquid, so products that track this index will often make adjustments around these stocks. This helps them to avoid costly trading that would be required to stay perfectly in line with the index, and usually makes little difference in the portfolio since stocks this small carry a negligible weight. On the fixed income side, the Bloomberg Barclays US Aggregate Bond Index represents the US investment grade bond universe, but products that track it don’t actually hold all of these bonds since this would not be feasible. Instead, they use sampling approaches in order to replicate its characteristics in a cost-effective manner. While some of the nuances within index methodology and index tracking techniques are there to provide more investable products, investors should still pay close attention to the details in order to make sure they get their intended exposure from passive funds.

**Similar Names, Different Results**

Passive products with similar names can have surprisingly different characteristics. For example, two of the more widely followed US mid cap indices are the S&P MidCap 400 (S&P 400), and the CRSP US Mid Cap (CRSP). Just going by the names, it may seem like they would provide similar exposure. However, a closer look at their methodology shows that is not the case. The S&P 400 targets a group of select stocks with market caps of $1.6-$6.8 billion, while the CRSP tracks stocks with market caps that fall within 70%-85% of the broad US market, which translates to stocks with a market cap range of roughly $8-$21 billion. This means that even though they are both headline indices for the US mid cap market, there could be zero overlap between them if they were to reconstitute on the same day! Because of this, products that track these indices can generate meaningfully different returns, and risks, during periods in which there is a wide dispersion between the performance of stocks based on market capitalization. This was precisely the case in 2016, which resulted in the CRSP generating a total return of 11.25% compared to 20.74% for the S&P 400.

![US Mid Cap Index Returns - 2016](image)

Source: FactSet

Performance dispersion of over 9% in a single year illustrates the importance of paying attention to index methodology when selecting passive investment products.
Challenges Remain

Passive funds may be appropriate for many investors, but the work does not stop there. Decisions still must be made regarding asset allocation, rebalancing, and which specific passive vehicles should be used. Additionally, the behavioral challenges associated with investing will not be eliminated just because of a choice to “go passive.” Investors, broadly speaking, tend to adhere to a number of behavioral biases that lead them to buy and sell at suboptimal times. One common bias is to think that a hot fund will continue to stay hot, which results in performance chasing. Fund flows data shows that many of the shareholders in top performing active mutual funds never actually benefited from the funds’ performance since they bought after periods of outperformance and sold following periods of underperformance.¹

Chasing Performance

Given the subjective nature of passive investing and the sheer number of products available, it should come as no surprise that this type of behavior often still applies to investors who use passive investments. Though chasing the performance of an individual manager may not be in play, investors still face the lure of trying to boost performance by timing the market, constantly changing asset allocations, chasing factors that have been in favor, swapping passive products within the same category, or moving back and forth between active and passive vehicles. Since trying to time the market rarely adds value over the long run,⁶ careful consideration of what is in one’s portfolio and why can give investors a conviction that will help them to avoid these temptations and maintain a disciplined investment process.

Conclusion

The inherent difficulties of active management and the nuances within passive management point to the necessity of a thorough and structured due diligence process for both types of investments. Both active and passive products can be appropriate, but only a careful look at the characteristics of each will allow investors to create a prudent portfolio, set proper expectations, and have confidence in their decision making.▲
Sources:
1 Morningstar Direct
2 Bloomberg
3 S&P Global
4 FTSE Russell
5 CRSP
6 CFA Institute: Scott D. Stewart “Manager Selection”

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<table>
<thead>
<tr>
<th>Investment, Insurance and Annuity Products</th>
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</thead>
<tbody>
<tr>
<td>Are Not FDIC-Insured</td>
</tr>
<tr>
<td>Are Not Insured by Any Federal Government Agency</td>
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