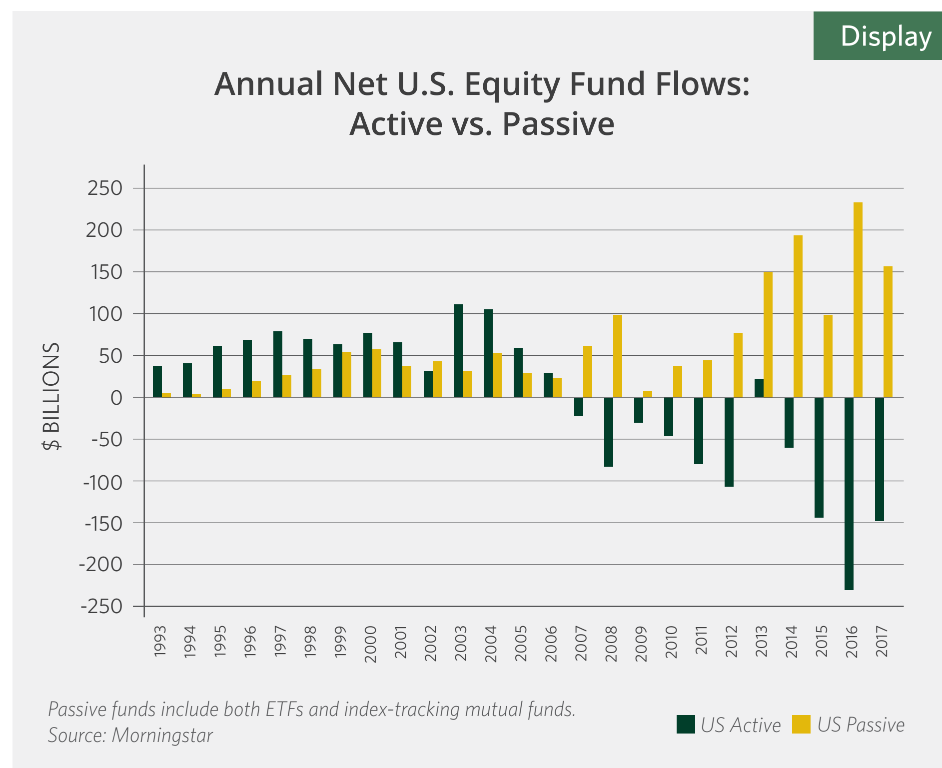
MONETA INVESTMENT MONTHLY

Active vs. Passive: The Debate That Never Ends

In the world of investing, no bigger debate can be found than that of active versus passive management. At a high level, the discussion boils down to performance: active management supporters tout their ability to analyze an abundance of information in order to outperform the market, while passive investing (index tracking) proponents simply reference active managers' inability to outperform the market over the long term and their higher fees. The reality though is that many investors are not best served by simply taking an either/or approach. Instead, it's worthwhile to consider passive funds as well as active managers whose philosophy is aligned with the investors' objectives.



Passive funds include both ETFs and index-tracking mutual funds.
Source: Morningstar

Taking Sides

First and foremost, it's always worth noting that those who are the most vocal are typically talking their book. In other words, most approach the debate starting with their own biases. One of the passive side's most popular jabs is that active management is a "loser's game," meaning that in every trade, one of the parties is making a mistake and the higher fees that active managers charge are not justified. All that matters, according to the passive proponents, is how the stock market performs over the long term.

On the other hand, active managers will note the importance of stock selection in order to beat the market, often referencing periods of heightened volatility. Unlike passive products, active managers have the ability to reduce or avoid exposure to weaker companies and/or sectors. Passive investors are assigned allocations to companies based on the index's methodology. For example, in a product tracking the S&P 500 Index, the weightings in the portfolio are assigned simply by the company size (market capitalization).

Regardless of which side of the argument is "right," one reason this debate has become so intense is because of the flow of assets into passive products, primarily at the expense of active managers. Many investors have clearly indicated their preference for passive, whether it's because of performance, tax efficiency, costs, or some combination of the three. Additionally, many firms are pushing passive-only investing simply because, in their opinion, recommending products with the lowest fees is a major indicator of providing the best fiduciary duty for clients.

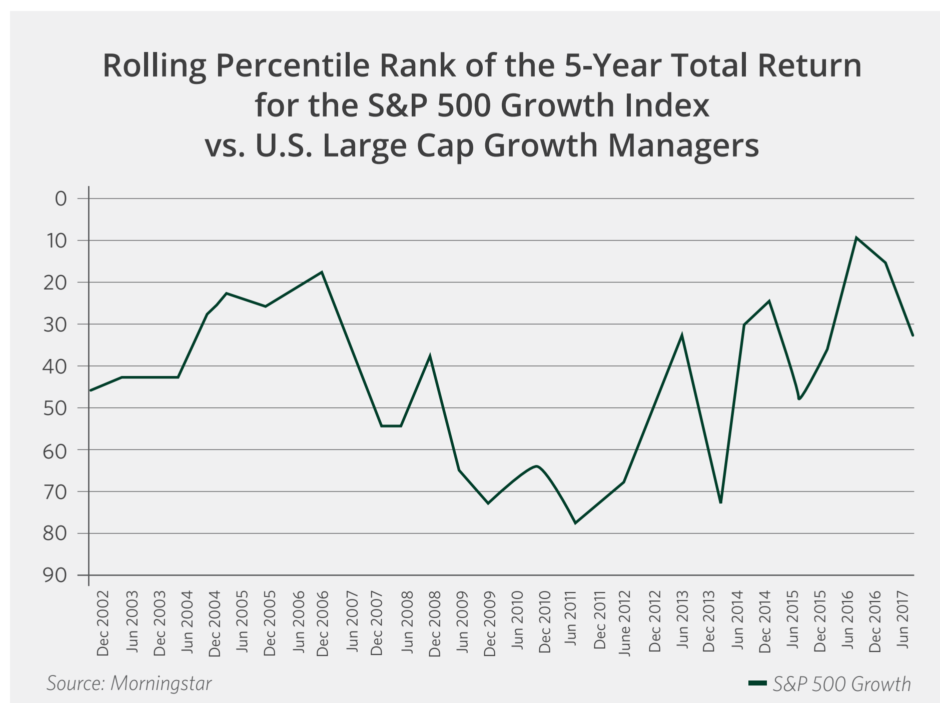
Even though active mutual funds still far exceed passive funds in terms of assets, actively managed U.S. equity mutual funds have seen an annual net outflow of cash in 10 of the past 11 years (including the first three quarters of 2017). Conversely, passive U.S. equity funds have received net inflows every year since 1993 (*Display*).

Where the rubber meets the road

After several years of consistent under-performance, possibly driven by factors like low market volatility, low return dispersion and high stock correlations, the skies have been brightening in 2017 for active managers relative to their benchmarks. For example, according to S&P Dow Jones Indices, in June 2016, only 5% of U.S. large-cap growth active managers had outperformed their benchmark on a year-over-year basis. As of June 2017, that number had increased to 62%.

That being said, it will take a steady series of out-performance going forward for longer-term active management numbers to improve. Staying with U.S. large-cap growth, even with the recent recovery in performance, only 24% outperformed over the past five years and just 8% over the past 10 years through June. Additionally, history has proven that it's very challenging to find managers that either consistently outperform their benchmark or even survive over the long term. However, many are cautiously optimistic that the tide has finally turned. Finally, it's always important to consider that this data is time-period dependent as relative performance has shown to be cyclical, historically, which is reflective of the market environment.

For example, as shown in the display below, the percentile rank of the S&P 500 Growth Index's five-year total return has varied significantly relative to U.S. large growth managers over the past 20 years.



Source: Morningstar

Where does this leave us?

There is no question that outperforming a benchmark is a daunting task for managers, especially over the long term. It's also clear that investors and advisors have preferred passive vehicles over active, reflected in asset flows. However, we at Moneta do not believe this is a binary decision. Active management's periodic under-performance should not be reason enough to simply discard a manager, as there may be more to the story:

- Does the strategy's philosophy naturally cause under-performance in certain periods (e.g., never hold companies with negative earnings)?
- Is the manager more risk-averse (e.g., placing an emphasis on downside protection and limiting volatility of the portfolio)? Passive products provide full participation on the upside but they also provide full participation on the downside, which could create value when using an active manager.

Even though active investing seems to have become a punch line for a bad joke, both active and passive investors are essential to the other's survival, and making the argument that one is always better than the other is a fruitless exercise. There are too many variables on both sides that raise questions while offering no unambiguous answers. Bottom line, we believe it's prudent for investors to consider both active and passive vehicles as options in their investment portfolios.

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