Heritage Wealth Advisors

Investment Insights: Passive versus Active Management

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The debate on passive versus active management is ongoing in the investment community. Below, we describe the differences between passive and active management, detail the recent trends associated with the two strategies, and explain why and how we incorporate both in client portfolios.

Passive Management: refers to investment products that replicate an index. Popular indices followed by investors include the S&P 500 for U.S. large cap equities, the MSCI All Country World index ex. U.S. for international equities, and the Barclays Aggregate Bond index for U.S. bonds. Passive management provides a low-cost means to gain broad exposure to a particular asset class or sector. Passive investments typically have low fees and expenses. Additionally, as buy-and hold-strategies, they tend to be more tax-efficient (lower turnover results in fewer trading costs and taxable distributions). Activity only occurs when the index is reconstituted based on its definitional parameters, or when M&A transactions take place among the index's constituents. Passive investments are primarily offered via exchange traded funds (ETFs) and index mutual funds.

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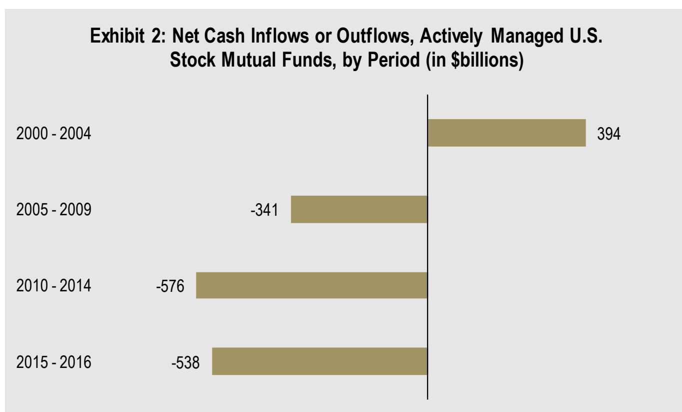
Active Management: refers to investment strategies designed by professional managers with the objective of beating the index that serves as a relevant comparison benchmark. Effective active strategies add value through driving returns in excess of the benchmark or providing risk mitigation within a portfolio. Investment managers construct strategies based on their investment philosophy and process with the goal of delivering a better outcome than the benchmark. As such, a fund's sector weightings and holdings typically differ meaningfully from the benchmark. Relative to passive investments, active strategies tend to have higher fees and expenses. Investors pay for the manager's expertise and the incremental value they strive to generate. Additionally, the manager's strategy typically results in higher turnover than the index, potentially making it less tax efficient. In order to beat their benchmark, managers must outperform the index after incurring all "active" costs. Active investments are offered via mutual funds and separately managed accounts.

Exhibit 1: Passive vs. Active Management Summary Comparison

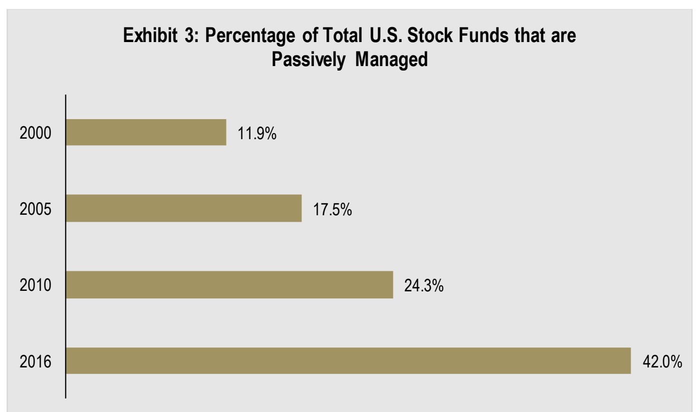
Passive Management		Active Management	
Rationale	Gain broad market exposure Low cost Tax efficient	Rationale	Drive returns in excess of the benchmark Risk mitigation
Vehicles	Exchange traded funds (ETFs) Index mutual funds	Vehicles	Mutual funds Separately managed accounts Individual securities

Recent Trends

Historically, the vast majority of equity assets under management have been deployed into active strategies. With the formation of low-cost ETFs and index mutual funds, however, passive management has grown in popularity. Today, Americans hold approximately $3 trillion in over 1,700 ETFs, up significantly from about $66 billion in more than 80 funds in 2000.[1] Factoring in both ETF and index mutual fund investments, 42% of all U.S. equity fund assets are passively managed today, compared to 12% in 2000.[1]



Source: Investment Company Institute

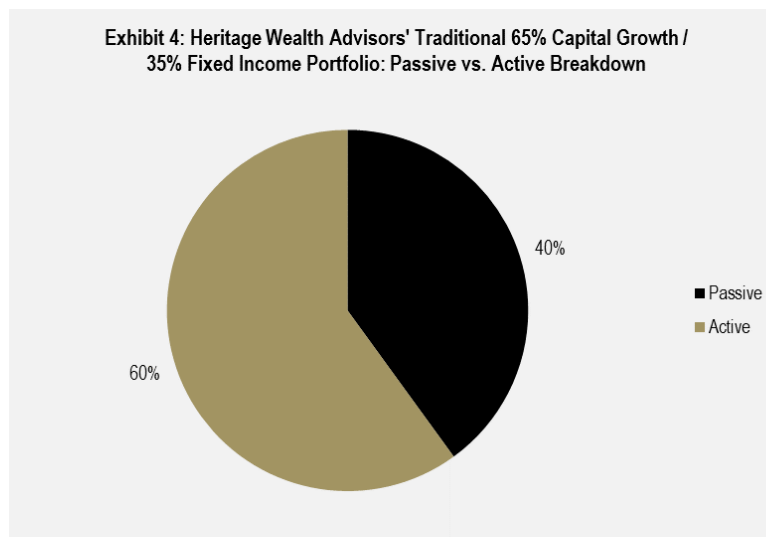


Source: Investment Company Institute

With the rise of passive investments, many investment managers have adjusted their product offerings in order to be more competitive. For example, the low-cost nature of passive investments has spurred many managers to reduce the costs of their funds. Specifically, fees and expenses associated with stock and bond funds have fallen 19% over the last 15 years.[2] Additionally, the turnover rate among mutual funds has declined 47% since the 1980s as more investors are choosing strategies that generate fewer trading costs and taxable distributions.[2] The focus on performance relative to passive investments helps ensure managers are committed to beating their benchmark. However, this also can produce negative, unintended side effects. For example, as they try to add value, some managers may deviate from their initial strategy, taking on undue risk in order to generate higher returns.

Decisions, Decisions…

When Heritage decides to incorporate an asset class or sector in client portfolios, our process is to determine whether passive or active management is appropriate based on the structural attributes of the market, analyst coverage and availability of research, composition of the index, and (to a lesser extent) aggregate long-term performance of managers relative to the index. Presently, our research suggests the optimal portfolio consists of a mix of passive and actively managed investment strategies – specifically, passive for U.S. large-cap and mid-cap equity exposure, and active for U.S. small cap, international equities, and fixed income. This is not a one-time determination but rather a continual assessment. We conduct asset class and sector due diligence regularly, including analyzing passive versus active management strategies within the context of current and expected market conditions. The quality and depth of our investment platform allows us to continually evaluate our passive versus active management decisions and implement shifts in client portfolios as necessary.



Opportunities for Passive Management

- US Large-Cap and Mid-Cap Equities:
  - The U.S. large-cap and mid-cap equity universes contain highly liquid securities. Information is ample and easily accessible. On average, 22 analysts cover each U.S. large-cap stock while 13 cover each mid-cap company, compared to only five for each small-cap.[3] The resulting market efficiency limits the number of opportunities for active management.
  - Consider the difference in performance between an equal-weighted S&P 500 index and the "standard" capitalization-weighted index. Equal-weighted represents the return of the average stock in the index. Cap-weighted is the performance of the average dollar invested. The spread denotes how much incremental return investors could earn by arbitrarily picking a stock.[4] Keep in mind the average manager typically underperforms random selection.[4] The equally-weighted index beat the cap-weighted index by just 0.3% on an annualized basis from 2011 to 2016.[5] Deducting average manager fees and expenses from the equally-weighted index, it lagged the cap-weighted index.[4] Low dispersion of returns implies a challenging environment for active management.
  - Due to high market efficiency, over 90% of U.S. large-cap and mid-cap managers failed to beat their comparison benchmark during the last 10 years.[6]

Opportunities for Active Management

- U.S Small-Cap Equities:
  - More than 15,000 small-cap stocks trade in the U.S. on various exchanges and over-the-counter-market, compared to approximately 1,000 large-cap and mid-cap companies.[2] However, the Russell 2000 index of small-cap stocks represents just 8% of the U.S. equity market's total capitalization.[2] Given the breadth of the universe and the small size of the companies, many of these stocks are not well covered by Wall Street Research, and the dispersion of returns is wider[2], providing more opportunities for active management.

- International Equities:
  - Breadth and dispersion of returns are even greater outside of the U.S.[2] There are nearly three times as many international companies as U.S. companies.[5] Regarding international small-cap in particular, 34% of the businesses in the Russell Global ex-U.S. Small Cap index have one or no analyst coverage.[7]
  - The composition of the index may be suboptimal as well. For example, companies in China and Taiwan represent about 40% of the MSCI Emerging Markets index.[5] Active management can offer better diversification and lower volatility.

- Fixed Income:
  - The fixed income universe is significantly larger than the equity universe.
  - Aside from U.S. Treasuries, fixed income markets possess numerous attributes that make indexing unattractive, including illiquidity.[8] Additionally, some exposures may present challenges. For example, the primary exposures in the Citigroup World Government Bond index are Europe and Japan[5], two highly indebted regions aggressively trying to drive higher inflation.
  - Managers can generate excess returns through superior interest rate forecasting and/or credit analysis.

The Makings of a Top Active Manager

We select experienced managers with a clear, consistent investment philosophy and process that aligns with ours. Funds with low fees and expenses, low turnover, high active share (i.e. meaningfully different positioning from the benchmark), and tilted away from any undesirable exposures in the index can deliver a better outcome. When selecting a new manager, we place relatively low emphasis on historical returns. Instead, we focus on various qualitative factors and understanding how the strategy performs in various market conditions. We select each manager to play a specific role in client portfolios. When reviewing an existing manager, we evaluate whether the strategy continues to fulfill its role. We do not simply measure performance; we understand it.

Exhibit 5: Characteristics of Top Active Managers

- Clear, Consistent Investment Philosophy and Process
- Low Fee and Expenses
- Low Turnover
- High Active Share
- Titled Away from Undesirable Exposures in the Index
- Discipline

Conclusion

Passive and active management are distinct approaches to investing, and we believe both have merits. Currently, our research suggests the optimal portfolio consists of a mix of passive and actively managed investment strategies based on our assessment of individual asset classes and markets. However, we continue to evaluate our passive versus active management decisions in order to drive the best solution for our clients. If you have questions about passive versus active management, our thesis, or any aspect of your investment portfolio, please contact a member of Heritage's Investment Research Team or your Advisor.

[1] *Investment Company Institute*
[2] *John Hancock Investments, Why Blending Active and Passive Strategies is Right for Investors*
[3] *UnionBank, Small Cap Equities as an Ongoing Portfolio Commitment*
[4] *S&P Dow Jones Indices, Why are Active Managers Lagging?*
[5] *Morningstar Direct*
[6] *Forbes, How to Beat 90% of Mutual Fund Managers in the Long Run*
[7] *Royce & Associates, Putting International Small-Caps on the Map*
[8] *CFA Institute*

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