THE DEATH OF ACTIVE MANAGEMENT

Global Financial Private Capital

SYNOPSIS

- The argument between active and passive management is one that never seems to get old for the financial media.
- These stories have inspired investors of all sizes to contemplate who will ultimately win the battle for investors' assets.
- This active versus passive debate may make for dramatic banter on television, but that's about where it ends.

AN EPIC BATTLE

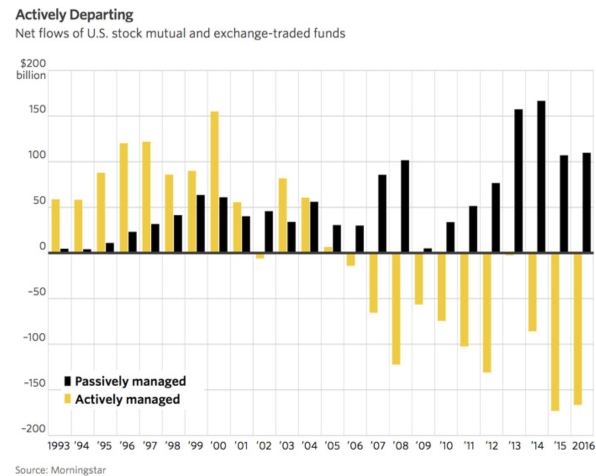
The debate between active and passive management is one that never seems to get old for the financial media. They have pitted one against the other, where passive champions inexpensive options for the everyday investor and active represents nothing more than remnants of an era where money managers got rich at their clients' expense.

These stories have inspired investors of all sizes to contemplate who will ultimately win the battle for investors' assets. Before we assess which side will prevail, let's quickly explain the difference between the two and why this has become such a hot button topic over the last several years.

Active investing attempts to beat an index or mitigate a risk. A manager aiming to beat the S&P 500 may own more healthcare stocks than in the index if she felt it is an attractive sector. Another manager may shift from stocks to bonds if he sees a recession on the horizon. In short, active managers actively manage their portfolios.

Passive investing is the exact opposite. When an investor goes passive, they buy an "index fund" or group of funds and stick to that allocation. An index fund is designed to track a benchmark rather than beat it. For example, an S&P 500 index fund's goal is to return the exact same performance as the S&P 500, no better or worse.

The chart below shows the outflow from active funds (gold bars going down) and inflow to passive funds (black bars going up) since the financial crisis.



The reason most cited for this seismic shift to passive is the questionable value of active management. Passive investing is a "set it and forget it" strategy, so the fees are often a fraction of what an active manager would charge.

Active managers have also underperformed their passive benchmarks since the financial crisis (per the chart below), so investors in active strategies now feel that they are paying more for less.

> *"There is just too much gray area where active and passive strategies both warrant consideration."*

Hence, it would appear that passive will be the clear winner and explains why some are even calling for the death of active management altogether.

THE CYCLE CONTINUES

The chart below was constructed by Baron Capital, and it compares the performance of actively managed funds to their passive counterparts. The green indicates when

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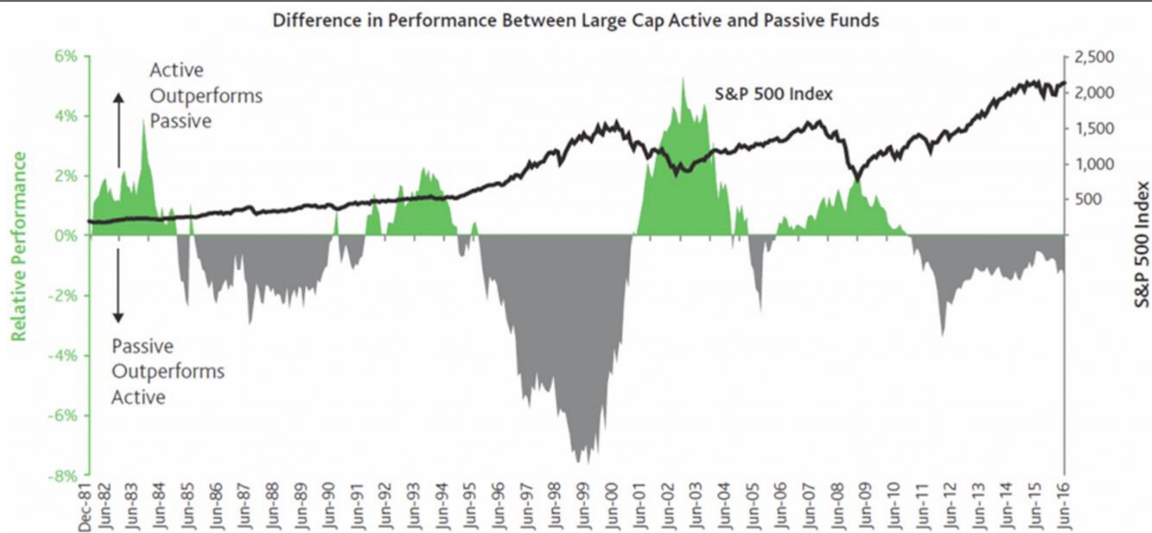

Source: Morningstar Direct, Baron Capital Analysis based on monthly rolling 3-year returns for the period 12/31/1981 to 6/30/2016. US OE Large includes all share classes in Morningstar's US OE Large Growth, US OE Large Value, and US OE Large Blend categories. The performance of passive funds is calculated as the average 3-year performance of all index fund share classes in each category. The performance of active funds is calculated as the average 3-year performance of all non-index fund share classes in each category. Results for each category are then averaged and the differences between active funds' averages and passive funds' averages are calculated. The S&P 500 Index measures the performance of 500 widely held large-cap U.S. companies. Past performance is not a guarantee of future results.

active management has outperformed passive, and the gray is when passive has outperformed active.

Two important conclusions can be derived from this chart. First, passive investors did better during bull markets. Look at the gray sections in the late 1990s and since 2009 to see just how much better passive has performed relative to active. It's not even close.

Second, active managers have outperformed during more volatile markets. The green spikes during the last two recessions show that manager skill may soften the blow when panic runs wild.

Active has performed better in difficult markets because these managers can be more selective of the stocks they own. For example, if they believe that banks and healthcare companies are overvalued, they can underweight these sectors or sell out entirely.

Passive investors cannot be as selective because they have to own all stocks in an index. Therefore, by extension, they own a lot of overvalued stocks in overheated markets, and these tend to sell off violently during corrections and/or when the economy moves into a recession.

Combining these two behaviors together exposes one of the most basic characteristics of any financial market. Just as some stocks do better during economic booms while others do better during busts, or as growth stocks can outperform value and vice-versa, cycles are pervasive throughout markets. Given that human nature is the root cause of these cycles, it's highly unlikely that this changes anytime soon. Consider the following scenario.

Let's assume that this shift to passive investing continues into the foreseeable future. This should reduce the supply of active managers since only the best managers will be able to stay in business. Fewer active managers chasing ideas translates to less competition, and this is when things start turning around for those who survive.

Concurrently, more passive investors means more people owning the same stocks, which pushes valuations on all stocks in an index higher. Some stocks will deserve the increase because their fundamentals warrant a higher price, but others will rise for the sole reason that they are included in a popular index like the S&P 500. These mispricings in the stock market act as bait for the remaining active managers skilled at hunting for deals.

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Eventually, the economy will start to slow down, which will create chaos in financial markets. Volatility spikes will cause passive investors to panic, and active managers will be waiting to capitalize on their emotional decisions to sell into the madness.

The improved relative returns from active managers combined with those who thought they were suited for passive investing until things got bad and realized they could no longer take the ride will begin to reverse the trend in the chart on page one. Assets will begin to flow from passive to active strategies and cause the black bars to fall and the yellow bars to rise. The cycle continues on.

Simply put, those who claim that active management is dying also need to explain why they believe that the human nature responsible for this cyclicality is permanently changing.

IMPLICATIONS FOR INVESTORS

This active versus passive debate may make for dramatic banter on television, but that's about where it ends. The world of investing is not black and white enough to support an "Ohio State vs. Michigan" style rivalry. There is just too much gray area where active and passive strategies both warrant consideration.

For example, active managers tend to be one of the biggest users of passive strategies because they offer cheap exposure to investments that may not require a fully active approach. To say that active managers would be better off if passive investing disappeared is ludicrous.

Consider the situation where an investor felt that Japan's economy was turning around and wanted to allocate 20% of her actively-managed portfolio to their stock market but did not possess the knowledge and/or experience to know which stocks to own. She could simply buy a passive index fund that gave her broad-based exposure to Japan's equity market.

On the flip side, to say that all investors would benefit if active investing disappeared is equally absurd. While passive investing can be a suitable option for some, most investors are not equipped for passive investing for three reasons:

1. **Time**: Unless an investor has several decades before needing to sell and pay for retirement, passive investing can pose real risk to meeting financial goals.

2. **Income**: The annual dividend yield on the State Street S&P 500 index fund (ticker: SPY) is 1.88%, and the yield on the iShares Barclays Aggregate Bond index fund (ticker: AGG) is 2.40%[1]. Therefore, no mathematical combination of the two indices exists where income could exceed 2.40%, which barely beats inflation.

3. **Comfort**: Investors prone to selling into panic are not suited for passive investing because going passive requires an investor to have a strong stomach during volatile times.

The bottom line is that pitting active against passive is a misguided debate because they both serve a purpose in asset allocation.

Sincerely,

Mike Sorrentino, CFA

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[1] *Source: Bloomberg. As of 8/24/2017.*

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