Should Investors Consider Going Passive?

SYNOPSIS

- The "active versus passive" debate that began many years ago continues to strengthen, and investors are asking if now is a good time to move over to passive.
- Passive investing is a perfectly fine strategy for some investors, but it is most certainly not appropriate for all.
- Those who moved to passive may have unknowingly risked meeting their long-term financial objectives.

ACTIVE VS. PASSIVE

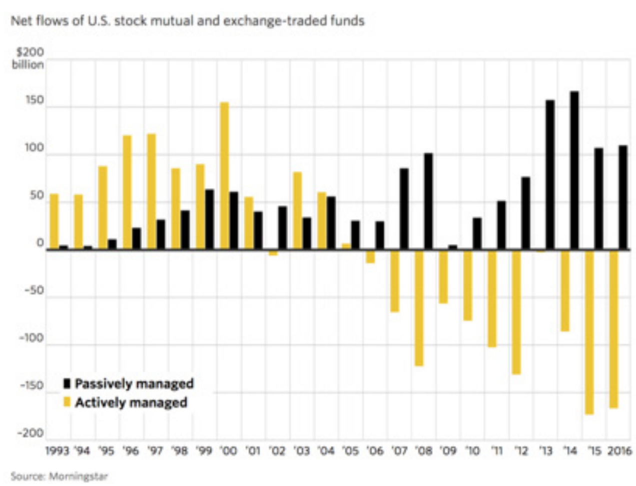
The decision to either actively or passively invest remains one of the longest running financial debates. The media has recently amplified the drama by televising regular stand offs between those for and against active management that rival the crudeness and civil disobedience witnessed in last year's presidential debates.

This holy war is far from over, so before we determine which side will win, let's quickly explain the difference between the two and why so much airtime has been devoted to the subject.

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, which is the crux of the debate.



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

Just be sure that you are not putting a right shoe on a left foot.

Thanks to consistently strong returns from stocks and bonds since 2009, passively managed funds appear to be the winner in the debate. All an investor had to do was buy a few index funds and ride this low-cost tide higher.

The attention from the media and frustration surrounding fees has prompted several investors to recently ask if switching to passive is the right move for them. Unfortunately, as is most things in life, the answer is that it depends.

Comparing returns is not enough to say that one strategy is better than another. Active managers do much more than beat benchmarks, so I created a three-step test years ago to help an investor decide if a passive investment strategy can meet their objectives. If you pass all three below, then you may be better off going passive.

1. Do You Need Income?

If an investor requires income from a portfolio to pay bills, then they immediately disqualify themselves from passive investing.

Currently, the dividend yield on the State Street S&P 500 index fund (ticker: SPY) is 1.93%, and the yield on the iShares Barclays Aggregate Bond index fund (ticker: AGG) is 2.06%. Therefore, no mathematical combination of the two indices exists where income could exceed 2.06%, which may not even beat inflation for some investors.

The Fed believes that inflation is running around 2%. Ignoring the absurdity that the cost of living is only rising by a mere 2% each year, let's assume the Fed is correct. Under a scenario where an investor allocated 100% to AGG, the portfolio would yield just barely enough to mitigate the effects of inflation.

For example, if a passive investor purchased AGG, they would only be left with 0.06% after inflation (2.06% - 2.00% = 0.06%). On a $1 million investment, that comes out to roughly $600 in additional purchasing power (excluding taxes).

That is nothing to write home about, but the situation becomes dire once we leave the Fed's fantasy land and get back to the real world where medical costs seemingly double every five years, grocery bills feel like they rise weekly, and rents have skyrocketed.

Here, passive investment yields are nowhere close to what is needed to meet obligations and keep pace with inflation. Hence, only those candidates who do not require income from a portfolio to pay bills should continue to the second test.

2. Do You Have Time?

Think about the buyers of health insurance and the types of coverage selected. Those who are young typically select bare-boned plans that are dirt cheap because they tend to be healthier. However, as generations get older, they opt for more expensive plans that cover more tests and procedures.

The same applies to active versus passive investing. Younger investors rarely need the expertise and associated cost of an active manager because they have several decades before they will access their nest egg. This runway provides protection from another crisis.

Every investor is different, so it's hard to say where the line in the sand resides, but a good rule of thumb is ten years. A decade tends to be enough time to capture an entire business cycle, so if a recession were to happen at some point, the investor should have either gained enough to endure a sharp decline late in the cycle or had time to recover from one early in the cycle.

Hence, only those investors who do not require income from their investments to pay bills and have at least ten years before needing to sell a single dollar can continue to the third test.

3. Can You Keep It Together?

While the first two tests are more quantitative in nature, the last test is more qualitative. This requires an investor to accept the risks associated with passive investing and then be honest with oneself.

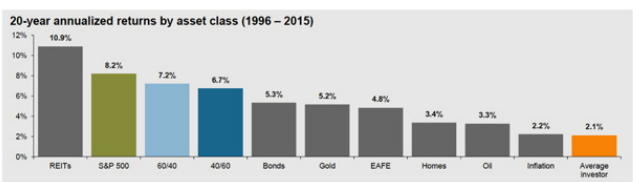
Those looking to cut costs often think that once they move to index funds, they become passive, but the two are not the same. An index fund can be bought and sold in the same manner as a stock, and both active and passive strategies are heavy users of index funds.

For example, an active manager may sell an equity index fund and buy a bond index fund if she feels a recession is looming, but a passive strategy would never make such a move. To be truly passive, an investor must buy and hold through thick and thin.

Meaning, if the S&P 500 falls over 40%, as it did during the financial crisis, passive investors cannot sell. If they do, they immediately revert to an actively managed strategy.

Therefore, an investor must determine if they can sleep at night when the next crisis whipsaws financial markets because a passive strategy provides zero protection against large drawdowns.

The reason this test is so important is because it's one thing to think you can tolerate a downturn, but it's an entirely different thing to take that ride, and the chart below shows that the overwhelming majority of individual investors are unable to take the pain.



Source: J.P. Morgan Asset Management; (Top) Barclays, FactSet, Standard & Poor's; (Bottom) Dalbar Inc.
Indexes used are as follows: REITS: NAREIT Equity REIT Index, EAFE: MSCI EAFE, Oil: WTI Index, Bonds: Barclays U.S. Aggregate Index, Homes: median sale price of existing single-family homes, Gold: USD/troy oz, Inflation: CPI. 60/40: A balanced portfolio with 60% invested in S&P 500 Index and 40% invested in high quality U.S. fixed income, represented by the Barclays U.S. Aggregate Index. The portfolio is rebalanced annually. Average asset allocation investor return is based on an analysis by Dalbar Inc., which utilizes the net of aggregate mutual fund sales, redemptions and exchanges each month as a measure of investor behavior. Returns are annualized (and total return where applicable) and represent the 20-year period ending 12/31/15 to match Dalbar's most recent analysis.
Guide to the Markets – U.S. Data are as of December 31, 2016.

This sobering chart shows that the average investor (orange bar) earned a fraction of a balanced portfolio (both blue bars) over a 20-year period. The two main reasons why individual investors have seen such paltry returns are they chase performance and sell into panic.

Panic selling is by far the most effective way to permanently alter an investor's financial future because it converts short-term pain into long-term misery. If an investor feels they are susceptible to panicking, then they simply must avoid passive investing.

Given so few investors possess the ability to truly set it and forget it, passive investing is only appropriate for a small cohort. The risks associated with panic selling are just far too great.

Implications for Investors

I lived just north of Miami back in the early 1990s and vividly remember Hurricane Andrew's wrath. Although most of the homes in my community were spared, one down the street was destroyed.

The devastation to the lives of the family that lost their home inspired most of my neighbors to purchase hurricane insurance within weeks of the dust settling. They saw how bad it could get and were willing to pay a premium to feel safe and secure again.

Fast forward the clock five years, and not a single hurricane ever came close to threatening the area. Those very same people who yearned for the security of insurance began asking why they kept paying the premiums and ultimately canceled their policies.

I mention this story because I feel like it is analogous to investors leaving active management today. The financial crisis was a tragic event, but it ended eight years ago. Since then, the economy has recovered, the S&P 500 has ripped, and investors now question paying for active management just as homeowners questioned their hurricane insurance premiums.

My concern is that so many who moved to passive would have failed my test above, and the chart below explains why.

Source: The Capital Group

The Capital Group is one of the largest asset managers in the world, and they recently conducted a survey that produced two alarming statistics:

1. The overwhelming majority of investors over 50 consider protection from market downturns to be a key priority.
2. Only 53% of respondents were aware that index funds expose investors to the full ups and downs of the market[1].

If the majority over 50 values protection, but only half realize that passive strategies provide no protection, then a chunk of the assets moving into passive to avoid paying active fees could be misaligned with those investors' financial objectives.

Fees do impact returns, so paying less is clearly optimal, but most active fees cover so much more than trying to beat an index. Investors need to determine if they value these services, and the test above is designed to help answer this question.

Lastly, just as no insurance company will write a policy days before a hurricane hits, trying to time when to move from passive back to active is impossible. The only way protection works is if it is in place at all times.

In the end, I do not think that "active versus passive" is a worthwhile debate. One is not better than the other because they both have their place. Just be sure that you are not putting a right shoe on a left foot.

Most millennials have as much reason to pay an active manager as homeowners in Iowa have to protect against a hurricane. However, a retiree who relies on income from investments, does not have a decade or two before needing to sell, or cannot sleep at night when his portfolio gets whipsawed is most certainly not a candidate for passive.

The bottom line is that passive investing is an excellent option for some investors, but it is most certainly not appropriate for everyone.

Sincerely,

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[1] *https://www.thecapitalgroup.com/content/dam/cgc/shared-content/documents/articles/WisdomOfExperienceSurveyReportFinal-1-21-16.pdf*