Passive Versus Active Investing

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Passively managed investments, also known as index funds, have experienced a surge in popularity since 2006.

In the years following, investors have shown a clear preference for these typically lower-cost strategies, pouring over $500 billion into U.S. equity index funds alone in 2016. These inflows have come at the expense of actively managed investments, notably U.S. fixed income and equity mutual funds. Active equity managers have not seen a positive net inflow since 2005. In light of these dramatic trends, we'll use this paper to examine the differences, risks, and benefits of passive versus active investments as well as the factors driving recent investor preference for passively managed strategies. Finally, we'll review the guidelines we use to determine an optimal mix of active and passive investments.

PASSIVE VS. ACTIVE – AN OVERVIEW

The first official passively managed investment strategy was a stock index fund created by the Vanguard Group in 1975. Now called the Vanguard 500 Index Fund, this early passive prototype sought to track the S&P 500 Index at a lower cost than its actively managed mutual fund competitors. Although we've seen a proliferation of the types of passively managed strategies offered since the first index fund debuted, not much has changed in terms of the basic structure. By definition, a passive or index fund typically tracks a well-known stock or bond index at a low cost. Given the reduced trading activity in these funds, they're also considered a type of buy-and-hold strategy that ideally allows investors to more closely track the market's return.

While an index fund seeks only to match its benchmark's return, reduced by a small fee, an actively managed fund attempts to outperform its designated benchmark. This strategy generally involves a portfolio manager and a team of research analysts who engage in active security selection. Because actively managed funds require additional resources and investment talent, expense ratios or fees on these strategies are generally higher than passive strategies. However, higher fees have been called into question recently as many active managers have been unable to consistently outperform their respective benchmarks. Poor performance and higher costs have been significant factors in the shift away from actively managed funds into passively managed funds in recent years.

Although history suggests that many actively managed funds fail to meet their stated objectives, some managers have bucked the trend. Research indicates that certain markets are less efficient than others, providing active strategies with an advantage over passive. Likewise, certain fund characteristics or management-related parameters may help identify active managers who are more likely to deliver above-market returns. We'll examine these below.

This initial overview of passive versus active investing suggests that choosing one strategy over another may not be as cut-and-dried as the popular media would have us believe. It also indicates the need to look more closely at the pros and cons of both options and that perhaps a case can be made for incorporating passive and active investment styles in a portfolio.

PROS & CONS OF PASSIVE INVESTING

Looking more closely at passively managed funds, the benefits of this strategy include keeping pace with market returns, diversification at a low cost, transparent holdings information, and in some cases increased tax efficiencies. While the first passively managed strategy used a mutual fund structure, today many index funds are constructed as exchange traded funds or ETFs.

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There are important differences between mutual funds and ETFs, two of which include liquidity and tax efficiency. ETFs trade on a stock exchange continuously throughout the day as opposed to mutual funds, which allow for share redemptions only at the end of a trading session. As a result, ETFs generally have higher daily liquidity levels. With regard to tax efficiency, mutual fund managers are required to constantly sell securities to accommodate shareholder redemptions. These trades often result in realized capital gains that are then distributed to current and even new mutual fund shareholders. In contrast, an ETF's structure helps avoid the large capital gains distributions seen with mutual funds. Instead of selling shares to accommodate shareholder redemptions, ETFs manage investment flows by utilizing financial institutions called Authorized Participants (APs) to create or redeem "creation units" or baskets of assets that mirror the ETF's underlying holdings. This design helps reduce investor exposure to capital gains on any individual security within the fund. These points are particularly noteworthy given that most actively managed strategies utilize a mutual fund structure, which is often less tax efficient than an exchange traded fund (ETF) structure. In contrast, passive investment strategies predominantly utilize ETF structures, which are able to reduce exposure to capital gains taxes and thus improve tax efficiency.

While higher liquidity is a frequently cited benefit of passively managed ETFs, these investment vehicles have encountered trading issues in the past. One such event happened in 2015. In August of that year, markets opened with wide bid-ask spreads that caused many Authorized Participants (APs) to sit on the sidelines. By refraining from redeeming and creating new ETF shares due to wide price disparities, APs contributed to the price divergence between the value of the stocks held within the ETFs and the prices of ETFs themselves. As a result, many index funds traded at significantly lower prices than their underlying holdings. While many tout the increased liquidity tied to the ETF structure, it was in fact that very structure that led to significant illiquidity in August 2015.

ETFs are relatively new investment instruments and as such, they may again exhibit unexpected behavior during volatile market periods. Other potential drawbacks tied to passive investing, most of which is done through ETFs, include price- or debt-weighted holdings and limited downside protection. When an equity ETF uses a price-weighted construction methodology, it means that those companies or stocks with the highest prices make up the largest positions in the ETF portfolio. When markets are moving higher and momentum is strong, ETFs and their respective indices will deliver healthy returns. However, when markets pull back it is often the most expensive stocks that fall the farthest. Although a high stock price doesn't necessarily translate into an expensive valuation level, often the two are connected. This is truer today as substantial inflows to passively managed ETFs have pushed up the price of many stocks within these funds, irrespective of company fundamentals.

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Similar to stock ETFs, most passive bond or fixed income ETFs determine the size of holdings in their portfolios based on debt. This means that the bond issuers carrying the highest debt levels make up the largest positions in a bond ETF's portfolio. Unlike an actively managed bond fund, in which a seasoned research team examines each holding to determine how well a company is able to service its debt, passively managed ETFs are most exposed to the most indebted issuers irrespective of those companies' financial strength. This weighting scheme could contribute to significant price declines in the event of a credit event or a recession.

Finally, most investors are unaware that many passive ETF strategies lend-out the stocks or bonds in their portfolios to earn additional income. This happens when a financial institution asks to borrow a stock or bond from an ETF in exchange for a fee and collateral. The collateral acts as insurance in case the borrower fails to return the ETF's stocks or bonds. However, if a borrower defaults and a shortfall arises between the collateral received and the cost to repurchase a loaned security, an ETF's value could come under pressure. Another risk tied to these activities is how ETFs reinvest the collateral they receive from financial institutions. While most ETFs invest the collateral from lending securities in safe, money market-like investments, some purchase riskier investments that could lose value. The good news is that most large ETF companies have significant risk-control measures in place to protect an ETF's value and its investors. In addition, the fees generated from these strategies can help to lower the expense ratio investors pay in an ETF.

PROS & CONS OF ACTIVE INVESTING

Now that we've examined some of the pros and cons of passively managed investment strategies, let's explore some of the benefits and drawbacks tied to active investments. Like index funds, actively managed funds often provide immediate diversification at a reasonable cost. However, fees are generally higher for active funds as compared to passive funds and many have underperformed their benchmarks over the long-term. Although research indicates that most actively managed funds have been unable to deliver consistently positive alpha, or risk-adjusted returns above the market, some have. This is an important point, because while index funds are only able to deliver the benchmark return reduced by the fund's expense ratio, an actively managed fund has the potential to outperform its index.

Most of today's investment theory and practice is based on the efficient market hypothesis (EMH). The premise of EMH is that "markets fully, accurately, and instantaneously incorporate all available information into market prices." Under these circumstances, no market participant should be able to deliver excess returns on a consistent basis. But some fund managers have done just that – produced returns above their respective benchmarks for the duration of their careers. A modification of the efficient market hypothesis, known as the weak form EMH, acknowledges the potential for fundamental research to deliver above-market returns. This suggests that fundamental analysis, in which analysts study a company's financial statements and competitive positioning, may lead to outperformance in less efficient markets such as international stocks and bonds as well as with smaller capitalization stocks.

Another potential benefit of active management is its focus on risk-management. Whereas passive investments simply replicate an index with no regard to portfolio risk, active managers regularly review a security's risk attributes before including it in a fund. The result can lead to a more attractive Sharpe ratio, or the level of return achieved per unit of risk taken. Investing in a fund with a favorable risk-return profile can mitigate underperformance during major market declines and provide investors with a smoother ride.

Finally, most active managers construct their stock or bond portfolios after performing significant research and assigning the largest position sizes or weights to those investments in which they have the highest conviction. In contrast, most passively managed funds determine the position sizes of their portfolios by either market capitalization (for stock funds), in which the largest companies have the largest weights, or by debt levels (for fixed income funds), in which the most indebted issuers have the largest weights. As a result of these differing construction methodologies, active funds could be less susceptible to a major market correction than passive funds, in which the largest companies or most heavily-indebted issuers realize the biggest declines.

POTENTIAL UNINTENDED CONSEQUENCES OF AN ALL-PASSIVE PORTFOLIO

While most of what we read in the popular press overwhelmingly highlights the positive features of passive investments, our review suggests there are risks involved with an all-passive approach. These risks may be compounded by the recent surge in popularity of this investment style. On one hand, as long as investors continue to favor passive investments over actively managed funds, index strategies will likely continue to see strong returns. This is because, regardless of the health of the underlying securities within these strategies, inflows to index funds will push the prices of the securities within these investments higher. On the other hand, when we have a significant market correction and investors again care about the underlying operating strength of the companies they own, passive strategies that don't consider company fundamentals could experience outsized declines as compared to actively managed strategies.

A CASE FOR INCLUDING BOTH PASSIVE AND ACTIVE INVESTMENTS IN YOUR PORTFOLIO

Given a number of positive and negative characteristics for both passive and active investment strategies, we would argue that both styles have a place in a well-constructed portfolio. Using passive strategies to gain exposure to more efficient markets such as U.S. large capitalization stocks can help lower a portfolio's overall expense ratio without taking on excess risk. At the same time, utilizing actively managed funds in less efficient asset classes including emerging country stocks or bonds, high yield (junk) bonds, and small capitalization stocks can generate returns above the benchmark and bring down a portfolio's risk profile, thus potentially providing more protection during a market downtown.

Combining both strategies may also lead to increased diversification benefits as the portfolio construction methodologies between passive and active funds often differ widely. These contrasting approaches to portfolio construction can result in substantial differences in portfolio characteristics, translating into lower correlations between the active and passive components of the portfolio. A portfolio that holds investments that are not perfectly correlated should provide a higher risk-adjusted return profile. Meaning, investors are able to realize the same level of return (all else being equal) for a lower level of risk. For instance, a passively managed equity fund may generate higher returns than an actively managed equity fund during a bull stock market, while an active stock portfolio may not decline as much as a passive strategy during a bear stock market.

At Parsec we practice what we preach.

PARSEC'S APPROACH

At Parsec we practice what we preach. When constructing investment portfolios, in addition to considering each individual client's risk tolerance and objectives, we incorporate a mix of both passive and active investment securities. In many instances we utilize individual stock securities for the U.S. large capitalization asset category in order to eliminate an additional layer of fees, improve tax efficiencies, and accommodate individual client constraints. Similar to an actively-managed equity fund, our Research Committee conducts in-depth due diligence and ongoing analysis on the individual stocks held in these portfolios. While we acknowledge that the U.S. large capitalization stock category is more efficient than other asset categories and thus may benefit less from active management, we believe that the reduced costs, tax savings, and client flexibility that come with owning individual stocks outweigh the drawbacks.

In our all-fund portfolios we likewise include both passive and active investments. In more efficient markets such as U.S. large capitalization stocks, we employ lower-cost passive ETFs. Doing so allows us to reduce clients' overall expense ratios while gaining immediate diversification benefits. In addition to researching the funds themselves, our Research Committee examines an ETF's trading volume to ensure adequate liquidity. We also examine the lending practices of our covered ETF's parent companies in order to avoid unnecessary risk exposure.

Given our view that fund managers have more ability to add value and lower risk in less efficient markets such as international stocks and bonds, our Research Committee prefers actively-managed funds for these categories. In particular, less transparency and increased corruption levels in emerging markets provide active managers with more opportunity to generate excess returns and often with less risk.

Although U.S. bond markets are much more transparent and corruption is typically not an issue, we use active management in this space as well. Concerns surrounding the debt weighted construction of most passive ETFs, in which the issuers with the highest debt levels account for the largest positions, lead us to prefer actively managed funds instead. We believe identifying fixed income portfolio managers with a strong performance track record, who consider an issuer's ability to service its debt, among other factors, should be able to deliver better risk-adjusted returns over the long-run.

While inefficient markets and riskier construction methodologies make passively managed funds less desirable in certain circumstances, it's true that most active managers fail to deliver excess returns over the long-run. What then should an investor do?

Although many active managers don't outperform over the long-term, some do. The key then is to identify portfolio managers who will be able to deliver excess returns and earn their fees. Research by the Capital Group identified three metrics that were effective in determining which managers were likely to buck the trend and deliver benchmark-beating returns over the long run. These metrics include funds with below-average expense ratios, portfolio managers who invest a significant amount of their own money in the funds they manage, and strategies that have historically performed better during market declines.

In addition to our own proprietary fund scoring system, Parsec's Research Committee assesses each of the above factors when considering a new actively managed fund for inclusion in our investment line-up. Doing so helps us select active managers who are more likely to outperform their benchmarks over the long-term.

CONCLUSION

Today's investors are showing a clear preference for passively-managed funds. Significant inflows into these strategies reflect investors' desire for low-cost strategies that track the major market indices. In contrast, actively managed funds for both stocks and bonds have seen substantial outflows in recent years due to above-average fees and inconsistent returns. Although most of what we read and hear in the media would suggest little to no benefit from owning actively managed funds, a deeper-dive indicates each strategy offers risks as well as rewards.

While passive funds can help lower a portfolio's expense ratio and provide diversification benefits in larger, more efficient markets, active funds or management can offer important risk controls and generate excess returns in less efficient markets. Therefore, we believe incorporating both active and passive investment strategies in a portfolio can lead to better long-term risk-adjusted returns.

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