ParsecFinancial
WEALTH MANAGEMENT

Parsec Financial's Philosophy on Passive vs. Active Investing

Passively managed investments, also known as index funds, have experienced a surge in popularity since 2006. As of 2019, the amount of passively managed equity (stock) investments grew to match the amount in actively managed equity investments for the first time.

Investors have continued to show a clear preference for these typically lower-cost passive strategies, particularly among equity funds. These inflows have come at the expense of actively managed investments, especially those funds with high expenses. 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 the continuing investor preference for passively managed strategies. We'll discuss why investing in an all-passive mix does not remove all decisions that an investor needs to make with regard to their portfolio. Finally, we'll review the guidelines we use at Parsec Financial to determine an optimal mix of active and passive investments.

AN OVERVIEW OF PASSIVE VERSUS ACTIVE INVESTING

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 higher than purely passive strategies. However, these 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.

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, potentially 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 obvious 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 both passive and active investment styles in a portfolio.

PROS AND CONS OF **PASSIVE INVESTING**

In 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 (ETFs).

There are important differences between mutual funds and ETFs, two of which include intra-day liquidity and greater 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, some of whom did not participate in the gains that were earned. In contrast, an ETF's structure helps avoid the large capital gains distributions sometimes 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, while maintaining the value of the ETF close to the value of the underlying holdings, or net asset value (NAV). These points are particularly noteworthy given that most actively managed strategies utilize a mutual fund structure, which is typically less tax efficient than an ETF structure. In contrast, passive investment strategies predominantly utilize ETF structures, which can 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 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 this very structure that led to significant illiquidity in August 2015. Another potential issue exists when an ETF trades continuously throughout the day, but it's underlying holdings are less liquid and do not. This phenomenon can happen in particular with fixed income ETFs in certain areas of the market such as high-yield or municipal bonds. However, it can even happen in the most well-known, broad market bond ETFs. For example, on March 12, 2020, the Vanguard Total Bond Market ETF (one of the largest and most liquid) closed a record 6.2% below its net asset value, in part due to concerns regarding liquidity of some of the underlying holdings.

Other potential drawbacks tied to passive investing, most of which is done through ETFs, include size- or debt-weighted holdings and limited downside protection. When an equity ETF uses a size or capitalization-weighted construction methodology, it means that the largest companies or stocks make up the largest positions in the ETF portfolio. When markets are moving higher led by a few large companies and momentum is strong, capitalization-weighted ETFs and their respective indices will deliver healthy returns. However, the situation can reverse when markets pull back if the decline is led by the largest companies. This is truer today as substantial inflows to passively managed ETFs have pushed up the price of many stocks within these funds, regardless of company fundamentals.

In addition, there is a considerable body of research that suggests that smaller companies earn a return premium over time. A pure capitalization-weighted index may have little to no exposure to such companies.

Similar to stock ETFs, most passive bond or fixed income ETFs determine the size of holdings in their portfolios based on the amount of debt outstanding. 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 regardless of those companies' financial strength. This weighting scheme could contribute to significant price declines in the event of a credit re-rating event or a recession.

Other potential drawbacks tied to passive investing, most of which is done through ETFs, include size- or debt-weighted holdings and limited downside protection.

PROS AND CONS OF **ACTIVE INVESTING**

Now that we have 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 this higher cost drag is one reason why 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.

Much 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 particularly 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. Active managers control both what they buy and what they don't buy, while passive funds must invest in most every company in the index regardless of the outlook for that company as an investment or its financial metrics.

Actively managed funds often provide immediate diversification at a reasonable cost. However, fees are generally higher for active funds as compared to passive funds.

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 and financial strength of the companies they own, passive strategies that don't consider company fundamentals could experience outsized declines as compared to actively managed strategies.

LOW-COST ACTIVE:
ANOTHER TOOL IN THE TOOLBOX

Another strong trend which has been benefiting investors is lower costs, both among active and passive investments. From institutional share class mutual funds to commission-free stock trading, to low (or even zero expense) index funds, the cost to create a diversified portfolio has declined significantly in recent years. According to Morningstar, the asset-weighted average fee for all open-end mutual funds and ETFs fell to 0.45% in 2019 from 0.87% in 1999.

In addition, there are families of low-cost active funds with expense ratios well below industry averages. For example, the equal-weighted average expense ratio for U.S. equity funds in 2019 was 1.10%. This represents what fund providers are charging for their product, regardless of the size of the fund. Dimensional Funds, who we currently use for a portion of our model client portfolios, charges 0.20% or less for their core U.S. stock funds. Low costs for an active strategy help overcome one of the major advantages of passive investments.

Low costs for an active strategy help overcome one of the major advantages of passive investments.

IT'S NOT THAT SIMPLE:
THERE ARE MANY MORE DECISIONS TO MAKE THAN JUST ACTIVE VERSUS PASSIVE

Within any investment portfolio, there are several layers of decisions that determine the investor's return. The most important and largest influence is determining the asset allocation, or policy mix of stocks, bonds and cash. This single decision, and sticking to it, will account for most of an investor's return over time.

DECISIONS WITHIN THE EQUITIES (STOCK) ALLOCATION:

- How much should I have in large versus medium versus small companies?
- How much in growth companies and how much in value companies?
- What weighting scheme do I use? (Many broad stock market indexes are weighted by market capitalization. But there are many passive ETFs weighted by sales, dividends, volatility and host of other measures).
- How much should I have in U.S. stocks and how much in international? Within the international allocation, how much should I allocate to developed markets and how much to emerging?
- What should my exposure be to each sector of the economy?
- How does it affect my portfolio strategy if I have existing investments with significant capital gains, or a large position in employer stock?

All of these are **active** decisions, even if you are using passive investments.

DECISIONS WITHIN THE FIXED INCOME (BOND) ALLOCATION:

- What types of bonds should be included in my portfolio (Treasuries, corporates, municipal, high yield, inflation-protected, asset or mortgage-backed, international)?
- In what proportions?
- Duration of my fixed income portfolio (how long until the bonds mature)?
- Credit quality?

Even a broad market benchmark such as the Bloomberg Barclays Aggregate Bond Index excludes many of these types of fixed income investments.

As you can see, passive investing carries with it many allocation decisions, just as active investing does.

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 believe that both styles have a place in a well-constructed portfolio. Using passive strategies 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 help generate returns above the benchmark and bring down a portfolio's risk profile, thus potentially providing more protection during a market downturn.

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. This means that investors can 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.

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 investments. In many instances we utilize individual stocks for a portion of the U.S. large capitalization asset class in order to eliminate an additional layer of fees, improve tax efficiencies, and accommodate individual client preferences and 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 asset class is more efficient than other categories of assets 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 addition, we have the flexibility not to buy individual companies we find unattractive, or companies in what we believe to be structurally troubled sectors or industries.

In our all-fund portfolios we likewise include a mix of both passive and active investments. In more efficient markets such as U.S. large capitalization and developed market international stocks, we employ a combination of mutual funds, primarily low-cost active funds, and 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.

Given our view that fund managers have more ability to add value and reduce risk in less efficient markets such as emerging market international stocks and bonds as well as small U.S. company stocks, our research committee prefers a higher proportion of active funds for these asset classes. 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.

By including an allocation to large-cap funds in all portfolios, we are able to be intentional about the way our clients are positioned relative to size and value factors, and we are able to gain exposure to several thousand large-cap stocks, limiting the possibility that we miss out on top performers. We believe that this will give clients a smoother investment experience with more market-like returns over a full market cycle. Additionally, we believe that over the long term, small tilts towards the value and size premiums will add to returns, as they have more often than not over the past 90 years.

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.

Parsec's research committee utilizes both external resources and our own proprietary fund scoring system when considering a new actively managed fund for inclusion in our client portfolios and in evaluating existing fund investments. Doing so helps us select active managers who we believe are more likely to outperform their benchmarks over the long-term.

CONCLUSION

Investors have continued to show 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. Low-cost active offers another approach for part or all of your portfolio, which overcomes one of the major advantages of passive investing.

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.

Regardless of which investing approach or combination of approaches you choose, there are a number of important decisions that will help determine your overall long-term return. We are happy to help guide our clients though those decisions, based on our research and their specific situation.

About Parsec Financial:

Parsec Financial is a fee-only registered investment advisor (RIA) with $3.06 billion in assets under management as of Sept. 30, 2020. Parsec provides investment management, financial planning, tax planning, trust services and business retirement services to more than 1,800 individuals and businesses in six offices across North Carolina.

Learn more at parsecfinancial.com

Additional information, including management fees and expenses, is provided on Form ADV Part 2, available upon request or at the SEC's Investment Advisor Public Disclosure site: https://www.adviserinfo.sec.gov/Firm/104919

REFERENCES:

American Funds Capital Group (2016), "Build Retirement Portfolios That Seek Greater Wealth and Lower Risk." American Funds Distributors, Inc.

Banz, R.W. 1981. "The Relationship between Return and Market Value of Common Stocks." Journal of Financial Economics, vol. 9:3-18.

Byrne, Alistair, PhD, CFA and Smudde, Frank E., CFA. (July 2015) "Basics of Portfolio Planning and Construction." 2016 CFA Program Level I. Volume 4. Corporate Finance and Portfolio Management.

Greifeld, Katherine and Ngai, Catherine. (April 27, 2020) "When ETFs Go Wild." Bloomberg Businessweek.

Morningstar 2019 U.S. Fund Fee Study, Morningstar Manager Research, June 2020.

PIMCO (December 31, 2016), "Bonds are Different: Resolving the Active vs. Passive Debate."

Pompian, Michael M. (July 2017) "Perspectives on Market Behavior and Portfolio Construction." 2018 CFA Program Level III. Volume 2. Behavioral Finance, Individual Investors, and Institutional Investors.

ParsecFinancial

PREMIER WEALTH

WEALTH MANAGEMENT

EMERGING WEALTH

TRUST SERVICES

TAX SERVICES

BUSINESS RETIREMENT SERVICES

Asheville 828-255-0271 | South Asheville 828-277-7400 | Charlotte 704-334-0894 | Southern Pines 910-684-8054 | Tryon 828-859-7001 | Winston-Salem 336-659-0050