Rhetoric vs. Reality Series

Passive vs. Active Investing

At Your Retirement Advisor we take an educated approach to deciphering the myriad of information about retirement and investing. Ultimately, we help you make the important decisions that will provide the best possible retirement outcome. Making a wrong decision regarding taxes, portfolio construction, Social Security timing, overall costs and fees, long term care, use of annuities, reverse mortgage, etc. can end up costing a retiree dearly, while dramatically decreasing the probability of retirement success (meaning running out of money).

In this paper we'll quickly explore several topics that must be addressed, along with the rhetoric versus reality of each in an effort to provide the best educated guidance possible. This paper will focus on the "Rhetoric vs. Reality" as it pertains to Passive vs. Active portfolio management. We'll attempt to uncover the truth as to which strategy offers investors and retirees the best chance of success.

Investment Management Fees and Expenses

Your total fees and expenses need to be assessed and overall fees should be as low as possible…which will ultimately net better returns. The retiree paying the lower fees overall, all other things being equal (investment returns and retirement guidance), will yield the highest probability of retirement success. Conversely, the retiree paying the highest overall fees, all other things being equal, will have the lowest probability of retirement success.

Absolute vs. Relative Returns

One must understand the relationship between *ABSOLUTE RETURNS* and *RELATIVE RETURNS* in reference to investment planning.

- ✓ **Absolute Return -** As the name suggests, Absolute Return refers to the returns of an asset class or strategy, *without* comparing it to any benchmark or index for comparative purpose.

  As an example, if you invested in a large company US based stock fund and you received a 9.27% net rate of return, that is your "absolute" return. Since this 9.27% is not compared to any applicable benchmark or index there is not any way to determine whether this rate of return was a good return, a bad return or an average return.

- ✓ **Relative Return** – A Relative Return is a measure of the return of an investment or portfolio relative to an applicable benchmark or index for comparative purpose.
  As an example, if you invested in a large company US based stock fund and received a 9.27% rate of return during a specific period and the average rate of return of all other large company US stock funds returned 10.96% during the same period, then your relative return versus the average manager was 1.69%.

When analyzing investments or investment portfolios the absolute return offers an isolated return with no ability to assess its true value. The relative return is the only way to assess the value of the particular investment or portfolio by comparing it to a benchmark or index (net of all fees and expenses).

Benchmarking Portfolio Performance

Each micro-component within your portfolio (mutual funds, ETFs or stocks) and your overall portfolio should be evaluated regularly on a relative return basis versus the appropriate benchmark net of all fees. This is essential to assure you are receiving value based upon the strategy or investment portfolio you are utilizing. Most individual investors have no idea what their relative returns are versus the appropriate benchmark. Benchmarking your portfolio versus the appropriate index is essential to prudent investment management. Relative returns are the most important factor when determining the effectiveness of any investment management style or strategy and must be compared to the appropriate style or index (net of overall fees or costs).

Passive Management Strategy vs. Active Management Strategy

There has been an ongoing battle between the two conflicting management styles known as passive management (indexing) and active management strategies. The empirical evidence and research proves that each strategy has its pros and cons and a combination of both passive and active management properly executed can offer the lowest cost and highest relative return potential.

- ✓ **Passive Management (Index Mutual Funds or Exchange Traded Funds)**

  The passive strategist, or what is known as indexing strategies, simply invests in an unmanaged basket of stocks or bonds that follow a particular index. The index strategy tracks the return of a particular index, whether positive or negative, the return of that index is what the investor receives year in and year out, minus any management fees and expenses. The most common index utilized in this strategy would be to invest in the S&P 500 Index that tracks the 500 largest companies in the United States economy. The passive or index strategy simply tries to replicate the index and track the index components as closely as possible. The benefit of utilizing this strategy is minimal expenses since there is no manager or analyst researching securities in an attempt to outperform the market. In addition, the composition of the index changes infrequently, thus minimizing trading cost from year to year. The advantage of not having to pay a money manager, analyst and minimal trading cost keeps this strategy extremely cost effective.

Returns of passive investing – The objective of utilizing a passive or index strategy is to get index returns. Each strategy tracks a particular index, whether it be the S&P 500 Index (large company US stocks), the Russell 2000 Index (small company US stocks), EAFE Index (large company international stocks) or any other index. This strategy simply attempts to realize the same return of the particular index or a portfolio developed with numerous indexes. When determining the net return of the specific index strategy all fees are deducted from the gross rate of return of the index utilized.

✓ **Active Management (Mutual Funds or Separate Account Managers)**

Active management strategists attempt to outperform the market or the specific index category. As an example, a large cap blend manager will research all large US companies in existence. He/she then selects the companies he/she believes will outperform the index over time. Unlike passive strategists that try to replicate the return of the market or index by purchasing the entire basket or index, the active manager attempts to outperform the index by employing their research prowess and purchasing the best stocks for inclusion in the portfolio to attempt to outperform the market.

An active management strategy employs an investment manager, as well as analysts, to help the manager identify potential securities for inclusion in the portfolio. This strategy is more expensive since it has to pay the investment manager and the analyst to continually monitor the portfolio and identify securities to purchase and eliminate as deemed necessary.

Additionally, actively managing a portfolio typically involves more purchasing and selling of securities from year to year adding additional trading costs. Typically, active managers have higher portfolio turnover rates than the passive strategist…resulting in higher costs.

The Ongoing Debate - Passive vs. Active Management

Continual research by academics on passive vs. active managers attempts to solve the question of what strategy offers the best value and ultimately the best relative return net of all fees. Based on the myriad of analysis developed, research shows that certain investment asset classes offer a higher probability that an active manager can outperform, while other asset classes favor a passive management strategy.

According to a study conducted by Baird Asset Management*, over the past 15 years some asset classes favor active management, while other asset classes favor passive management. Still other assets classes are “mixed” and either style has exhibited success. In addition, the study indicates that top quartile performing active managers have outperformed the passive management style by wide margins net of fees. As stated in their report, “The median mid-cap manager outperformed the benchmark by 1.98%, on average, for three-year periods included in the study, while top-quartile managers added 4.09% of excess return during those periods. Clearly, there is a great difference between average and above-average managers and this directly influences a client's ability to meet or exceed performance expectations".

A Wharton School study explains, "Passive management generally works best for easily traded, well known holdings like stocks in large US corporations," says Smetters. "Because so much is known about those firms, active managers are unlikely to gain any special insight. You should almost never pay for active management for those things".

He continues, "But in certain niche markets, like emerging market and small-company stocks, where assets are less liquid and fewer people are watching, it is possible for an active manager to spot diamonds in the rough."

Another research report by Hotchkis and Wiley concluded the following, "After reviewing innumerable research papers that dissect the benefits and drawbacks of active and passive investment management, we have identified three results that appear to be widely acknowledged as fact:

Fact 1: The average active manager has underperformed the passive benchmark after fees
Fact 2: Some active managers have demonstrated the ability to outperform the passive benchmark after fees
Fact 3: High conviction is a common characteristic among active managers that have outperformed

Combining Active and Passive Strategies

We feel it's in a client's best interest to follow the research and combine both passive and active strategies where each has the best potential to add value to the overall portfolio. This strategy will reduce overall portfolio fees, while adding the potential to outperform the indexes over time.

Active Management: Utilize high quality, high conviction, low-turnover active management where studies show outperformance is possible and probable.

Passive Management: Utilize passive management where outperformance by active management is highly improbable.

Passive & Active Management: Utilize both active and passive in the asset classes that the Baird study indicated "mixed" or where neither active or passive has shown over-performance.

In addition, when utilizing active managers, it's absolutely essential to utilize managers that have below average turnover, as well as exhibiting a "system" to obtain above average relative returns versus their index over time. Active managers will not outperform their indexes in all timeframes and it's important to have patience and an evaluation process to determine when an active manager needs to be replaced.

To have the highest probability of success (excess returns above the index) with an active manager and combination strategy (active and passive), it's imperative to identify managers that offer low fees and have a proven track record that can be duplicated over time. The effective combination of high quality active managers with passive, low-cost indexing strategies offers the highest probability for a portfolio to consistently create high relative returns above the passive indexed strategy on its own.

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Sources

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