No Middle Ground:
Passive, or Truly Active and Diversified

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Ever since John Bogle and Vanguard changed the mutual fund industry with the introduction of the first retail index mutual fund in 1975, debate over passive index investing and hiring fund managers to pick and choose stocks has raged. But after more than four decades, a few things on the relative merits of each strategy have become clear.

Most active managers are not that active nowadays. Investments in passive, low-cost index tracking products can make real money, or lose it. And truly active managers often outperform their benchmarks, after expenses.

In the 20 years to December 31, 2016, an investment in the U.S. equity market benchmark, the S&P 500 Index, with dividends reinvested realized an annual return of 7.7%, for a total 339% gain. Yet, index investing can just as easily generate painful losses or paltry returns: Consider a low-cost 1996 investment tracking the Nikkei 225 Index. How has Japan's benchmark index done? With dividends reinvested into the index, the Nikkei gained an annual 1.3% in the period, for a total return of 28.3%.

Benchmark returns are normally described as "middling," as index investments by definition have no chance to outperform. But they usually do alright, beating the average actively managed fund, after fees, by 0.41%, according to a widely cited study by Antti Petajisto, updated in the July/August 2013 edition of the *Financial Analysts Journal*. The study partly substantiated previous research supportive of index investing. Not surprisingly, index mutual funds and their even more cost-efficient offspring, exchange traded funds, have proliferated over the years—at the expense of actively managed funds. In 2010, just over 50% of U.S. equity mutual fund assets were actively managed, down from about 65% a decade earlier.[1]

Another criticism of active management is that most management today is less active than in the past. According to Petajisto, in 1980, 60% of U.S. mutual funds had active share above 80%, meaning more than four-fifths of their holdings differed from those of their benchmark. In 2013, just one-fifth of U.S. mutual funds were more than 80% active. An actively managed portfolio that largely mimics its benchmark, a "closet indexer," is hard-pressed to materially outperform, despite the marginal over- or underweighting of various stocks or sectors in the portfolio, due to its higher management fees.[2]

"Because only the active positions of the fund can possibly outperform the benchmark, it is very difficult in the long run for a closet indexer to overcome such fees and beat its index net of expenses," wrote Petajisto, who generally classifies any manager with active share of less than 60% a closet indexer. Another category of nominally active managers pick stocks based on a top-down, macro approach, and also doesn't tend to have higher active share. They don't outperform their benchmarks, either. Trying to time shifts in sectors of the economy hasn't in aggregate proven a successful investment strategy.

But for investment managers, here's the compelling part of the study: The most actively managed funds, those with a divergence in holdings of more than 80% from their benchmarks, have on average outperformed their benchmarks by 1.26% a year after fees and expenses, "displaying a non-trivial amount of skill," Petajisto noted. These most active managers focus on individual security selection based on fundamental research. And they made more money for their investors than the benchmark would have, with a diversified set of researched holdings. The key is high active share.

Stock selection gets at the heart of the debate over passive versus active investing. The proponents of index-based strategies have for years leaned on the theory that markets are efficient. The idea is that with innumerable market participants analyzing securities all the time, all securities are ultimately fairly priced, crimping opportunities for active managers to outperform.

The problem with the efficient market hypothesis is that it's obviously flawed. If investors collectively were rational and markets efficient, price bubbles and

Past performance does not guarantee future results.

1. Strategic Insight and Thornburg, as of 12/31/2010.
2. Antti Petajisto, "Active Share and Mutual Fund Performance," *Financial Analysts Journal*, July/August 2013, Vol. 69, No. 4: 73–93. Based on performance (1990–2009) of more than 1,100 U.S. equity mutual funds.

> Employing fundamental research in selecting their holdings, Diversified Stock Pickers with high Active Share outperform: The most actively managed funds, those with a divergence in holdings of more than 80% from their benchmarks, have on average outperformed their benchmarks by 1.26% a year after fees and expenses.
>
> –Antti Petajisto

their subsequent bursts wouldn't happen. Yet history is replete with examples of "irrational exuberance," from ancient times, to the 17th-century Dutch tulip craze, to the more recent tech, housing, and financial bubbles.

In market bubbles, speculative investment inflates the valuations of securities far above the intrinsic value of the companies that issued them. So one of the problems with indexes is stocks in sectors caught up in price bubbles see their weightings, or representation in the indexes, grow disproportionately. Index-linked investments are locked into positions that, in price bubbles, become overpriced and vulnerable to crashes, which can just as easily result in securities being markedly underpriced.

Active, fundamentals-focused managers can sell over-bought, exceedingly pricey shares before they collapse, and afterward buy over-sold shares on the cheap, enabling them to potentially outperform through down and up markets. They may provide less volatile performance—a lower loss, or a higher return—than index funds might.

Index investment strategies have another problem. Indexes are backward-looking, and constructed by those who consider a company only after its share price or market capitalization have qualified it for inclusion in an index. As John Authers, the *Financial Times*' Long View columnist observed in a September 15, 2013, piece: "Those who draw up stock indexes, in a world ever more driven by passive investment, have immense power. The world's most powerful stock-picker, in effect, is the governing body of the S&P 500 Index," as more than $7 trillion is linked to it.

The S&P 500 Index's constituents aren't the biggest 500 U.S. stocks. Rather, the index's members are "adjusted to mirror the sectoral balance of the market as a whole," Authers pointed out. "But this discretion creates controversy. Google joined years after many thought it should." And Facebook waited until December 2013, when it was already a $135 billion company, for admission. "So without meaning it, investors have outsourced much power to the index providers," Authers noted.

Truly active managers can research the prospects of companies that are positioned for future growth. Closet indexers, by contrast, can only pick up companies that have already arrived in an index, potentially undermining their chances of investing at favorable prices.

Skilled active managers can also avoid heavily weighted index constituents that may be facing future, discernible risks, such as pending shifts in the political and regulatory environment. Think natural resource companies, especially the big publicly traded but state-controlled "national champions" in some countries, such as China, Russia, or Brazil. Or in developed markets, financial sector legislation that expands rules on lending, proprietary trading, and capital ratios. Changes in tax regimes are another uncertainty that can have real impact on the cash flow and valuations of companies, even before they are implemented, if previously telegraphed by government authorities.

Market conditions, structural backdrops, and technological innovations constantly change the outlook for future earnings growth. Active managers at least have a chance to anticipate it.

And unlike passive investors, they can also evaluate whether a company is using

Active Share	Tracking Error: Low	Tracking Error: High
High	**Diversified Stock Pickers:** Individual security selection, high Active Share, lower tracking error. Outperformed by 1.26% a year	**Concentrated Stock Pickers:** Individual, but very limited security selection, high Active Share, high tracking error. Underperformed by 0.25% a year
Low	**Closet Indexers:** Lowest Active Share, low tracking error. Underperformed by 0.91% a year	**Factor Bets:** Top down sector allocation, lower Active Share, high tracking error. Underperformed by 1.28% a year

Source: Antti Petajisto, "Active Share and Mutual Fund Performance," July/August 2013 edition of Financial Analysts Journal, Volume 69, Number 4, CFA Institute. Study was based on total returns from 1990 to 2009 (net of fees, excluding sales loads) of more than 1,100 U.S. equity mutual funds. Holdings and returns were sourced from CRSP databases and Thompson Reuters. Sector funds, index funds, and funds with assets less than $10 million were excluded. Funds were compared against the primary benchmark stated in their prospectus.

Diversification does not assure or guarantee better performance and cannot elimiate the risk of investment losses.

Past performance does not guarantee future results.

cash or debt on its balance sheet wisely; what a potential acquisition by, or of, a company implies for the share prices of the firms involved; how management changes may affect a company's prospects; and in extended periods of high-market volatility, examine a firm's defensive capabilities, perhaps selling before it's removed from an index after a threshold-tripping decline in market value and the index's periodic adjustment. In times of economic expansion, active managers also have a shot at identifying promising companies positioned to flourish, possibly before some are inducted into an index.

Given the differentiated nature of their holdings, truly active managers—those with high active share—will no doubt underperform their benchmarks during shorter measurement periods, particularly when broad market swings dampen dispersion among index constituents. But over longer-measurement periods, when correlations both ebb and flow, select stocks with attractive fundamentals and favorable prospects can help astute active managers outperform. ■

Important Information

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The views expressed by Mr. Roth reflect his professional opinion and should not be considered buy or sell recommendations. These views are subject to change.

Dividends are not guaranteed.

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Active Share – A measure of the percentage of stock holdings in a manager's portfolio that differ from the benchmark index.

Beta – A measure of market-related risk. Less than one means the portfolio is less volatile than the index, while greater than one indicates more volatility than the index.

Exchange Traded Fund (ETF) – A security that tracks an index, a commodity or a basket of assets like an index fund, but trades like a stock on an exchange. ETFs experience price changes throughout the day as they are bought and sold.

Standard Deviation – A measurement of dispersion around an average which, for a mutual fund, depicts how widely the returns varied over a certain time period. Higher standard deviation of returns indicates greater volatility.

Tracking Error – A measure of how closely a portfolio follows its benchmark. Typically, it's the standard deviation of the difference in returns between a portfolio and the benchmark. Actively managed portfolios tend to have a higher tracking error compared to passively managed investments.

Japan's Nikkei 225 Stock Average is the leading index of Japanese stocks. It is a price-weighted index comprised of Japan's top 225 blue-chip companies on the Tokyo Stock Exchange.

The **S&P 500 Index** is an unmanaged broad measure of the U.S. stock market.

The performance of any index is not indicative of the performance of any particular investment. Unless otherwise noted, index returns reflect the reinvestment of income dividends and capital gains, if any, but do not reflect fees, brokerage commissions or other expenses of investing. Investors may not make direct investments into any index.

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