By **Andre Abrantes**

Active Versus Passive Management

Reject an oversimplified framework

The active–passive debate dominates current discussions in the investment industry. A seemingly endless number of articles have been written on the topic, with some arguing investors should pursue active stock-picking strategies and others passive index approaches. It's a battle that's been painted in stark contrast—highlighting two distinct and opposing ends of the spectrum—in search of which approach is best for investors.

Recently, momentum has swung in one direction. In the last decade, $1.4 trillion has flowed into passive index mutual funds and exchange-traded funds (ETFs), as investors turned their backs on actively managed strategies. Today, estimates suggest that indexing represents approximately 40 percent of aggregate equity mutual fund assets, a level twice that of 10 years ago. (See "Actively Departing," p. 58.)

To some, the debate is complete, as proved by the headlines and fund flows. Even Warren Buffett (perhaps the world's most famous active manager) recently devoted a portion of Berkshire Hathaway's annual meeting to promoting indexing. Yet, this surge in passively managed assets (some might argue "bubble") doesn't mean all investors should flock to build passive-only portfolios.

Investors should reject the oversimplified framework applied to the active versus passive debate—as it's not that simple, and all investing requires active decision making—and consider their investment choices more critically. I won't re-hash the academic research supporting index investing, as this has been amply covered. Instead, I'll take the devil's advocate position and put forth several arguments illustrating the underlying complexities that are ignored in the current passive narrative and suggest that investors consider their options more critically.

Andre Abrantes is managing director at Cambridge Associates in Arlington, Va.

Indexing Isn't Passive

What's typically labeled as "passive" investing isn't actually passive. The passive label most commonly refers to index investing and specifically to capitalization-weighted indexing. What this means, in practice, is an investment strategy that mechanically buys a portion of every security within a specific universe in proportion to the security's size within the overall universe.

The passive label emerges from the fact that this type of indexing approach doesn't seek to identify the specific winners versus losers in a market through security selection—it just seeks to buy the entire market. The concept underlying indexing is powerful, but the passive label is misleading and masks the underlying complexities embedded in an investor's decision to index.

Wide Range of Decisions

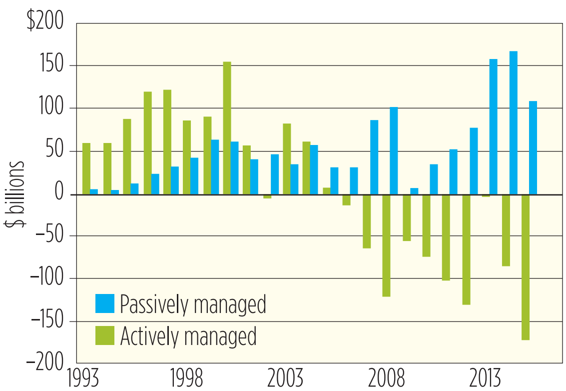
It's important to note the wide range of active decisions that are embedded in the seemingly simple and benign decision to pursue a passive index approach.

Exposure. What exposure would the investor like to own? This is an active decision to allocate capital to an asset class versus holding cash. Is it stocks, fixed income, real estate or other asset classes? Does he have exposure to the asset class globally, just U.S.-based assets or a sub-geography or sub-sector?

Indexing. Should the investor index or not? This is a complex active decision. Indexing requires believing that a systematic, rule-based, basket approach to buying

Actively Departing

Momentum has swung in one direction



— Morningstar

market exposure is attractive and that the specific rules governing the indexing methodology are robust.

Universe of securities. If indexing, what specific universe of securities should the investor include in the basket? Using U.S. equities as an example, the investor must decide which stocks in the U.S. market to include. Will it be the full market (~5,000 companies), just the largest and most robust companies (S&P 500) or the smaller and higher return/risk profile companies (Russell 2000)?

Indexing methodology. Which type of indexing methodology does the investor want to use? The most common approach is using capitalization-weighted rules (buying stocks in proportion to the overall value of the company), but there are competing methodologies. This is a particularly difficult decision to make today, as academic research has continued to evolve, and investment firms have rushed to offer an ever evolving line-up of newer index methodologies. The industry has labeled many of these approaches as "Smart Beta," implying an improved and smarter indexing approach. However, in reality, most of these products represent a specific tilt in how to create the index—including rules that focus on equal weighting, value, momentum or even the underlying fundamentals of company performance, among many other options. Many of these indices don't feel exactly passive, and choosing among the various methodologies certainly isn't a passive exercise.

Fund manager. Which index fund manager to use? When Vanguard launched the first index fund in the mid-1970s, few competing choices existed, but this is no longer the case today. Many large investment conglomerates offer a wide variety of index products—both in traditional as well as newer and more complex flavors—and the competition is fierce in products and pricing.

The vehicle. Which vehicle is most appropriate? An investor must decide the appropriate vehicle, choosing from mutual fund, exchange-traded fund, separate account or options-based instruments—each with different fee, liquidity and implementation trade-offs. (See "A Case Study in Decision Making," p. 59.)

Who's the Active Manager?

Who, ultimately, makes each of the active decisions outlined above is another important consideration. Is it the investor directly, an advisor or an investment manager? One of the ironic facts in the recent surge in indexing is that many individuals and institutions are taking full responsibility for investment decision making, essentially assuming the role of active manager themselves rather than using investment professionals. Whether a nonprofit's investment committee, a neighbor or a retiree, many investors who choose to index are making an active decision on what index to use, what fees to pay and when to enter and exit a particular asset class.

While there are many benefits to indexing, the simplest being lower costs (Buffett recently estimated that investors have wasted more than $100 billion on active management over the last decade),[1] there may also be some negative consequences. DALBAR, Inc., a quantitative investment research group, highlighted in a recent study that the average investor experienced significantly lower returns over the last 20 years, relative to those available in the market with a buy and hold strategy—due primarily to poor timing and execution (active management by the average investor detracted from performance). (See "Negative Consequences," p. 60.)

Therefore, an individual investor must carefully consider his context and knowledge level and make one of his most critical decisions—to determine who'll serve as the active manager making these decisions in investment strategy.

Costs Matter, But So Does Price

Investment costs, including manager fees, trading costs

and taxes, are a critical component impacting performance. However, the pendulum has swung too far in the current narrative, and some have focused excessively on simply minimizing costs, while ignoring other risks, such as price.

When indexing, investors systematically buy a sliver of each security in the market at a very low cost. This approach has a tremendous cost advantage due to its systematic nature and low trading turnover.

In contrast, active fund managers, who select individual securities, face significant costs as they build portfolios and trade with one another. Some will make gains, while others will experience losses—resulting in a zero sum game across managers. Fund managers charge management fees and pay trading costs, meaning the average performance of active managers should be negative relative to the index. Additionally, active trading can result in tax implications for individuals or institutions, further lowering net returns available to investors. As a result, active fund managers have an initial disadvantage relative to indexing, simply due to the costs.

Containing investment costs is a critical priority, and indexing has a clear advantage. However, costs aren't the only factor impacting performance; the purchase price and valuations of the underlying holdings also matter. I'd argue that the current narrative is excessively focused on simply minimizing costs, at the expense of paying attention to other risks.

By definition, cap-weighted indexing concentrates in the largest companies and adds more to those that have recently gained in price relative to other stocks in the index. Thus, an index can have significant embedded momentum and become particularly exposed to expensive securities. Some argue this is happening today, as certain sectors (tech) and specific companies (Amazon) have experienced strong gains and represent an ever increasing proportion of the overall index. While the fee and trading costs of an index are low, the benefits could be overwhelmed by losses from buying at elevated prices and adding to already overvalued stocks.

I suggest that investors consider costs as one component of an investment decision and focus on total performance, net of fees, as the primary objective, instead of simply seeking minimal costs. Additionally, I recommend allocating fee budget to areas with the largest opportunity for active management (such as private investments or hedge funds) while minimizing costs in more efficient markets (U.S. Treasuries and others)—essentially matching costs with appropriate investment types and expected returns.

Indexing Breaks Capitalism

I'd like to make a final argument as to why investors shouldn't blindly implement an indexing strategy based on the allure of simplicity and passiveness and should instead remain critical on a forward-looking basis.

As a thought experiment, imagine that the trend

A Case Study in Decision Making

Investors must answer many questions, even when choosing to index

A recent interaction with a family member living in Europe and dealing with an estate transition perfectly illustrates the non-passive nature of the decision-making process, even when choosing to index a portfolio.

Points of discussion included:

- Should the family invest the proceeds from the estate?
- What should be the objectives and risk profile of the portfolio?
- The family lives in Lisbon, Portugal. Should the exposure be global? Europe only? Portugal only? What are the currency implications?
- Hire active stock-picking managers or index?
- What's the most appropriate index for the desired exposure?
- What type of index methodology to use? Are Smart Beta options superior?
- What should the family do if the market appears expensive? Should the individual investor move in and out of the index based on the market environment and valuations?
- What provider should the family use? The investor is familiar with Vanguard in the United States, but this isn't an option on his bank's platform. Are the other providers as good?
- What fees are appropriate for advisors, index funds or active managers?
- Which index vehicle—mutual fund or exchange-traded fund?

Investors would be well served to consider these and other questions critically in determining their overall investment strategy and to acknowledge that all require active decision making, even if ultimately using indexed strategies for implementation.

— Andre Abrantes

to indexing continued to accelerate and that indexing came to represent a majority of the market. For simplicity, assume that all investors shifted to a purely indexed approach—100 percent. What might be the implications?

Today, when one invests $100 in the cap-weighted S&P 500 index, mechanically, the index fund purchases a sliver of each company based on its relative size within the market, at the closing market price for each stock. As an example, currently, the four largest companies in the S&P 500 are Apple, Microsoft, Facebook and Amazon. The share price for each stock represents the current fair value, determined by the collection of all investors trading in the stock today. The company's percentage weighting within the overall index is set by the price multiplied by the number of the outstanding shares. Essentially, indexing is built on the premise of free riding the collective wisdom of the marketplace to determine the fair price and overall value of the company.

In a 100 percent indexed world, without fundamental analysis, stock selection and trading among active participants, the weights of the index and relative prices of stocks would become fixed. Price discovery would no longer exist. The S&P 500 index would become a static list of companies each held in the exact same proportion as historically. An investor allocating a portion of his savings to the S&P 500 would buy Apple, Microsoft, Facebook and Amazon at exactly the same percentage of the overall market as historically. Prices might rise based on new capital being added to the marketplace, but with no differentiation across companies and in complete isolation from company fundamentals.

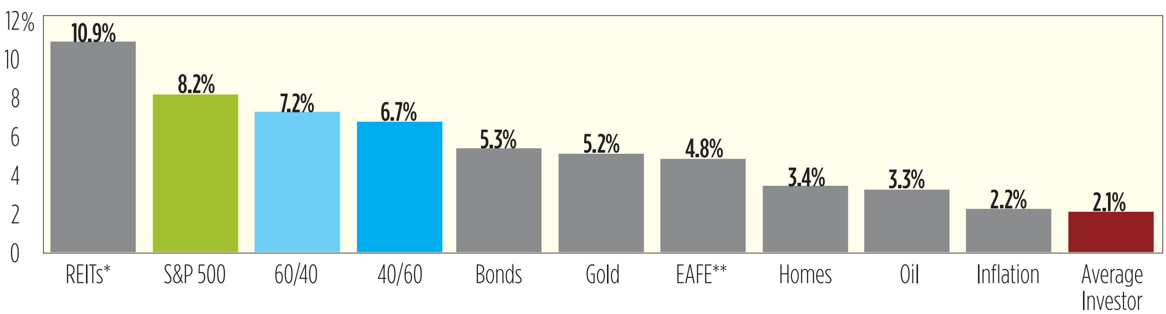
It's not difficult to imagine a world in which Facebook, as an example, declines in popularity, revenues and profitability falling precipitously within the next 20 years. However, in this context, an investor would still be buying $1.90 of Facebook stock for every $100 added to the index, based on the percentage allocation Facebook holds in the index based on today's context, pricing and overall company value. In effect, in a world with 100 percent indexing, it would no longer be possible to free ride on the collective and dynamic wisdom of the marketplace.

At its core, investing is a critical component of

Negative Consequences

Decision making by average investor likely impacting performance

20-year annualized returns by asset class (1996–2015)



* REITs: real estate investment trusts
**EAFE: Europe, Australasia and Far East

Note: Indices used are as follows: REITs: NAREIT Equity REIT Index; EAFE: MSCI EAFE; Oil: WTI Index; Bonds: Bloomberg Barclays U.S. Aggregate Index; Homes: median sale price of existing single-family homes; Gold: USD/troy oz; Inflation: Consumer Price Index; 60/40: a balanced portfolio with 60 percent invested in S&P 500 Index and 40 percent invested in high quality U.S. fixed income, represented by the Bloomberg Barclays U.S. Aggregate Index. The portfolio is rebalanced annually. Average asset allocation investor return is based on an analysis by DALBAR, Inc., which uses 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 Dec. 31, 2015 to match DALBAR, Inc.'s most recent analysis. Guide to the Markets—U.S. Data are as of Sept. 30, 2016.

— JPMorgan

capitalism—a mechanism for savers to funnel money to new opportunities for growth within the economy. In a world of 100 percent indexing, if implemented in its current approach, capital would be funneled to companies regardless of fundamental needs or merit, simply because of their historical sizing within an index. This obviously brings into question how 100 percent indexing and capitalism might peacefully coexist.

While the logic of this thought experiment is purposefully extreme, some argue that markets are already showing early warning signs of these types of problems. These include stock prices that increasingly appear overly influenced by money flows and that move in monolithic tandem, rather than based on a fundamental analysis of the merits of individual companies, their strategies, revenues and resulting profits.[2]

Some will counterargue that these issues can be addressed by, for example, shifting to more fundamentally oriented index rules or other fixes. I agree, but this illustrates perfectly why these aren't simple or passive decisions but rather complex and active investment decisions.

A Skeptical Lens

I recommend that investors resist the oversimplified narrative in the active versus passive debate. All investing requires active decision making.

As an advisor to institutions and individuals, in practice, I employ a mix of index and active fund managers across our client portfolios. I believe that a small group of top-tier managers can indeed add value over time, net of their fees and contribute positively to overall portfolio performance and risk mitigation. But, identifying and gaining access to these top-tier managers requires significant research resources, expertise and patience.

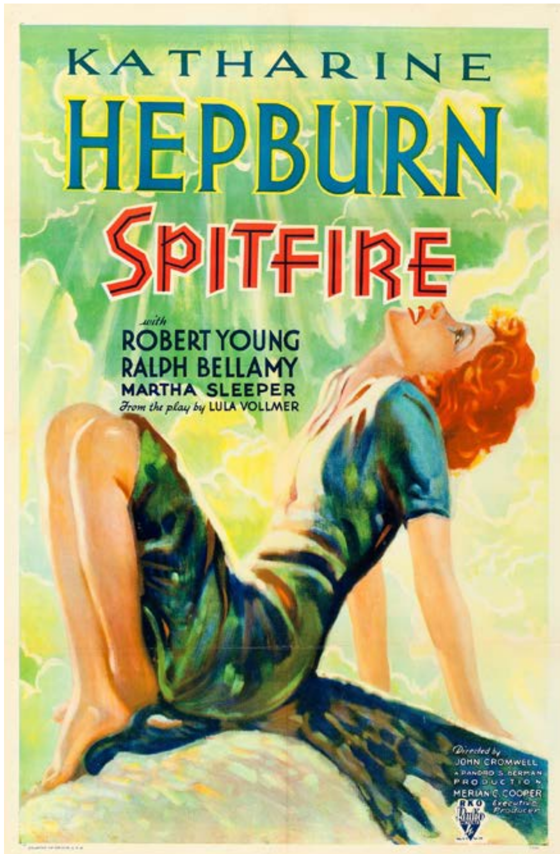
Investors should consider their investment strategy carefully, including the benefits and challenges of implementation across indexing, traditional stock-picking or various permutations in between, and determine the appropriate solution for their portfolio, based on their context and level of resources.

Thus, I recommend that investors:

1. Design an overarching investment strategy to meet their objectives;
2. Determine what level of active management to engage in;
3. Identify who should be responsible for the active decision making; and
4. Match costs with the selected investment approach.

Endnotes

1. *www.berkshirehathaway.com/letters/2016ltr.pdf.*
2. *www.eipny.com/epoch_insights/papers/the_impact_of_passive_investing_on_market_efficiency.*



SPOT LIGHT

Wildcat

Spitfire (RKO, 1934) sold for $23,900 at Heritage Auctions' Movie Posters Signature Auction in Dallas on July 29-30, 2017. An action flick, *Spitfire* starred the talented Katharine Hepburn who, over her career received a record four Academy Awards for Best Actress. *Spitfire* wasn't one of the films she received such acclaim for—it was considered one of her worst.