



Will Passive Investing Always Be The Holy Grail?

An Update on the Ongoing Active vs. Passive Debate

November 2016
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- Passive management continues to attract both headlines and additional fund flows from investors due to low fees, simplicity, and strong recent relative performance in numerous asset classes.
- However, investors often error in extrapolating recent results into the future and may have erroneously declared passive options the long-term winner across all asset classes.
- We believe some asset classes are prime candidates to invest passively to reduce fees. However, a thoughtful approach is still required for portfolio construction across a variety of asset classes.
- Investors may be surprised to learn that passive investments have as much peer group volatility as active managers and do not consistently provide median or above average peer group ranks over long periods.

In some cases, passive investments are not only less expensive, but also the optimal choice for investors. However, at times investors can be hardwired to lose money by observing recent information and extrapolating that information into the future as a certainty. Investing solely in what has recently done well is hardly a new idea and can lead to suboptimal outcomes for investors. The recent attention given to passive investing as superior to active management in every way fits well into this flawed behavior. We strive to not be dogmatic about the active vs. passive decision and instead look for empirical evidence to support the best after-fee portfolio for our clients. We offer the following points to consider when deciding which type of strategy makes sense for your portfolio:

1) Opportunity for Excess Return is Not Uniform

Figure 1 is an excerpt from our white paper *The Next Chapter in the Active vs. Passive Debate*¹ where we assess the excess return of Large Cap Core managers. Large Cap Core was chosen since the asset class is frequently cited as an example of passive investment superiority. The data supports this view since the median portfolio experiences negative excess return of 0% to -2% on an annualized basis in 90% of rolling three-year periods over the 10-year period ending December 2014. Even a top quartile manager (which we view as a reasonable goal for manager selection) fails to generate excess return approximately a third of the time, which is a significant headwind. For analysis purposes, we prefer this approach of using multiple rolling periods to mitigate end point sensitivity present in many common trailing return analyses.

Figure 1

	% of Rolling 3-Year Periods:					
	Below -4% Excess Return	Between -2% and -4% Excess Return	Between 0% and -2% Excess Return	Between 0% and +2% Excess Return	Between +2% and +4% Excess Return	Above +4% Excess Return
Large Cap Core						
25th Percentile			34%	59%	7%	
50th Percentile			90%	10%		
75th Percentile		45%	55%			

¹ <http://www.dimeoschneider.com/wp-content/uploads/2015-Update-The-Next-Chapter-in-the-Active-vs.-Passive-Debate.pdf>

Source: Morningstar data used for all calculated figures and classifications of asset class categories. Information is obtained from a variety of sources which are believed though not guaranteed to be accurate. Any forecast represents median expectations and actual returns, volatilities and correlations will differ from forecasts. Past performance does not indicate future performance. This presentation does not represent a specific investment recommendation. Please consult with your advisor, attorney and accountant, as appropriate, regarding specific advice.



When the same analysis is applied to Small Cap Value in Figure 2, the odds of selecting an outperforming manager increase substantially. Comparing to the metrics cited for Large Cap Core, the median manager underperforms in only 21% of rolling three-year periods, which is materially better than 90% for Large Cap Core. Also, 21% of rolling periods resulted in significant excess return of +2% to +4% annualized, compared to zero in Large Cap Core. Lastly, the top quartile manager outperformed in 100% of the measured rolling three-year periods, with annual excess return greater than +4% a third of the time. This data supports the use of active management in the Small Cap Value asset class since moderate to strong manager selection would have often led to excess return generation, including significant excess returns in some periods.

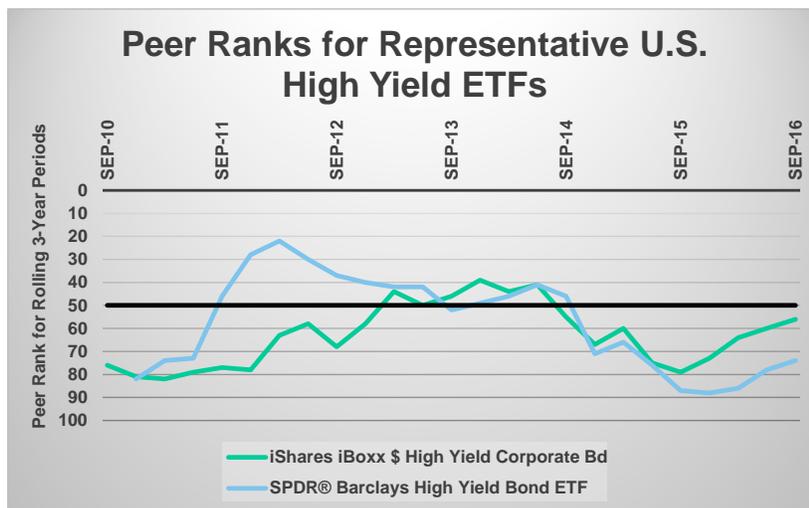
Figure 2

	% of Rolling 3-Year Periods:					
	Below -4% Excess Return	Between -2% and -4% Excess Return	Between 0% and -2% Excess Return	Between 0% and +2% Excess Return	Between +2% and +4% Excess Return	Above +4% Excess Return
Small Cap Value						
25th Percentile				41%	24%	34%
50th Percentile			21%	59%	21%	
75th Percentile	3%	7%	66%	21%	3%	

2) Not All Passive Investments Have Performed Well

Despite the “it’s best to just index everything” mantra nowadays, certain asset classes are far more challenging for passive investors. When certain parts of the index are difficult (if not impossible) to purchase due to a lack of available supply, low liquidity and higher trading costs, among other reasons, investors may not benefit from a passive allocation. U.S. Corporate High Yield is a good example, which as a category has two representative ETFs but zero open-end funds that attempt to deliver the index return. Despite the ETFs’ objectives, Figure 3 highlights that both have failed to deliver competitive performance with peers in the asset class. These results are not supportive of choosing a passive strategy in High Yield.

Figure 3



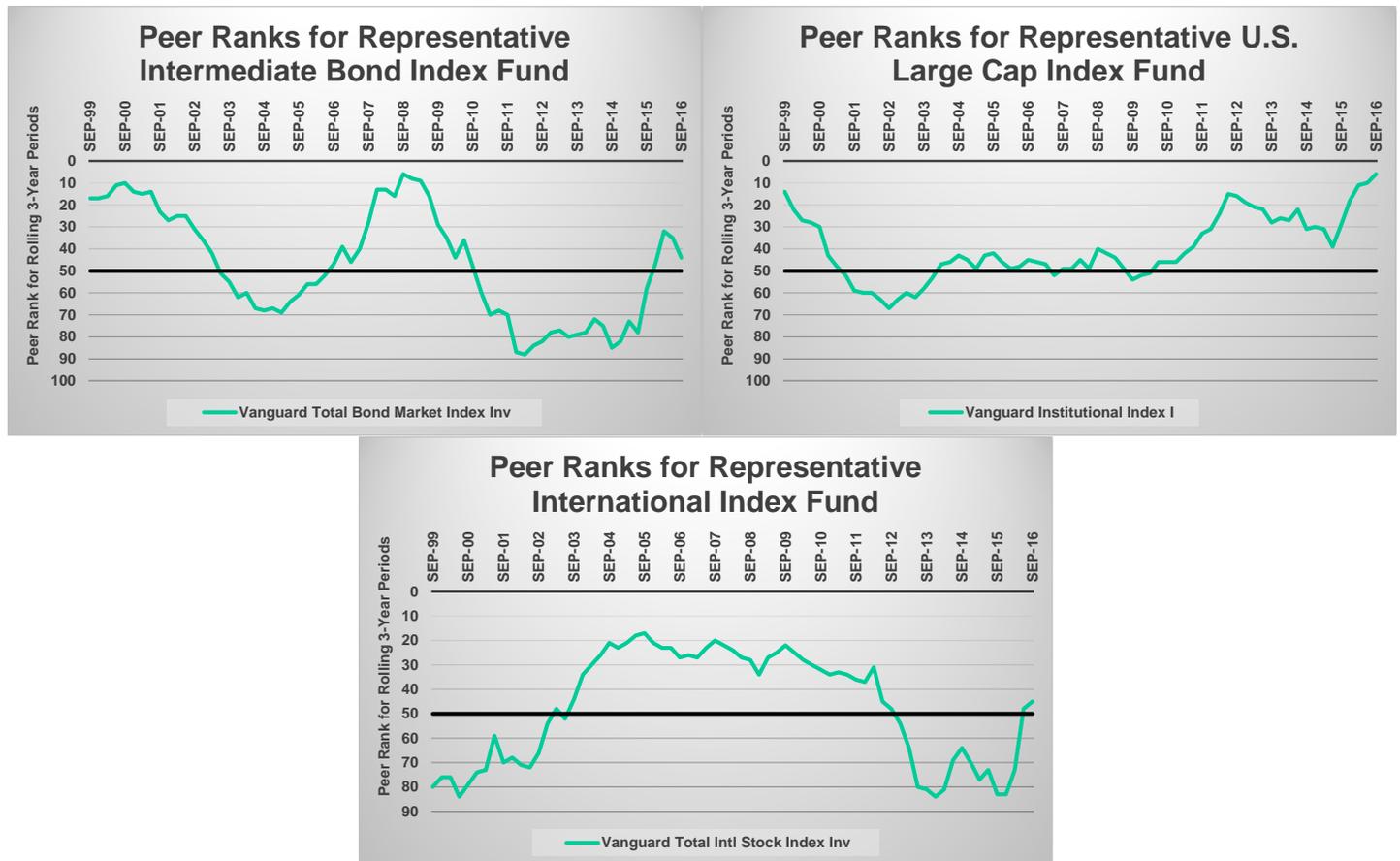
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3) Indexing Investing Falls Out of Favor Too

It may come as a surprise to some investors that passive portfolios are subject to the same peer rank volatility as active strategies. Figure 4 displays rolling three-year peer ranks (based on annualized return) over the last 20 years for three different asset classes relative to their respective Morningstar categories. For simplicity, we show a representative Vanguard index fund for each category that could potentially be used if the primary goal was to index the asset class. While many passive strategies have performed well recently, this has not been consistent historically. The volatility of peer rankings among passive investments has been just as volatile as active investments since many representative funds have ranked as poorly as the 90th percentile to as high as the 6th percentile over one or more rolling periods. When assessing relative performance among peers, there are points in time where passive strategies look just as poor as poorly performing active strategies. What is clear in Figure 4 is none of the three asset classes below exhibit significant consistency of peer rank around the median or better when looking at three-year periods. This is at odds with the idea that passive investing is the panacea of long-term investing across all asset classes.

Figure 4



Source: Morningstar data used for all calculated figures and classifications of asset class categories. Information is obtained from a variety of sources which are believed though not guaranteed to be accurate. Any forecast represents median expectations and actual returns, volatilities and correlations will differ from forecasts. Past performance does not indicate future performance. This presentation does not represent a specific investment recommendation. Please consult with your advisor, attorney and accountant, as appropriate, regarding specific advice.



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4) Taxes Can Change the Conversation

For taxable investors, the active vs. passive debate is even more complicated. Potential higher turnover in active strategies can often lead to taxable events, especially if short-term gains and/or ordinary income are generated as a result of active manager decisions. Vehicles such as Exchange-Traded Funds (ETFs) have many positive attributes such as extremely low turnover and the ability to utilize Creation and Redemption baskets to limit taxable events. These qualities alone do not mean taxable investors should always invest passively, but they do warrant additional consideration for those seeking after-tax returns.

To conclude, extrapolating the recent success of passive management is a risky proposition, just like it was when the widely held beliefs in 1999 and 2006 were that technology stocks could only rise and that property values could only increase, respectively. Investors would be wise to take a step back and bring context to their decisions. We think passive investing in some instances is an excellent way to gain market exposure and lower portfolio fees. In others, we think it can be an ill-advised move that is dangerously reactive to recent strong relative performance. We remain convicted that a thoughtful mix of active and passive management increases the opportunity for portfolio success.

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