THE ACTIVE-PASSIVE DEBATE: WHAT REALLY MATTERS TO YOUR INVESTMENT PORTFOLIO

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Arguably, the most frequently debated topic in investing today is the comparative value of active investment managers versus passive investment strategies. While certainly not new, the debate has been taken to new levels with the proliferation of low-cost index vehicles, often in the form of exchange-traded funds (ETFs) and mutual funds. While the debate over the relative superiority of active managers versus passive strategies will conjure many strong opinions, it is important not to conduct the argument in a vacuum. Evaluated using single variables, these comparisons run the risk of overshadowing other issues which may play a more important role in determining whether your portfolio will successfully support your long term goals.

The massive surge in popularity of passive, or index investments, can be illustrated by fund flows, with investors transferring trillions of dollars out of active management and into passive investment vehicles. What has been the primary catalyst for this shift? The average active manager, particularly those managing large cap US equity strategies, has underperformed their benchmarks net of fees in recent years, as we have seen global correlations increase. Increased correlations since the end of the 2007-2008 financial crisis have resulted, in part, as a byproduct of the cyclical global equity market leadership, low asset class volatility and a subdued interest rate environment. A recency bias has also played a role in driving investors to significantly increase their exposure to passive vehicles. With passive vehicles nearing 30% market share of the investment universe, Vanguard Chairman Jack Bogle commented “Indexing, doesn’t need any help. It is growing at an astonishing rate and, for someone who never intended to build a colossus, a kind of frightening rate.” Another noteworthy consideration is that many “active” managers are extremely focused on maintaining a low tracking error to the benchmark, leaving them little chance to outperform, and further muddying the analysis of active versus passive management styles.

At Waldron, we believe that the optimal approach is to selectively choose where active and passive strategies are utilized, based on asset class and market conditions, rather than taking a blanket active or passive approach. For example, we tend to favor passive, or index strategies, for large cap US equities, an asset class that is highly efficient and receives significant analyst coverage, reducing the opportunities for active managers to outperform consistently. On the other end of the spectrum, for allocations to asset classes like emerging market equities and high yield bonds, we typically employ a more active approach. Within emerging markets, the typical equity market is much less efficient, receives far less analyst coverage and often experiences country concentration, resulting from weighting within the index. The lower efficiency, along with the flexibility of managing currency exposure, can yield a number of attractive opportunities for an active approach. A key reason for not being passive in high yield is that passive ETF vehicles, which track high yield bonds, can have a liquidity disconnect with the underlying bonds, which has resulted in material operational issues during times of market stress. The liquidity mismatch between the liquid passive ETF and the less liquid underlying asset class it tracks is not unique to high yield bonds, as recently passive ETFs tracking emerging market debt and gold miner stocks have run into structural issues as well.

The relative performance of active managers is also related to the overall investing environment. As noted earlier, periods with low correlations and elevated volatility tend to favor active managers. Since the end of the financial crisis, the global investing environment has been the exact opposite: below-average volatility and high correlations. In addition, studies have shown that environments with stronger US small cap and international equity performance tend to benefit active management (GMO: *Is skill dead?* Feb. 2015). Once again, we are coming off of the third consecutive year of US large cap equity outperformance, a streak which is relatively rare, historically.

For our Investment Department, deciding to incorporate both active and passive strategies, as dictated by the goals of the client and the prevailing economic environment, is a byproduct of our historical analysis of asset class performance and our customized approach to portfolio construction. Similar to many industry experts, we have seen that asset allocation decisions have a much greater impact on the long term success of a portfolio, both from a mathematical and behavioral standpoint, than whether a portfolio is actively or passively managed. Consider the following example:

- Allocations to active US small cap equity (10%) and active US large cap equity (20%)

- Your active US small cap equity manager outperforms by 3% (ex. 17% vs. 14% for the index) in the previous year, while your passive large cap strategy underperforms by 2% (ex. 4% vs. 6% for the index) in the previous year.

What was the bigger driver for portfolio-level returns? *Not* the difference in relative manager performance, but the *absolute allocations* to the sub-asset classes. This phenomenon has occurred frequently since 2010, a time period where US large cap equities have consistently outperformed other asset classes, particularly developed international and emerging market equities. As is the case with any asset allocation adhering to prudent diversification, portfolios will have material exposure to asset classes that are underperforming, and overperforming, at any given time. To illustrate the point, international equities have recently trailed their U.S. counterparts, but make up over 40% of the global equity universe (MSCI: *All Country World Index* Apr. 2017). As we have referenced in previous publications, global equity markets historically go through leadership cycles when comparing domestic and international equities, with neither class consistently outperforming the other over time. Leadership has shifted from domestic to international in both shorter and extended periods, as illustrated in the following chart. We believe in making adjustments to allocation weights (both overweight and underweight) based on fundamental valuations, and staying the course with a diversified asset allocation. Any decision to exit domestic equities or international equities entirely is *market timing* and is unlikely to support long term success.

Historically, the MSCI EAFE and S&P 500 have taken turns outperforming since 1971

Start date	End date	Outperformer	Excess return
April 30, 1971	March 30, 1973	MSCI EAFE	60.9%
March 30, 1973	October 31, 1976	S&P 500	33.3%
October 31, 1976	October 31, 1980	MSCI EAFE	77.6%
October 31, 1980	October 31, 1982	S&P 500	35.1%
October 31, 1982	February 28, 1989	MSCI EAFE	392.2%
February 28, 1989	August 31, 2000	S&P 500	502.2%
August 31, 2000	November 30, 2007	MSCI EAFE	54.3%
November 30, 2007	December 31, 2016	S&P 500	85.1%

Source: Henderson Global Investors

There are also many asset classes and investment strategies that cannot be replicated successfully by passive vehicles, which still play a key role in a diversified portfolio. This includes different types of alternative strategies, such as hedged equity (long/short equity) and managed futures (trend followers) that can help reduce overall portfolio risk by decreasing the volatility of the portfolio through a lower correlation to equities and bonds. These strategies historically generate returns between equities and core fixed income, and served to dampen returns in the most recent market cycle of large cap domestic equity leadership. However, actively managed diversifying positions tend to demonstrate their value during times of equity market volatility and overall market stress.

Risk reduction is important on two fronts: Lower volatility helps to reduce the probability of "bad" behavior, and helps to reduce sequence of withdrawal risk, two very real and impactful actions. The field of behavioral finance has grown immensely over the last decade, and has helped to quantify the true impact emotions can have on investment portfolios. For example, the so-called behavior gap has been illustrated as follows: an average investor has returned 2.1% over the last 20 years, while a traditional, moderate allocation has returned 6.7%. The 4.6% return gap can largely be attributed to emotional decision making; buying at highs and selling at lows (JPMorgan: *Guide to the markets* Mar. 2017) Such emotional behavior correlates strongly to how volatile the markets are, which is why proper asset allocation is needed for long term success. Additionally, for those drawing cash flow from their investment portfolio, volatility can have an even bigger impact. An investor making withdrawals from their portfolios after downside moves locks in permanent losses, and increases the return needed to make up the shortfall. The potential impact of these two behaviors could be devastating, which is why our investment team constructs goal-based portfolios, including diversified assets such as alternatives and real assets, so you are not forced to sell depressed assets at the wrong time.

As is the case with many discussions today, the debate of active investment managers versus passive investment strategies is not black-and-white, which is why we believe a combination of the two approaches is critical to successfully managing a portfolio. While undoubtedly, there are many active managers who consistently underperform their benchmarks (and with whom we would not recommend investing) the analysis should be focused on the main driver of portfolio performance over the long term, the asset allocation decisions of the portfolio. The most important consideration when building an Investment portfolio is understanding the goals, designing an allocation that supports them, and sticking with your long-term plan without letting emotions and hype derail it.

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Ben leads the strategy and implementation of the Waldron Investment Team, overseeing asset allocation, developing investment strategies for Waldron clients aligned with their unique goals and driving due diligence for investment managers.

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