Ruminations on Active vs. Passive Management

There are two main approaches to investment management: active management and passive management. The traditional (and by far the more popular) approach is active management. We employ the less popular passive management approach (sometimes referred to as indexing though they are slightly different). Below I will explain these two approaches, explore the pros and cons (for those who want the details), and summarize it all in the last section (for those who don't want all the details). First, the definitions:

Active Management, the traditional approach, attempts to 1) find mispriced (typically undervalued) securities and profit from the market eventually adjusting to the "true" value (this is known as security selection), and/or 2) profit from switching between asset classes such as stocks, bonds, and cash in a timely manner (this is known as market timing).

Passive Management is the approach favored by leading academics, researchers, and many institutional investors. Research, not to mention logic, has demonstrated that securities and markets as a whole are driven toward equilibrium (i.e. "accurate" pricing) by market participants. In light of this, passive management adherents believe that on average the same performance can be achieved by simply buying the entire asset class (or a representative sample) without using either security selection or market timing.

So, which approach is "better"? There are four primary issues:

1) Performance. Proponents of active management argue some managers do outperform the market, and therefore, an investor who uses that manager would do vastly better than one who simply indexes. Those of us who advocate passive management readily admit there are a number of very smart people with tremendous talent and energy managing money. Indeed, the problem is there are so many of them that securities are already fairly priced. If you put the world's greatest fisherman in a lake devoid of fish, he won't catch anything. In modern times, mispriced securities (fish) simply don't exist. Ironically, they don't exist because there are so many investors and money managers (fishermen) looking for them. As soon as the smallest mispricing (a minnow?) appears, it is immediately eliminated by the enormous number of people looking for it.

There is an even deeper issue, however. While it is true you cannot prove a manager with a great track record didn't achieve it through being more intelligent/skillful/insightful than his competitors, the number of managers who outperform is consistent with (actually below) the number expected even if it were sheer luck. In other words, if enough people try to pick stocks (or gamble at casinos for that matter) someone is going to do very well. The greater the number of people who are trying, the higher the odds that some lucky person will do phenomenally well. Even if you believe some managers really are "better," the real question is: Can you identify them in advance? There does not appear to be a way to do this.

We have calculated that if a manager has outperformed his or her benchmark by 2% per year on average (a 2% alpha is huge), 56 years of data would be required to know with confidence he or she was actually better (not 2% better – just better at all) and that it wasn't just luck (assumes 90% correlation and 20% standard deviation).

The groundbreaking research study in this area, *Determinants of Portfolio Performance*, was published in the July/August 1986 issue of the Financial Analysts Journal by Gary P. Brinson, L. Randolph Hood, and Gilbert L. Beebower. They studied the asset allocations of 91 large U.S. pension funds from 1974 through 1983 and found that the strategic (long-term) asset allocation accounted for 112% of the returns achieved. In other words, market timing (switching in and out of asset classes) and security selection (which specific investments are used to implement the allocation) combined to remove 12% of the returns. The pension plans would have done better to set their allocations, invest in index funds, and resist the temptation to do anything further.

Caveat: This is not to say there are no mispricings and the market never gets carried away. There are a few areas where for psychological reasons securities may be mispriced (value stocks for example), and sometimes markets yield to euphoria or panic (numerous recent examples), but in general the assumption that it is correct is a good default position.

2) Costs. Notwithstanding the study just mentioned, the primary argument for passive management is the certain cost savings. While the gross returns of the two approaches can be posited to be the same, the net return is quite different. Employing active management incurs costs far higher than the passive management approach. An advisor who employs passive management strategies can generally recoup his or her entire fee for each client just by choosing more efficient investment vehicles. Alpha (outperformance) is ephemeral, costs are persistent.

Another not-so-obvious cost savings – a passive management approach generally has far lower portfolio turnover. This can save significant money on trading costs and taxes.

Caveat: This is not to say that purchasing the absolute cheapest fund in a given category is the correct answer. While costs should matter a great deal, there are frequently reasons not to buy the absolute cheapest fund in each asset class. For example, passive strategies that have a better weighting system for securities held in the portfolio, a better (more patient) trading methodology, or that are less prone to front-running of index reconstitutions may be worth slightly higher fees.

3) Emotion. This factor tends to favor active management. Many people are excited by the prospect of buying a stock or fund that will have fantastic performance, even though it isn't likely – and if they are properly diversified, it won't matter much. The mere possibility does encourage many people to save and invest who probably wouldn't otherwise though. This is proven whenever markets decline as people contribute less to their 401(k)'s when logically they should be contributing more. Apparently, people don't invest rationally to reach goals like retirement; they invest emotionally for the thrill of it.

In addition, people like to "do something" about problems even when the best response is to do nothing (Congress is a great example of this). It makes investors happy to be able to "fire" one manager (sell one mutual fund) and "hire" another (buy a different fund). Even though on average it will make no difference (actually research shows that the fired manager will tend to outperform the hired manager after the change), it feels good.

Last, but certainly not least, people who employ passive strategies don't have exciting investments to talk about with their peers. I am not denigrating this factor. It is very important to some people and social groups to be able to talk about their hot stocks, etc. Our clients do not have that opportunity. Their investments are boring. They are not doing what "everyone else" appears to be doing. If your investments are exciting, we believe you're doing it wrong.

Caveat: Because of the reduced emotion, a passive strategy generally allows more objective decisions about rebalancing and tax-loss harvesting.

4) Diversification and Asset Allocation. While both strategies can be properly diversified and maintain targeted exposure to various asset classes, the passive approach usually does a better job.

Caveat: Frequently proponents of active strategies will also use passive vehicles to fill out some niches, so these two strategies are not mutually exclusive.

Summary: While gross investment performance will be similar across the two approaches, the passive approach should have better net performance because of lower costs. Furthermore, while people may feel better with an active approach, they are probably better diversified and are able to maintain better alignment with their target asset allocation using passive management.

Notes:

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