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Skepticism about the value of an actively managed versus passive portfolios has been on the increase.

There is a great deal of confusing information floating around the media and the internet regarding passive and active investing. Often that information is biased, ignores historical fundamentals and misses the importance around managing investor goals, objectives and expectations.

The purpose of the following is to provide some clarity to the issues.

The starting point really needs to be definitions. There have been a lot of characterizations regarding passive and active investing. In the end, it's like saying a color is blue. What type of blue? Is it pale blue, midnight blue, sea green blue or deep purplish blue?

From a professional perspective, I use the following as basic definitions.

Passive – any investment that is holding securities based on some specific orientation with minimal if any management. An example would be an S&P 500 index or an ETF that follows a specific MSCI benchmark. One could argue there is some management to keep the portfolio in line with the index but, beyond that it is passive.

Active – A portfolio of investments that is managed to a specific set of qualified metrics. For example, the purchase of stocks that are undervalued based on metrics such as PE and sold based on those same metrics when they become overvalued.

Another definition that needs to be clarified is "The Market". Depending on your source of news "The Market" can mean the S&P 500, Dow Jones 30 or some undefined environment called "The Market". For my purposes, "The Market" is the universe of investment opportunities available to investors.

With these three definitions we can begin to build an understanding of value for active versus passive investments.

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For the past 8 plus years Markets have experienced mostly upward growth. Historically this is highly unusual. Typically markets like the S&P 500 experience 1 to 3 market corrections (a 10% plus downturn) per year. In this type of environment, there has been a rallying cry from some investment arenas for Passive investing. Why? Because if the markets are relatively stable then, the need to pay close attention to volatility, market metrics and security investment metrics is diminished.

In environments like this there is a sense that the markets will never go down.

However, we do know markets go down and sometimes for reasons we don't anticipate. As an aside, there is a growing concern among economists that increased flow of money into passive investments will create a self-fulfilling investment bubble. That's a conversation beyond the scope of this brief commentary.

This still doesn't completely answer the Passive versus Active conversation. So, let's dig a little deeper.

There is an underlying conversation from proponents of passive only investing that ignores an important tenant of investing – allocation/diversification. The Passive narrative advocates buying and holding a certain set of investments that is diversified then rebalance only as needed. In other words, as those investments change in value over time your portfolio can move out of alignment to the original design. Rebalancing should bring the portfolio back into alignment. Okay, simple enough. But,

- When should you rebalance and how will you know the time is right (*metrics of when*) and what's the cost of reallocating?
- Will the rebalance maintain the diversification required (*e.g., has the underlying passive investment changed orientation – style drift*)?
- Has the correlation between passive holdings increased negating the diversification (*e.g. Correlation - everything goes up or down in tandem*)?
- Should you rebalance irrespective of given market conditions at that time (*the old adage phrased as a question "are you throwing good money after bad" just might apply here*)?
- Will passively rebalancing cause taxation issues or negatively impact your goals? (*e.g. unanticipated or expected capital gains*)
- Does a passive rebalance throw you into a risk setting that is not acceptable to you at that time?

These are just some of the questions that come into play.

Two big arguments in favor of passive investing are:

1) You shouldn't have to pay high fees for investments
2) Passive investments outperform actively managed investments

Let's start with fees.

What constitutes a high fee? Even more importantly, are fees the defining metric for what to invest in?

I maintain that fees are a metric to consider only when all other considerations (*between 2 or more investments*) are equal. That means the management orientation is the same, the volatility is the same, performance is the same, etc.

I also maintain that the concept of *"You get what you pay for!"* applies when you deal with high quality money managers and strategists. Notice that I did not say "ALL money managers and strategists". As in any profession there are good and not so good managers.

Let's consider a simple example with Fund A and Fund B. For the purposes of this example, both funds are identical except for cost and historical returns. Fund A costs 0.50% and has an historical return of 3.25%. Fund B costs 1.60% and has an historical return of 5.45%.

In this simple example choosing Fund A based on cost would be a costly mistake. Why? The historical net return (what you would have put in your pocket) is the difference between the historical return and the fund cost. Here is the math.

Fund A – 3.25% Hist Ret minus 0.50% cost = 2.75% hist net return
Fund B – 5.45% Hist Ret minus 1.60% cost = 3.85% hist net return

Fund B in this simple example has historically provided return that is *more* than 1% higher compared to Fund A.

Do Passive Investments outperform actively managed investments?

This is really a trick question. The real question should be, *"What are you attempting to accomplish with your investments?"* Following the "real question" raises other questions such as:

- What is the purpose of the investment?
- What time frame are you dealing with (*days, months, years or lifetimes*)?
- What amount of market volatility can you stomach? (*most people stomach less than they think they can.*)

- What are your other available financial resources?

- If you had to take a loss how much time do you have in earning and investing time frame to recoup the loss? Just because you are far from retirement doesn't make this a non-issue. *Large downturns earlier in your life still require large positive returns just to get back to even. That could put you behind in reaching your goals.*

Now let's put this all together using the analogy of driving. We use automobiles to drive on city, highway and country roads.

Every auto has seats, an engine, brakes, lights, steering and some have backup assistance. Think of these as the various components or investments in the portfolio (*stocks, bonds, real estate, alternatives, etc*.).

What type of auto you need depends on what you are trying to do – in town commute, road trip, hauling kids or moving equipment. Each goal has its own destination/purpose, time frame, risk (*depending on where you are going and the time of day*) and cost associated with the drive and you need someone to drive the auto.

Driving means stepping on the accelerator, signaling, using the brakes and making judgements about how to avoid lights, congested areas (*depending on the time of day*), getting out of the way from bad drivers, avoiding pedestrians and so on.

A good active portfolio is like driving an auto. The managers of the various strategies in the portfolio make investment judgements based on specific metrics just like you would make specific changes to your driving based on a myriad of conditions.

When we design solutions and strategies for our clients we incorporate a number of active strategists/managers in the design. Each has its purpose for the overall portfolio.

Continuing with the car analogy, there may be a sports car, family van, and a truck in the garage. This provides diversity to meet a range of driving needs. In the same way, having several strategists provides diversity both in assets and management approaches to deal with a range of anticipated market conditions.

Does this relegate passive funds to the dustbin? No, where appropriate we "actively" use passive investments as part of the overall portfolio design but, that passive investment resides inside an actively managed portfolio.

So, back to the question of “Do Passive Investment outperform actively managed investments?”

1. In stable environments – potentially yes.
2. Is “The Market” stable? Historically no and from a future perspective Highly Unlikely.

This brings into play the issue of protecting against downside risk.

If, like many investors, you lost 50% of your portfolio value during the 2008/2009 period, basic math dictates that you had to pick up a 100% gain to just get back to where you started.

> For example, $1,000,000 subjected to a 50% loss leaves you with $500,000. It takes a $500,000 gain or a 100% increase to recoup the loss.

Why is that important? Because downside risk can be as dangerous or more so than costs or returns in your portfolio. Massive portfolio losses can put you in “Catch up” mode to meet your goals (*retirement, buying a house, funding a child’s education, etc*.).

“Catch up” mode may be easier to live with when you are younger but, even then “Catch up” mode can do harm to your financial wealth and well-being. Passive management just doesn’t provide much room for downside risk consideration.

There are a variety of “Active” strategists/managers. Each utilizes a specific set of metrics to their management design. A good “Active” manager/strategist will put in place metrics to achieve specific goals such as:

- minimizing downside risk,
- investing in securities that meet the qualifications for “Antifragility”,
- capturing alpha on a specific set of securities,
- buying low PE and selling high PE stocks, etc.

Some of these terms may be foreign to the reader but, they are part of the considerations that a good strategist may incorporate into an active design.

Which active management style is correct? For our work it depends on your specific Intentions, Goals, Desires, Concerns, Risk Tolerance, Age, and other pertinent considerations such as the financial commitments you've made. From that foundation we design and create a plan that incorporates appropriate investment vehicles that are in alignment with who you are.

The real benefit from our work is your Confidence and Peace of Mind that you have a plan in place that truly fits with the commitments you've made to yourself and those you care about.

My hope is that this provides you a firmer grounding when assessing passive versus actively managed accounts.

Do you have questions? Contact us for a conversation.

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