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## Active and Passive: the Yin and Yang of Investing

*Active versus passive. No, it's not a debate to stir the passions of the public, but in the world of investing and deciding how to gain exposure to sectors, it is a rivalry up there with the Hatfields versus the McCoys, the North versus the South, the Yankees and the Red Sox.*

Proponents of active investing tout the ability of astute fund managers to beat the managers and add “alpha,” that amount of outperformance attributable to the skill of the manager. On the flip side, advocates of passive investing point to the long-term inability of most active managers to beat the market and to the high fees charged for sub-par performance, not to mention the tax inefficiencies. And so the debate goes.

In truth, however, while the polarized positions speaks to different groups of managers battling for fund flows and for the upper hand in a market debate, most investors are best served not by an either-or approach. Instead, placing select bets on select active managers can and likely should be combined with select positions in select passive

funds. That approach may not have the fireworks of “I’m right; you’re wrong,” but there you go.

### The debate

Advocates for one style over the other tend to speak in absolute terms. The recent cover of *Barron's* hailed the return of “stock picking” this year, and called for a period of outperformance for actively managed funds. John Bogle, the now-legendary founder of Vanguard’s approach to passive investing, has called active management that depends on the acumen of stock picker’s “a loser’s game.”<sup>1</sup> Meanwhile, the differential between low-cost index funds and exchange-traded funds (ETFs) and higher-cost actively managed mutual funds and hedge funds has drawn the negative scrutiny of both pension consultants and financial advice columnists.



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<sup>1</sup> Source: “In Bogle Family, It’s Either Passive or Aggressive”, *The Wall Street Journal*, 28 November 2013

Over the past decade, the debate has become ever more heated as the number of passive investment options have proliferated with the explosion of ETFs and with money pouring into low-cost index funds. In 2004 there were about 150 ETFs; by 2014, there were about 1,300, comprising nearly 20 percent of all mutual funds and at nearly \$1.5 trillion about 10 percent of total assets.<sup>2</sup>

While actively managed funds still dominate the landscape, conventional wisdom has clearly shifted toward passive vehicles. Many investors are advised to use ETFs and index funds almost exclusively and are warned that the high costs of actively managed funds will dilute their returns. Many advisers are understandably concerned about a world of limited returns that are further undercut by high manager fees and see in ETFs and index funds a more tax-advantaged way to be the best fiduciary for their clients.

Conversely, active managers contend that the only way to “beat the market” is to make active decisions about which stocks and bonds to select. In addition, in periods of volatility, active managers have the ability—which passive vehicles do not—to steer clear of weak sectors and companies and shift gears dynamically with changed market conditions. For instance, in the recent dramatic sell-off of oil and commodities, a passive index fund would have seen losses precisely commensurate with the losses in the energy sector overall. An active manager, however, might have

been underweight energy even before the recent sell-off and then reduced exposure during. Then, an active manager could increase exposure as bonds weakened and stocks sold-off, potentially capturing alpha for the next phase of the cycle. While few managers may have been able or willing to achieve such advantages, skilled active management can potentially inoculate investors from fundamental weakness in sectors or geographies or constructively position investors to benefit.

### Performance

It is certainly true that in terms of performance, a large percentage of actively managed funds fail to beat their respective benchmark, both in one-year periods and over time. For instance, only 19% of large-cap funds beat the large-cap index last year (Figure 1). The numbers were only slightly better on a three-year basis and about the same for five years. Meanwhile, small-cap equity managers did particularly poorly in 2014; though more beat the index than with large cap, the average returns were far less than a passive large-cap vehicle.

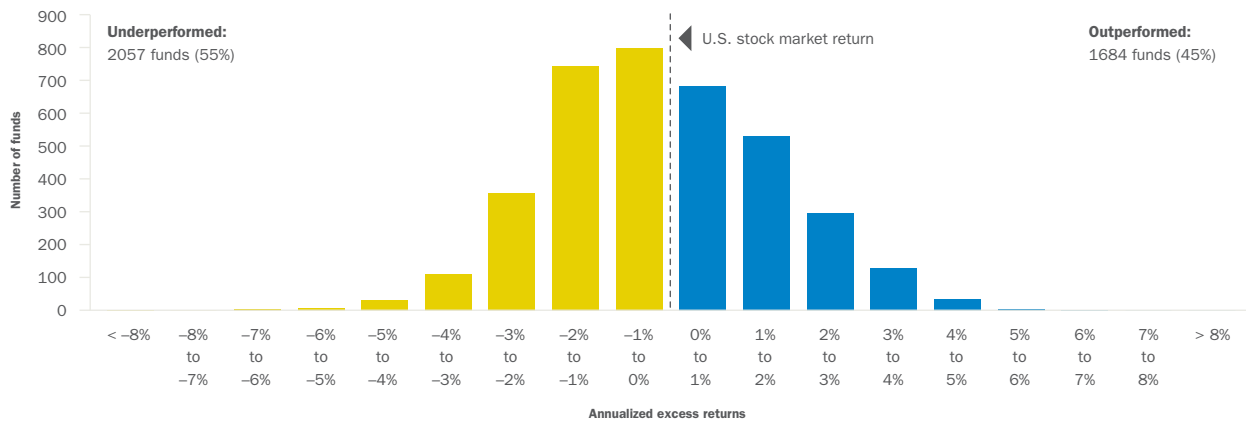
**Figure 1:**  
Percentage of active managers outperforming index

	1YR	3YR	5YR
<b>Large-Cap</b>	19%	31%	19%
<b>Small-Cap</b>	43%	36%	32%
<b>International</b>	44%	30%	44%

Source: Morningstar. Data as of 12/31/2014

<sup>2</sup> Source: 2014 Investment Company Factbook, Investment Company Institute

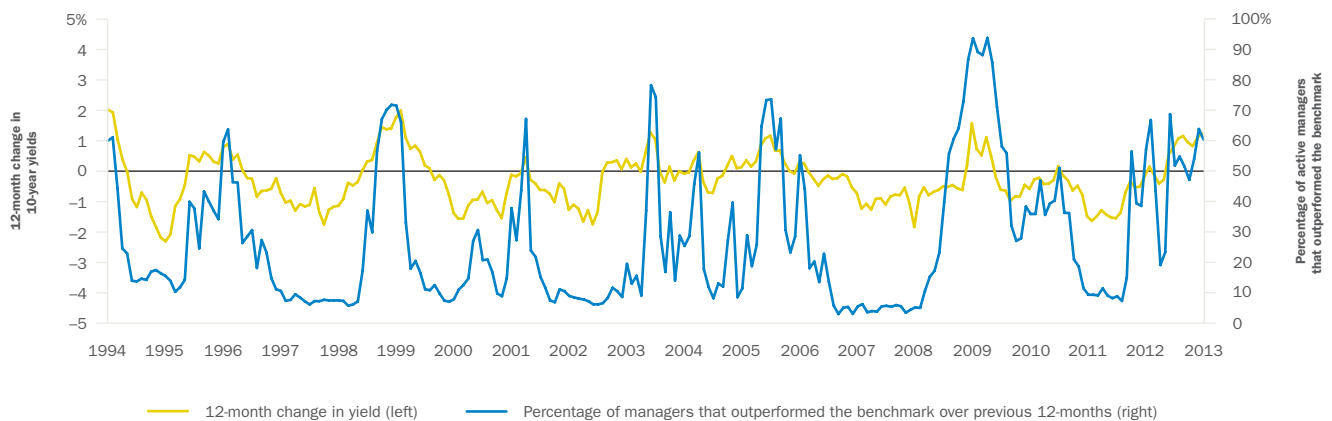
**Figure 2:**  
Distribution of active manager net excess return vs. benchmark\*



\*Data for 10-year period ending December 31, 2013.

Source: “The Active-Passive Debate: Market Cyclicalities and Leadership Volatility”, Vanguard, July 2014

**Figure 3:**  
Interest rate changes and active manager performance\*



\*Data for 10-year period ending December 31, 2013.

Source: "The Active-Passive Debate: Market Cyclicalities and Leadership Volatility", Vanguard, July 2014

On a ten-year basis ending in 2013, 45% of active managers outperformed the index, and most of those barely outperformed, by less than 1% (Figure 2). Most of the underperformers also barely underperformed, by the same margin. Given higher fees, the conclusion of pure performance data is that one often pays active managers for index returns, and pays them considerably more than for passive funds.

For bond funds, performance is much more disparate. In the roiling period of 2008–2009, almost no active bond managers beat their indices, and in the two years of recovery following, almost all did (Figure 3). Perhaps because bond prices and yields can vary more from issue to issue, from sovereign to sovereign and corporate to corporate, there can be greater dispersion in results than is often the case with stock funds—though stock funds do experience periods of high correlation when stock picking *per se* matters less.

One final factor: there are still areas of the investing world that lack effective passive vehicles. Very liquid markets such as U.S. large-cap equity have index and passive funds that act as good proxies for the asset class. The same is true for say, developed government bonds. But for other areas that is less true. Emerging market debt has some ETFs, but the variation in yield and quality means that no index effectively captures that. In addition, for an ETF to be sufficiently liquid, it is often forced to own large chunks of a few mega-cap stocks, which in the case of international and emerging stocks can lead to a high concentration

in bank stocks or consumer staples. Yes, some index and passive fund managers compensate for that and come up with ingenious ways to weight their indices, but given the newness of many passive funds, there are often not good ways to gain passive exposure to these asset classes.

#### What to do

Investors and advisers have clearly been voting to move money towards passive vehicles and away from active. Last year, investors piled hundreds of billions into passive vehicles and yanked nearly a hundred billion from active domestic funds, as only about 20% of active equity managers outperformed their benchmarks.<sup>3</sup> The trend is clear.

But the argument is not as binary as it appears. Investors and advisers seek outperformance, and while they can fall short, that is not a reason to throw in the proverbial towel and go passive only. Whether motivated by a need to reduce volatility or add alpha (outperformance), the use of actively managed funds is a key component to long-term returns. Active managers on average tend to be more risk averse. Incorporating them into a portfolio strategy can potentially lessen market downside, whereas a pure passive approach could leave investors fully exposed in a market drop.

Investnet has long supported a core-satellite strategy of picking and choosing active versus passive based on where you can find more dispersion of performance and less correlation and where there are a few adequate passive vehicles available. That could mean using passive funds

<sup>3</sup> Source: "Return of the Stockpickers", *Barron's*, 12 January 2015

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## About Envestnet®

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for large-cap equity and active for small-cap and emerging markets, passive for government bonds, active for high-yield and emerging market debt, active for international equity and so on.

Another approach is to use a mix of active and passive for major asset classes, to have some of the cost and performance advantages of indexing with the possibility of outperformance by selecting skilled active managers who will either offset index volatility or add alpha.

A twist on all of this is to resist the tendency to pick active managers who have steadily done only a tad better or worse than an underlying index. Outperforming a large-cap index by less than 1% or underperforming by less than 1% suggests that the manager is more of a closet index manager (whether by intent or not) than a true active manager. That makes justifying those fees complicated. In an odd way, it is “better” to have your active manager significantly underperform than be at the benchmark because that indicates that the manager is attempting to achieve what you are paying them for: outperformance. Yes, you may reasonably choose to liquidate a position in an underperforming manager, but in paying for active management, you do want the manager to be, well, active.

Finally, some themes and some areas of the market are still not well represented by passive

vehicles. In the next decade, we may see more opportunities to create individualized ETFs that are constructed according to the theme or tax structure that an adviser and/or client seeks. That will alleviate some of the current issues of lack of appropriate vehicles, but until then, not all themes have a good index or ETF. But almost all themes have talented active managers attempting to create strong portfolios. Even in the asset classes where the average active manager underperforms, there are still active managers outperforming. They may be harder to find, but sound research can uncover them.

Too much of the debate between active and passive is represented by partisans who are “talking their book.” The two styles, in truth, are less Hatfield and McCoys and more yin and yang. Think about it: if theoretically, we woke up tomorrow and all investing were passive, there would be no stock movement, no alpha, no nothing. The only movement in prices would come from the flow of money in and out. Why mention this? The reason so many passive funds beat active is that active funds are managed by people who make mistakes or see their decisions go awry. Passive investing is thus the flip side of active and can only do well in a universe where there are active managers picking and choosing. Passive and active investing are thus twined, and the best strategy is to use both wisely and filter out the noise advocating one at the expense of the other. ■

### Advisor Take-Away:

It's not one or the other: active and passive investing are best when they work together. Despite passive managers having a moment, keeping active managers in the mix is key to minimizing volatility and achieving long-term returns. Don't let the averages turn you away from active managers; diligent research can identify the skilled ones with a record of outperformance that justifies fees. In practice, investors can blend active and passive, using active funds for sectors and asset classes that lack good passive vehicles and passive for market segments that tend to have higher correlations (for example, passive for large-cap equity and active for small-cap and emerging markets); or they can take on a mix of active and passive within asset classes to achieve the advantages of cost and performance (passive) with the possibility of outperformance by offsetting index volatility or adding alpha (active). The debate should be more about when and how to use one or the other. Active managers fill the void of asset classes without a good index or ETF; passive managers provide exposure to indices and benchmarks, but will only do well in a universe where active investing exists.

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