Active vs. Passive Investment Management[1]

Investment managers have generally fallen into two broad categories: *Active* and *Passive*; each discipline reflects a different belief system regarding the behavior of the capital markets.

Active Management

Active management is the traditional way of building a securities portfolio, and may include a wide variety of strategies for identifying stocks or bonds that appear to offer above-average returns. One method might focus on companies with impressive growth in revenues and earnings, another on firms with promising new technologies, and still another on "turnaround" situations. Regardless of the individual approaches, all active managers share a common ideology: to selectively purchase securities based on some forecast of future events. Implicit in this ideology is the belief that carefully selected securities will produce higher rates-of-return than those chosen at random.

Active managers periodically reshuffle their portfolios in an effort to keep them stocked with only the most promising securities. The costs associated with generating and implementing these revisions makes active management a rather expensive investment approach. These expenses are passed along to their clients. Academic studies of money manager performance over the past fifty years offers powerful evidence that active managers as a group have been unable to generate pre-tax investment returns high enough to recoup these costs and extract excess profits. If the effects of realized taxes are incorporated into these performance calculations, and the challenge of being a market-beating active manager only gets more difficult.

Passive Management

Passive management makes no forecasts of the stock market or the economy, and no efforts to distinguish "attractive" from "unattractive" securities. A passive manager investing in large U.S. companies, for example, makes no determination if Ford is preferable to General Motors, Coca-Cola to Pepsi, or Campbell Soup to Kellogg. Instead the manager simply buys everything from Abbott Laboratories to Xerox, resulting in a portfolio with hundreds of stocks. Portfolio adjustments are made only in response to changes in the underlying universe or index—when Chrysler disappears in a merger with Daimler Benz, or a new company such as Microsoft joins the ranks of large company stocks. Passive managers often construct their portfolios to mirror the performance of well-recognized market benchmarks such as the Standard & Poor's 500 Composite Index (500 large U.S. companies), Russell 2000 Index (2000 small U.S. companies), or Morgan Stanley Capital International EAFE index (large international companies). Passive investment products first appeared in 1973 and have become increasingly popular, with over $1 trillion worldwide dedicated to various indexed strategies.

Marketing Works

Despite all the academic studies and historical evidence to the contrary, the prevalent

assumption is the superiority of active management. At traditional investment firms that practice active management, armies of portfolio managers, traders, economists, strategists and research analysts scrutinize enormous daily flows of information on companies, industry sectors, business conditions, and political developments. They produce volumes of detailed reports and analysis recommending stocks and bonds to buy or sell, and sectors to overweight or underweight.

Does all this effort pay off?

For the majority of active fund managers, it does not. The fact is, most active investment managers underperform the indexes they *should* be measured against (the appropriateness of particular indexes will be discussed in a future newsletter). This consistent underperformance is particularly obvious over longer periods of time. It is interesting to note that this conclusion is usually reached using pre-tax data. After-tax data makes the argument against active management even more compelling.

The reality is, even if an active manager outperforms his or her respective index over short periods (1 to 5 years) of time, there is so much "hot money" chasing a manager's historical investment returns that after a short period of outperformance, many of these managers get so much new money that they have too much money to invest in the very strategies that produced the superior returns. As a result, the returns of these "outperforming" funds tend to decline relative to their respective indices as the size of the fund increases.

A good example of this is the nation's largest mutual fund, the Fidelity Magellan fund. While portfolio manager Peter Lynch had a period of index-beating performance during the 80's, the increased size of the fund (due to extensive marketing by Fidelity) and inevitable changes in the Fund's managers have resulted in marginal performance versus the S&P 500 Index performance for the last 10-15 years. As a realistic example, if we compare the actively managed Fidelity Magellan fund with the passively managed Vanguard S&P 500 Index fund, the long-term (5 to 15 year) pre-tax performance is virtually the same, yet the Magellan Fund's portfolio turnover is higher (tax efficiency is lower) and its expense ratio at 0.93% is about 5 times higher than the Vanguard Index 500 fund's at 0.18%.

It should also be noted that the Fidelity Magellan fund charges a 3% sale load to purchase the fund whereas the Vanguard Index 500 charges no sales fees whatsoever. This sales load insures that investors in Magellan start out 3% behind investors in non-sales load funds like the Vanguard S&P 500 Index.

With high fees, loads and portfolio turnover, Fidelity and Uncle Sam always win, both at the investor's expense (pun intended).

So if so few active managers out perform passive strategies, why do investors invest in actively managed funds?

Marketing works.

Markets Work
Indexing a securities portfolio is the logical outgrowth of a belief in the effectiveness of a free market system. Just as prices for steel, oil, or lumber quickly reflect new economic developments, so do prices for financial assets. At any given moment, the price of a stock represents the best estimate of its worth by market participants. Do some companies have superior prospects due to a trusted brand name, a “breakthrough” technology, a unique marketing strategy, or overall financial strength? Of course. And this optimism is reflected in higher stock prices relative to other companies. Securities prices change, sometimes with great volatility, in response to new information, but as news is by definition unpredictable, so are securities prices.

Are Active Managers Special?
To construct a market-beating portfolio, active managers must identify mispriced stocks. To do so, active managers must have information that is not only accurate, but also NOT shared by other investors. Furthermore, in order to profit from these insights, other investors must eventually act upon this “special” information at some future date, causing the mispriced stock to change and reflect its “real” value. In a world where information is rapidly disseminated, and the use of “inside” information illegal, this is a formidable task. In such a world, gaining sustainable advantage over other skilled participants in a hotly competitive marketplace is extremely difficult.

For active strategies to work consistently enough to deliver excess return to investors, markets must repeatedly fail to price securities correctly. In other words, the traditional active money manager pursuing a “beat the market” strategy is espousing a viewpoint that “markets don’t work”. Passive managers, in contrast, believe markets do work, meaning at stock prices quickly incorporate all useful information that determine their value.

Active managers do indeed think they are special. Historically, however, their long-term investment performance would indicate that the majority of them are not.

Passive Strategies in the Context of Asset Allocation and Portfolio Management
Passive managers are not stock pickers: the goal of passive management is to give the investor the capital markets return for the specific asset class he or she has invested.

That being said, there is more to having a properly diversified investment portfolio than just owning an S&P 500 Index fund. The S&P 500 is merely a popular domestic large cap index and a properly diversified portfolio should consist of more than a single asset class investment. Each asset class (i.e. domestic large cap, international small cap, REITs, fixed income, etc.) has different return, risk and relative correlation characteristics and should play different and separate roles in an investment portfolio.

The selection of the asset *classes* is of the utmost importance in the construction of an investment portfolio. In essence, the process of asset allocation is to pick asset classes. The

goal of asset allocation is to pick multiple asset classes that give an investor an optimal mix of investments with historical return, risk and correlation characteristics that will result in a portfolio that will produce higher and more consistent return with lower risk.

As few active managers outperform their benchmark indices on a long-term basis, investors should strongly consider using passive strategies for specific asset class investments in the context of their asset allocation plans.

The concept of asset class performance in the context of risk and correlation will be discussed in a future newsletter.

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[1] Portions of the Active vs. Passive Investment Management discussion were excerpted with permission from the Research section of the Dimensional Fund Advisors website.