BLEND ACTIVE AND PASSIVE INVESTING IN A STRESSED MARKET

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There was a time not so long ago when almost all investors seeking exposure to the stock and bond markets held a limited number of individual stocks and bonds in their portfolios or achieved diversification through investing in active mutual funds. But when the first index funds appeared in the 1970s, indexing (or holding all the stocks in one index) became a viable investment approach for many investors.

For several decades, index mutual funds were successful on their own. However, when exchange-traded funds (ETFs) that traded intraday appeared on the horizon in the 1990s, another flood of assets poured into index investments.[1]

The debate around active versus passive investing styles is ongoing: Does it pay to invest in active funds for the chance to outperform the index over time, or is an investor better off keeping costs low and performing in line with an index? We believe the sweet spot is a blend of the two investing styles—and that patience can be rewarded by combining them over the long term.

INVESTED ASSETS FOR BOTH INVESTING STYLES

Today, about $13.3 trillion in assets are invested in active mutual funds and many trillions more in individual stocks and bonds. Additional assets are invested in derivatives (such as futures) on indices.

This compares to around $8.5 trillion in assets invested in index funds (mutual funds and ETFs), with the vast majority of indexed assets in equities.[1]

WHY A COMPLEMENTARY APPROACH MAKES SENSE

With active management, investors rely on a manager's knowledge and in-depth research to capture opportunities in the market when they arise. Of course, this close management comes with a cost—to justify this, investors in active funds expect consistent performance that exceed the benchmarks.

Passive management refers to mutual funds or ETFs that are built to replicate the returns of a specific market benchmark. A common example would be a mutual fund built to replicate the returns of the S&P 500 Index.

Our research shows that actively managed funds in certain asset classes (e.g., mid-cap and small-cap growth) have been able to outperform passive options on average when measured over the long run. It's also common for actively managed funds to perform above a benchmark or index and outperform during periods of market volatility when stock selection matters more.

On the flip side, our research shows that actively managed funds on average struggle in certain categories (e.g., large-cap value) over the long run, and in those categories passive investing makes sense.

While periods of market stress should present an opportunity to investors, some shy away from active management in favor of the trend towards passive management—they don't feel comfortable with the risk of underperforming the market. Often, they assume it's best to invest in the index because it's more predictable.

It's true that even the best actively managed funds will experience periods of underperformance from time to time. That's why combining complementary managers or styles can smooth the rollercoaster ride for investors—such as potentially including an index fund with a more aggressive actively managed fund, for example.

Diversification also plays an important role. By complementing active and passive management, you can add value and diversification of investment styles (aggressive growth combined with growth at a reasonable price) to a portfolio and provide an opportunity to outperform the benchmark.

Keep in mind, however, not every actively managed fund is going to win every year. Judge performance over a full market cycle—often thought of as a peak-to-peak period in the market with at least a 15% decline in the middle—based on a five- to ten-year track record. Often that patience will be rewarded by sticking with an actively managed fund through a full market cycle to realize its potential.

It's also important to understand that at market extremes (up or down) is often when the correlations of all stocks converge and diminish the value of stock selection—stock picking doesn't matter that much.

As we saw in March 2020, investors can panic—they sell everything, and all stocks behave the same. In that environment, all stocks decline together. But in the ensuing recovery, the markets and investors decide which companies will be the winners. This is where the differentiation and benefit of stock selection is seen.

WHY TODAY'S BIGGEST MARKET WINNERS MAY BE RISKY FOR INDEX FUNDS

Many investors are unaware of the significant exposure their index funds may have to some of today's biggest stocks and market winners—thus increasing the risk beyond what many would expect from their index funds. In our report titled, "Pandemic Forces New Realities on S&P and Dow Indexes," we discuss how a very small pool of names is driving the concentration that now exists in the S&P 500 Index®: Facebook, Apple, Amazon, Netflix, Google, and Microsoft (a.k.a. the FAANGM stocks). Consider this:

- These six companies represent roughly 23% of the S&P 500 market capitalization and approximately 20% of the earnings (as of December 31, 2020).
- They represent over $7 trillion of market capitalization, up from roughly $4 trillion in April 2020.
- Collectively, these six companies have a larger market capitalization than the combined market cap of the energy, materials, industrial and financial sectors of the S&P 500.[2]

The largest companies can have a great impact on market returns. Evidence of this is clear in 2020 calendar year returns, with the index returning 18.4% compared with the return of the six FAANGM stocks of 56.4% (and a return of 10.4% for the other 494 companies in the index).

Longer term, a similar pattern exists over the past five years in which these companies have outperformed the S&P 500 Index by 16.4% per year. While this overwhelming influence feels like a good thing as these six stocks continue to lift market indexes to new record highs, it can be just as scary when those same market indexes drop lower as investors decide it's time to sell. As a result, you should carefully consider your ability to weather this risk during these volatile times.[2]

HOW TO FIND THE SWEET SPOT

Contact your Commerce Trust Company advisor to learn more about ways you can integrate active and passive management styles in your portfolio.

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[1] Source: Commerce Trust Company Research Group, Commerce Trust Company Research Report, "The Active vs. Passive Management Debate," 2020.

[2] Source: Commerce Trust Company, Matt Schmitt, CFA®, "Pandemic Forces New Realities on S&P 500 and Dow Indexes," September 17, 2020.

The opinions and other information in the commentary are provided as of March 02, 2021. This summary is intended to provide general information only, and may be of value to the reader and audience.

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