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Revisiting the "Active" versus "Passive" Investment Management Debate: Investment Styles Come and Go

There was a time when virtually all investors seeking exposure to the stock and bond markets held a limited number of individual stocks and bonds or achieved diversification through actively managed mutual funds aiming to outperform the market average.

It wasn't until the first index funds appeared in the 1970s and the subsequent advent of exchange-traded funds (ETFs) in the 1990s that indexing became a viable investment approach for many investors. Index funds simply mimic their benchmark holdings (hence the term *passive*) and typically are the lowest-cost funds available. Today, more than $4 trillion in assets are invested in index strategies, with continued positive inflows due to recent active manager underperformance.

Proponents of indexing argue that markets are so efficient that active managers cannot benefit from mispricings enough to overcome the additional active manager expense – especially for funds focusing on large-capitalization stocks.

It's true that the average active stock manager in a number of equity categories has not been able to outperform the index over the past several years, but if we look back over history, we see that significant percentages of active managers have been able to beat their benchmarks.

For example, a Commerce Trust study of active manager success in domestic large-cap growth equities showed that while only 23% of active managers outperformed the index for the single five-year period ending Dec. 31, 2015, the longer term tells a more favorable story. Ten years ago, more than 60% of active large-cap growth managers outperformed the index for the five-year period. If we look at 10-year periods, only 26% outperformed as of Dec. 31, 2015, but 62% outperformed as of Dec. 31, 2005.

In small-cap value, those numbers were 61% for the five-year period as of Dec. 31, 2015, and 57% as of Dec. 31, 2005. For 10-year periods, the batting averages were 87% and 64%. It is clear that we see cycles of outperformance and underperformance as investing styles experience varying levels of success over different time periods.

Even if the headline is that the average manager hasn't outperformed, that doesn't mean that ***no*** manager has. If you can choose *superior* managers, your chances of success can be markedly improved. However, even the best managers can experience shorter-term periods of underperformance. Our study shows that virtually no manager has had a perfect record of outperformance over rolling one-year periods (rolled quarterly). However, a number of managers have excellent records over rolling 10-year periods.

One way of smoothing the up-and-down performance of a portfolio over shorter periods, then, would be to combine skilled managers with uncorrelated patterns of outperformance or underperformance. These types of combinations can reduce periods of underperformance as one manager "zigs" while the other manager "zags." This is especially true if we consider an entire portfolio, which can comprise a number of manager combinations in different categories.

On the bond side, active managers have enjoyed better success recently, but not necessarily over the long term. As the country prepares to absorb the effects of rising interest rates, some proponents of active management believe it will be important to invest with active managers, who may be able to navigate the interest-rate landscape better than a bond index fund on "autopilot."

So what's the "right" answer in a continually changing landscape?

Longer periods of market history tell us not to abandon good active investment managers, particularly in certain categories where market efficiency is lower. However, active investing may not be for everyone, particularly for investors with short time horizons or those who may be tempted to terminate a manager for short-term underperformance. That temptation may come at just the wrong time.

Since the past seven years of our current bull run have been characterized by higher-than-average returns and stocks are somewhat "expensive" today, we could see lower-than-average market performance in the coming years. Another Commerce Trust study shows that active managers tended to outperform the index and protect investors during periods of poor market performance. This tendency was particularly true among large-cap managers.

What's encouraging is the trend in manager fees. Fund management fees have declined significantly over the years. According to ICI, asset-weighted expense ratios across all actively managed equity funds was 0.84% in 2015, down from 1.06% in 2000.* This favorable trend should help active manager performance in the future.

So we do not believe now is the time to discard active managers. The fact is, you can expect any manager to underperform at times. Investment styles come and go…and come back again. Virtually no active manager has a perfect record over all shorter time horizons, but many have shown they can beat the index over longer periods. We believe that choosing better-than-average managers is important, and that investors should pay close attention to fees. In some categories, it may be wise to use low-cost index funds or enhanced index funds for all or part of the category.

Investors should always consult with an investment professional in reviewing the strategies that are right for their investment portfolios and particular tax situations.

* Investment Company Institute, "2016 Investment Company Fact Book." 56th edition.