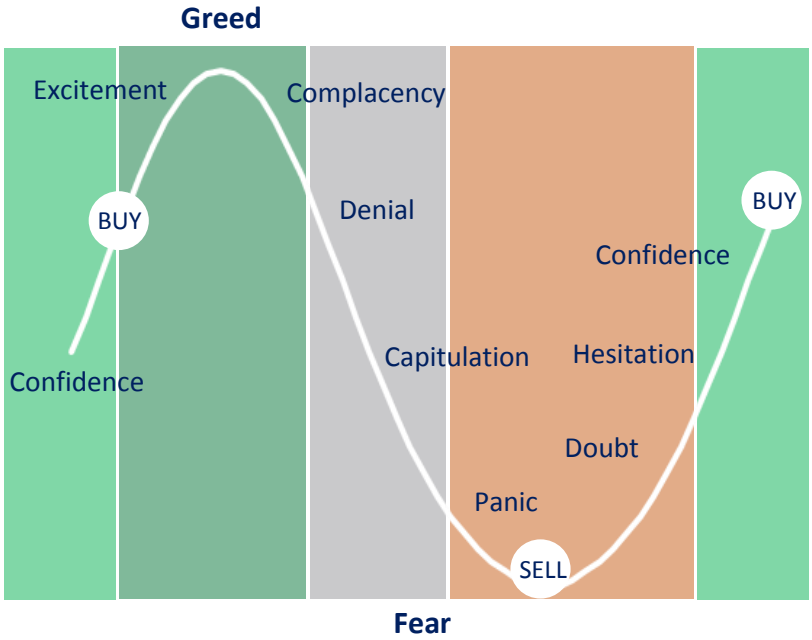
Active vs. Passive Is the Wrong Debate

It is time to end the distracting debate between active and passive. It is the wrong debate!

What our industry needs to do is focus on providing solutions that meet the expectations and needs of the average retail investor: *growth strategies with defensive capabilities*. When you hear the words "just stay invested," they are most often uttered by either a very wealthy person who can afford a large loss or an investment manager who has never sat across the table from a retail investor.

The debate between active vs. passive is forgetting that we are talking about people. We invest money to try to improve our future, to reach our goals, to educate, buy a home or live a comfortable retirement. In a bear market, or even a severe correction, our futures become threatened. The average investor forgets about their time horizon and loses discipline. They don't want to or mean to, but we are just subject to the emotional decision of trying to protect our future. Let's start with a refresher:



Passive vs. Active Management

Passive management is often synonymous with index investing. By simply investing in the holdings of the index the strategy follows, the buy and sell decisions are not discretionary but rather based on the rules of the index. The returns will typically closely match the index, which means if an index fund that you invest in enters goes into a period of market failure, then your portfolio will also succumb to those large losses. Even though costs are typically lower as there is little management of the portfolio, the losses can get expensive in a bear market.

Active management can be thought of as any strategy that uses human discretion to decide what the portfolio should own. The manager(s) generally employs some combination of fundamental, quantitative, or technical research in conjunction with their experience, knowledge and judgement to try to find opportunities greater than the market. The fees are typically higher than passive as you are paying the managers for their work.

The issue is that active managers often have a dual mandate to serve both institutional and retail investors. The mandates, or the expectations of these two types of investors, are vastly different and are in direct conflict. Let me explain:

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The Institutional Mandate

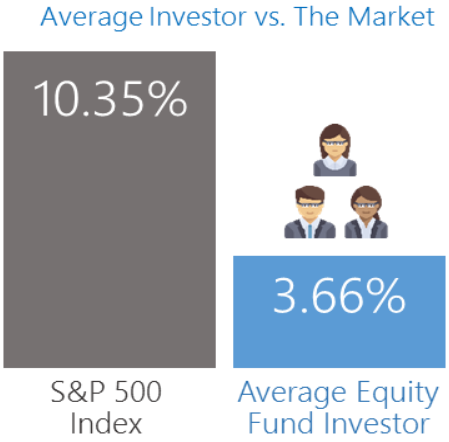
An institutional mandate dictates that the manager follows their investment process, and that the manager stays fully invested according to this process at all times. Why? Institutions want the management style to be pure as part of a larger portfolio construct. As a result, if the market enters a period of failure, the active manager is severely limited on how much selling or alternative assets can be introduced to try to mitigate loss.

The influence of institutions on active managers is profound. When the markets go over a cliff, they expect the manager to follow and if management deviates from their process, they are fired. This is how most large endowments and institutions think. Why? Institutions are typically able to withstand a large loss because their time horizon is long enough and their discipline is strong enough to endure a bear market.

The Retail Mandate

In stark contrast, the average retail investor has a very different expectation of an active manager and a varying time horizon. The average retail investor now holds stocks and/or mutual funds for less than one year (versus 6 years in the 1970's and less than 2 years in the 1990's)[1], which is far too short a time horizon to deal with multi-year bear markets and the time required to recover.

More importantly, the average retail investor thinks their active manager is going to grow their assets during good times and even sideways markets. But when markets enter periods of failure, such as the 2000-02 and the 2007-09 bear markets, the retail investor expects the active manager to sell positions to try to protect the assets in their account. As you can see, these expectations are in direct conflict and the average retail investor is going to lose to the institutional mandate every time. Although rarely discussed, the reality is that active management will continue to ride through a bear market without preserving capital.



What does the average investor really want?

Based on decades of working with investors, we find the average investor wants a manager to make the buy ***and*** sell decisions for them. Yet, since most active managers do not sell, the average investor is forced, based on their emotions, to make their own sell decisions, and typically just fire the manager. These emotional decisions are most often made at the worst possible time, at or near the bottom of the bear market. A recent DALBAR study shows year after year the average equity fund investor only receives about 1/3 of the U.S. Equity market returns over time.[2]

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Tactical management is a type of active portfolio strategy that shifts the percentage of assets held in various asset classes, sectors or individual investments to take advantage of opportunities as they present themselves. Tactical is also unique in that in times of market duress, tactical managers seek to protect the assets by raising cash, shifting into other asset classes or geographies, or using other types of defensive mechanisms to avoid large losses.

The portfolio construct can change significantly based on the market environment. In a positive or even sideways market, tactical managers tend to stay fully invested. But when markets turn bad, tactical is engineered to sell and get defensive until the markets are through correcting and begin to turn positive. This is what tactical ETF strategists are engineered to do.

The Real Debate:

We should be talking about how best to construct portfolios that meet the needs of our clients and can withstand the test of time through all market conditions, while being realistic about how retail investors really feel and react. Let's talk about how best to blend strategic investing with rules-based, tactical managers. What is more important to retail investors: avoiding a few dozen basis points of expense or a few dozen percentage point decline in a bear market?

Tactical is what most investors think they are getting when they buy an active mutual fund. Investors expect growth in "good times" but also expect the portfolio manager to protect their investment when markets are failing. Unfortunately, most active managers do not incorporate this loss avoidance into their process and are unable to meet these expectations. Tactical managers can and make it a focus.

Authored by: David M. Haviland, Portfolio Manager
Published: May 8th, 2017

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Beaumont Financial Partners, LLC DBA Beaumont Capital Management – 250 1st Avenue, Suite 101, Needham, MA 02494 – (844) 401-7699 salessupport@investBCM.com.

Sources

[1]Ned Davis Research, December 2015

[2]Quantitative Analysis of Investor Behavior (QAIB), 2016, DALBAR, Inc. www.dalbar.com. Returns are for the period January 1, 1986 through December 31, 2015. The QAIB uses data from the Investment Company Institute (ICI), Standard & Poor's, Barclays Capital Index Products and proprietary sources to compare mutual fund investor returns to an appropriate set of benchmarks. Investor returns are represented by the change in total mutual fund assets after excluding sales charges and costs, but do captures realized and unrealized capital gains, dividends, interest, trading costs, sales charges, fees, expenses and any other costs. After calculating investor returns in dollar terms, two percentages are calculated for the period examined: Total investor return rate and annualized investor return rate. Total return rate is determined by calculating the investor return dollars as a percentage of the net of the sales, redemptions and exchanges for each period.

Beaumont Capital Management
(888) 777-0535
fidelity@investbcm.com
investbcm.com

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