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Active Management May Be On the Rise Over Passive

But Active vs. Passive is the Wrong Debate

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Following the 2007-2009 bear market, passive management, specifically index investing, was given the opportunity to thrive. Coming off the lows of a brutal bear market, the S&P 500 and other large cap indices thrived in an environment f easy monetary policy and quantitative easing. Many years of this 9+ year bull market expereienced low or extremely low volatility leaving little room for active managers to squeeze out excess returns or alpha. Now, as volatility begins to reintroduce itself, active management may be coming back into favor among investors. Some in the industry believe we are "in the early stages of an active versus passive regime change"[1]. However, active versus passive is the wrong debate. In this evolving market environment, what our industry needs to do is focus on providing solutions that meet the needs and expectations of the typical 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), an investment manager or an "academic" who has never sat across the table from a retail investor. As every advisor knows, managing client emotions is difficult at best.

The debate between active vs. passive is forgetting that we are talking about people. People invest to try to improve their futures. Whether their goals are funding education, buying a home or to enjoy a comfortable retirement, a bear market or severe correction poses a threat to those goals. These threats bring out emotion, and emotions have no place in investing. The average investor forgets about their time horizon and loses discipline. They don't want to or intend to, but as people we are just subject to the highly emotional decision of trying to protect our respective futures. Let's start with a refresher on the different types of management:

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're invested in enters a bear market, your portfolio will also experience those large losses. Even though costs are typically lower as there is little management of the portfolio, the losses can be extensive and the typical investor will make an emotion-driven decision, selling during the capitulation stage of the bear market.

Active management can be thought of as any strategy that uses human discretion to decide what a portfolio should own. The manager(s) generally employs some combination of fundamental, quantitative, or technical research in conjunction with their experience, knowledge and judgment to try to find opportunities greater than the market. The fees are typically higher than passive as you are paying the manager(s) for their work. The problem is that most investors think an active manager will buy and sell as markets rise and fall, but nothing could be further from the truth.

Now Let's Talk About Why

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

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. Institutions want the management style to be pure as part of a larger portfolio construct. If a manager sells to cash or another asset class, they have altered the allocation of the institution without permission. As a result, if the markets enter 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. Even if the markets cascade down, they expect the manager to follow their process and if management deviates, they are often fired. This is how most large endowments and institutions think.

Why? Institutions are typically able to withstand a large loss because their investment committees are run by experienced investment and business professionals, their time horizon is long, and their discipline is strong enough to endure a bear market. Additionally, since it is not the personal money of the investment committee members, there is little to no emotional reaction to volatile or failing markets.

The Retail Mandate

In stark contrast, the average retail investor has a very different expectation of an active manager. The typical 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 accounts. As you can see, these expectations are in direct conflict and the retail investor is going to lose to the institutional mandate every time.

Because of this, regardless of their goals and time horizons, the average retail investor now holds stocks and/or mutual funds for less than one year (versus 8 years in the 1950's and less than 2 years in the 1990's)[2]. Less than one year is far too short a time period to deal with multi-year bear markets and the time required to recover.

What Does the Average Investor Really Want?

Based on decades of working with investors, we find that investors want a manager to make the buy and sell decisions for them. Yet, since most active managers are not able to sell as described above, the average investor is forced, based on their fears, to make their own sell decisions. These emotional decisions are most often made at the worst possible time, at or near the bottom of the bear market. This means they have secured that loss, and compound the mistake by missing much of the subsequent recovery. 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.[3]

What is the Answer?

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, most 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 to provide growth. But when markets turn bad, tactical is designed 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.

A Deeper Dive into Buy and Hold (Passive) vs. Trend Following (Tactical)

A subset of tactical management known as trend following can be a good alternative to the "Buy and Hold" phenomenon that is currently being shown to investors. While many in the financial services industry will tell you that over the long term, Buy and Hold investing will provide you with index-like returns and can beat most active managers, we have already mentioned why this is highly unlikely. Their philosophy is essentially that there are three steps you should take as an investor: 1) build an asset allocation to manage your risk, meaning deciding what percent to put into the growth portion of your portfolio like stocks or stock funds, and what percent to put into the more stable piece of the portfolio like bonds/fixed income; 2) pick the investments; 3) set it and forget it. This model was built in a lab by academics and neglects to take into account one very important variable: humans.

Buy and Hold strategies all assume a rational decision-making process by humans and their ability to stay invested no matter what is happening in the market. It also assumes a time frame of forever, which only serves institutions and is unrealistic for retail investors. These are two of the fatal flaws of the Buy and Hold approach. Humans have emotions, are afraid of losses, have time horizons a lot shorter than forever, and realistically shouldn't be asked to sit idly by while their nest egg may get cut in half like the S&P 500® Index did in 2000-2002 or 2007-2009.

Finally, ignoring emotions and timeframes becomes even more unrealistic as people pass age 50, and their portfolios are likely growing larger. As investors inch toward retirement, their investing window becomes shorter and they can't afford the risk of starting off their retirement right in front of or even during a 2000-2002 or 2007-2009 type market. The industry calls this "sequence-of-returns" risk. This unfortunate timing would leave an investor watching their retirement dreams get delayed (or worse) if their investments take a large hit. That would literally be a life-changing event.

There Are Two Primary Types of Retail Investors

There is a segment of the population that avoids investing altogether because of the gripping fear of a potential bear market on the horizon. Peter Lynch famously said, "People have lost more money waiting for corrections than has ever been lost in a correction". The Buy and Hold model makes no allowance for this fear. Again, because humans have emotions, it's not fair for academics and advisors to dismiss this fear as irrational. Back in the days of "normal" interest rates where an investor could earn ~5% or more in high quality bonds, this was not as big an issue. But in today's low rate environment, and the current volatility in the bond market, having this fear of a future loss can prove to be a real impediment to reaching your goals while investing with such low returns.

Then there is another type of investor who will never let go of hope and chooses Buy and Hold because they refuse to sell at a loss. They think, "If I sell my investments now, I will miss the next big bull market

when prices move higher." The Buy and Hold community has driven in the mantra that if you sell now, you will miss the eventual bull market, despite the fact that the losses keep mounting on your holdings. I guess I missed the fine print where it says that if you sell, you can't buy back in. You just need an unemotional re-entry buy rule to get back into the market.

A better alternative to Buy and Hold is the rules-based, unemotional process of trend following. Trend following takes the approach of staying invested in uptrends when there is less risk present, and getting out of the market in a downtrend when there is more risk. Trend following systems come with built in risk management that includes rules for both the buy and the sell decisions. For examples on how trend following works and how it could fare in both good and bad markets, please see our piece Trend Following: An Alternative to Buy and Hold.

The Real Debate

Rather than talking about active vs. passive, 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.

Sources & Disclosures

[1]Financial Times, Robin Wigglesworth. "The Return of the Stock Picker", September 2017. https://www.ft.com/content/294de4ec-9eb2-11e7-8cd4-932067fbf946

[2]Ned Davis Research, December 2015

[3]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.

The views and opinions expressed throughout this paper are those of the author as of May 2018. The opinions and outlooks may change over time with changing market conditions or other relevant variables.

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