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Are Active or Passive Investments the Way to Go?

Why a volatile market may affect the answer

As stock index funds persistently outperformed actively managed portfolios over the past 10 years, the long-standing debate over which investment approach is superior—passive or active?—became gradually muted.

The proof seemed apparent in the numbers: Large-cap stock index funds returned a 14.9% average annual return over the decade through 2018, while less than 10% of actively managed portfolios survived the 10-year period and outperformed the market.

But then came December's raucous market. The S&P 500's 9.17% decline—the worst monthly rout since 1931—rattled investors and raised the volume on the old debate as active managers' portfolio values held up better than index funds. According to Morningstar, passive stock funds declined 4.4% in the six months through December, while actively managed stock portfolios were down 2%.

"Passive investors got exposed to elements of the broad market that had become risky and that could get stripped out by an active manager," says Michael Hans, a Chartered Financial Analyst® (CFA®) charterholder and the chief investment officer (CIO) at Clarfeld Financial Advisors in Tarrytown, New York.

So is it time to shift focus toward active stock pickers?

Most advisers use a combination of passive and active strategies and believe a new volatile period in the market can create opportunities for active managers to shine—both by outperforming indexes on the upside and softening losses in sharp market pullbacks.

It's undeniable that stock index funds trounce actively managed funds when you look at average fees and performance. The average expense ratio for U.S. stock index funds is 0.59% compared with 1.34% for actively managed portfolios, and average returns for index funds beat actively managed funds over three-, five- and 10-year periods through December, according to Morningstar.

But a good adviser isn't looking for an average active manager. "We believe there is a slice of active managers that are very good, and don't necessarily charge exorbitantly for it, but you really have to do the work to find them," says Jason Pride, a CFA charterholder and CIO at Glenmede, based in Philadelphia.

Alex Shahidi, a CFA charterholder and partner and co-founder of Advanced Research Investment Solutions in Beverly Hills, California, recommends using index funds for core stock market exposure, and adding carefully selected active managers to offset volatility and outperform the market. But he sets the hurdle high when screening for the active managers, choosing only those whose portfolio's performance has a low correlation to benchmarks.

"Managers are only valuable if they can produce a total return that is different than what you can replicate with an index fund," Shahidi says.

Such managers aren't easy to find. A big strike against most actively managed funds is that they are modeled after their benchmarks to avoid dramatic underperformance. "The number of managers truly taking active risk has been cut by 65% over the last 25 years. It's remarkable," says Ted Neild, CFA charterholder and CIO at Gresham Partners in Chicago. "The industry itself is its own worst enemy."

The reason for closet indexing? Simple: job security. "If the market is down 5% and you're down 10%, there are a lot of people who will want to fire you, so managers tend to hug indexes," says Joshua Gross, CEO of Mill Creek Capital Advisors in Philadelphia.

To add value, look for managers who are benchmark agnostic. Review their historical returns and lay an index on top of it, Shahidi says, "When they are 90%-plus correlated, they provide no advantage over an index fund."

Ongoing monitoring is critical, advisers say. Over time, an exceptional manager will attract attention and is at risk of taking on too much money.

"This is a death knell for managers because they lose the ability to be nimble," Gross says. "If a small cap fund goes from $1 billion in assets with a 30-stock portfolio to $3 billion with 50 stocks, well, that's not how it originally achieved its outperformance so you have to question its ability to continue to do so."

While some advisers add active management to some degree across all stock asset classes, others use purely index funds for large-cap exposure and use active management only in small- and mid-cap U.S. markets and foreign portfolios.

Active managers generally add less value in United States large cap stocks investing, because big companies are so well researched by Wall Street firms that it's hard for stock pickers to find an overlooked opportunity.

"It's really hard to win, and when you do, you're not going to win by a lot," Neild says.

In contrast, hidden gems are easier to uncover in less efficient US small- and mid-cap markets and foreign stocks, where there are fewer analysts covering a much bigger universe of stocks.

The success rate of active funds in these asset classes—meaning they not only stay in existence, but also outperform their benchmarks—far exceeds the success of US large-cap actively managed funds.

According to Morningstar, the success rate for actively managed US large-cap growth funds was 9.8% over the 10 years ending mid-2018, compared to 92% for foreign small- and mid-cap blend funds.

In some cases, advisers create their own actively managed proprietary portfolios to keep costs down and improve tax efficiency in taxable portfolios.

"This gives you the flexibility to sell individual shares at a loss to offset gains," says Denise Farkas, CFA charterholder and CIO at Sigma Investment Counselors in Detroit.

When it comes to fixed-income portfolios, many advisers are more prescriptive in their recommendations, saying they go with fully actively managed portfolios.

"There are significant weaknesses in the passive fixed-income approach, so I prefer 100% active management," says Joe Martinez, CFA charterholder and managing partner at Phlox Capital Management in Dallas.

Because of the construction of the Bloomberg Barclays U.S. Bond Index, "the companies with the highest indebtedness get the highest index allocation, so the deeper a company is in debt, the more money you would be investing in the company," Martinez says.

Other advisers are concerned that fixed-income indexes aren't diversified enough, with more exposure to Treasuries and investment-grade corporate bonds than an investor may want.

"It's hard to find a one-size-fits-all option in fixed income," Hans says. "Because of low yields, it pays to be active. You want to be more nimble and mindful of rising rates or credit spreads."

In both stock and bond portfolios, high-net-worth investors have the benefit of being able to customize the mix of active and passive styles for the best results, thanks to their large investable assets, Martinez says. His firm runs a proprietary actively managed portfolio specializing in Blue Chip stocks to enhance tactical growth opportunities on a core index fund, he says.

But beating the market isn't always the aim in adding active management. The goals of wealthy investors vary widely. To smooth volatility, a long-short hedge fund could help. To emphasize values, "there's social investing—the ESG (environmental, social and governance) funds," Martinez says, adding that there's no one-size-fits-all combination of passive and active exposure. "The goal is to design a bespoke portfolio specific to investors' needs and goals."