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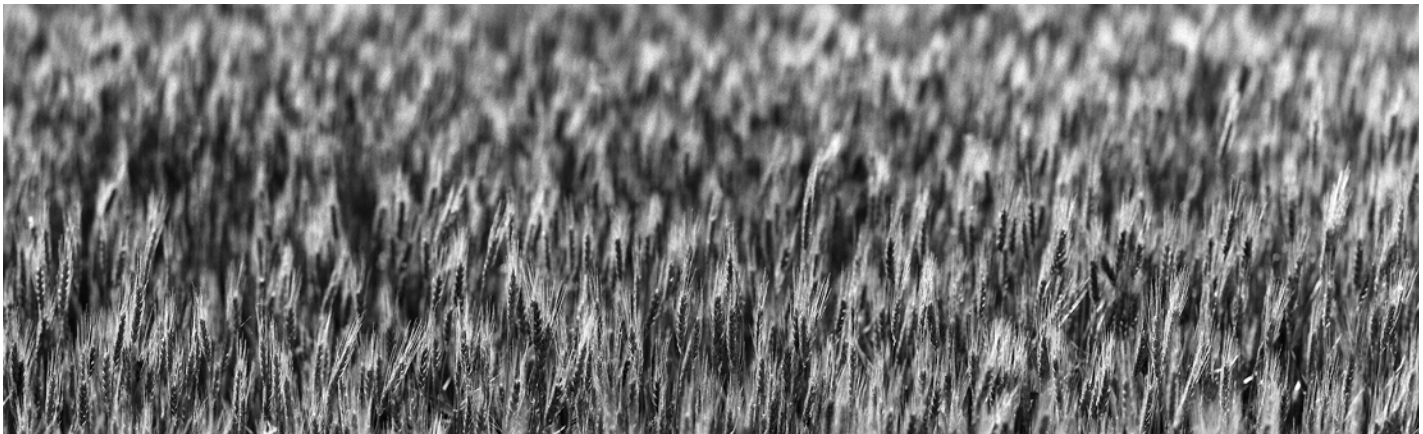
For further information
please contact Annelise Bovet
abovet@collaboration.capital




Strategy Insight

Equities: A Passive Play?

4Q2017

Active vs. Passive

The debate between active and passive management of equity investments has been going for several decades and shows no sign of slowing. However, evidence suggests that the passive position *currently* appears to be winning the argument (emphasis on "currently").

The distinction between active and passive approaches lies in the decision rules that dictate the construction of a portfolio. An active approach utilizes buy and sell disciplines around a set of specific investment criteria, such as valuation levels, growth metrics (earnings, sales, margins), debt ratios, industry positioning, management quality, among a host of other criteria that would favor one stock over another. An active quantitative discipline may buy only those stocks that are favorable on 'X', 'Y', and 'Z' metrics, while controlling for market risks, with an objective of posting stronger performance than a benchmark Index such as the S&P 500 or Russell 1000. An active fundamental discipline may construct a concentrated portfolio of those stocks that a portfolio manager (PM) believes has the most potential for succeeding in their respective industries. Whether it is a new disruptive technology, a promising product pipeline, a shift in the regulatory landscape, a merger that has enormous potential, or spinning off unprofitable businesses, the PM has unique insights into such developments that are expected to translate into strong performance of their stock picks.

A passive approach, on the other hand, is intended to be much less subjective in nature and abides by strict portfolio construction criteria. For example an S&P 500 approach would mimic every position in the S&P 500 with an objective of replicating the behavior of the Index. The same can be said for strategies replicating the Russell 1000, Nasdaq 100, or MSCI World Index. The proliferation of passive styles has been so significant in recent years that there are now hundreds of passive vehicles for indices built on country, region, sector, size, style (growth and value), and theme (social responsibility, clean energy, ESG), among many others.

The active manager often charges fees that are significantly higher than their passive counterparts and is thus expected to generate returns that beat the benchmark after fees. If they do not, the passive providers argue that the active approaches are not worth the effort. History appears to side with the passive proponents. John (Jack) Bogle, founder and former CEO of the Vanguard Group, launched the first Index Fund in 1975 on the basis that the S&P 500 Index had outperformed the average large cap mutual fund for the preceding 30 year period. As he pointed out in his 'Viewpoint', published in the Financial Analyst Journal[1], the subsequent 30 year period proved eerily similar:

DÉJÀ VU? THREE DECADES OF INDEX SUPERIORITY–TWICE

	1945-1975		1985–2015	
	Average Equity Fund	S&P 500 Index	Average Large-Cap Fund[a]	S&P 500 index
Annualized return	9.7%	11.3%	9.6%	11.2%
Index advantage	–	1.6%	–	1.6%
Cumulative return	1,539%	2,402%	1,548%	2,494%
Index advantage	–	863%	–	946%
Standard deviation	16.4%	18.6%	16.8%	17.3%
Sharpe ratio	0.38%	0.42	0.39	0.48
R^2	0.96%	1.00	0.99	1.00

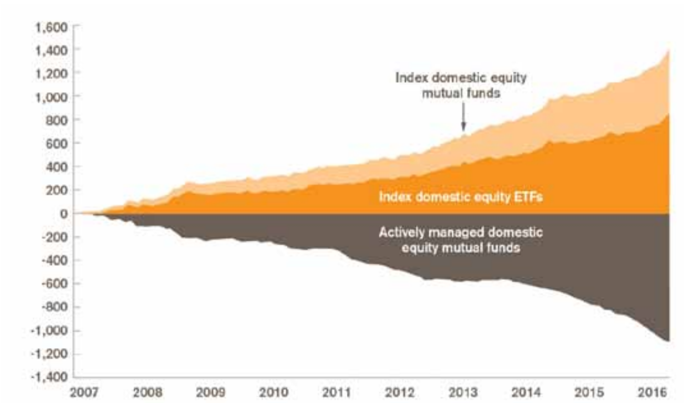
Note: The starting dates are 31 December 1944 and 31 December 1984; the ending dates are 30 June 1975 and 30 June 2015. By the start of this period, equity fund portfolios had become far more diverse. This series represents the average return of the Lipper large-cap funds category, the most appropriate comparison for the Large-cap dominated S&P 500 Index.

Sources: Wiesenberger Investment Companies; Morningstar.

Over the past few years, the flow of capital to passive investments, at the expense of active management, has been staggering. According to the Investment Company Institute (ICI) , “from 2007 through 2016, index domestic equity mutual funds and ETF’s received $1.4 trillion in net new cash and reinvested dividends, while actively managed domestic equity mutual funds experienced a net outflow of $1.1 trillion.”[2]

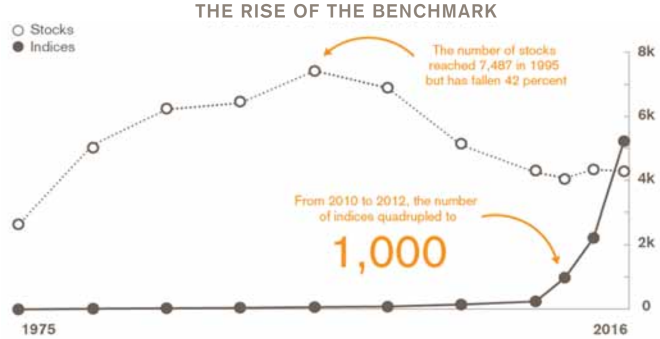
SOME OF THE OUTFLOWS FROM DOMESTIC EQUITY MUTUAL FUNDS HAVE GONE TO ETFS

*Cumulative flows to and net share issuance of domestic equity mutual funds and index ETFs * billions of dollars; monthly, January 2007-December 2016*



The onslaught of passive strategies, specifically ETF’s has created an environment where there are now more funds than there are stocks[3].

THE RISE OF THE BENCHMARK



*Bloomberg LP (which owns Bloomberg Businessweek) and its affiliates provide indices tracking various asset classes.
Data: Bloomberg Intelligence, Sanford C. Bernstein, World Bank, Cash Flows as of March 31; Graphic by Bloomberg Businessweek.

Mic Drop (Argument Settled)?

Not so fast. When comparing the average return of active large cap mutual funds to their respective benchmarks over long time periods, the Index will often come out on top. Consistent with Jack Bogle’s assumptions, there appears to be proof that investing in the Index and forgetting about it will yield a better outcome than investing in the active alternative, after fees. On average, that may be true; however, most investors do not buy the ‘average’ large cap mutual fund. Depending on the time period analyzed, the percent of mutual funds outpacing the Index will vary considerably. Even the 30 year periods displayed will show that over 20% of the active mutual funds outpaced the Index. The trick is to identify those active approaches that can do just that. At Collaboration Capital, our most widely utilized active mutual fund has generated above-benchmark returns, after fees, for 1, 3, 5, and 10 year periods ended November 2017. That fund, somewhat ironically, is part of the Vanguard Fund family.

Another point that should be considered is the timing of the analysis. There are periods where active managers have difficulty keeping up with the Index, usually in a large cap, momentum driven market. Conversely, when the large cap stocks are not driving the market, the added value from the active manager can be significant. The popping of the tech bubble is a case in point where the active manager fared quite well compared to the benchmark Index[4]. An analysis by sector and quality ratings in the November 2002 YTD period, reveals that there were some fairly dramatic spreads between the active approach and benchmark returns:

**U.S. EQUITY FUNDS:
AVERAGE S&P 500 INDEX FUND RETURNS VS.
AVERAGE MORNINGSTAR 5 STAR – 2 STAR RETURNS**

(LOAD ADJUSTED)

	YTD 29-Nov.-02	1yr	3yr	5yr	10yr
2 star	-25.25%	-18.05	-11.37	-2.93	6.22
3 star	-22.32	-15.17	-7.7	0.04	8.22
4 star	-19.63	-12.22	-3.55	2.83	10.08
5 star	-14.19	-7.15	3.04	7.13	12.07
S&P 500 Index Funds	-21.68	-15.65	-12.27	0.07	9.33

Source: Morningstar, Inc. 30-Nov.-02

**U.S. EQUITY FUNDS:
ACTIVE MANAGEMENT BY SECTOR VS. SECTOR INDEX FUNDS**

(LOAD ADJUSTED)

SECTOR	YTP 30-Nov.-02
COMMUNICATIONS	
Index Funds	-67.68%
Active Funds	-42.01
FINANCIAL	
Index Funds	-15.61
Active Funds	-12.63
HEALTH	
Index Funds	-40.59
Active Funds	-29.58
NATURAL RESOURCES	
Index Funds	-29.52
Active Funds	-8.32
REAL ESTATE	
Index Funds	-7.23
Active Funds	-2.57
TECHNOLOGY	
Index Funds	-48.31
Active Funds	-44.72
UTILITIES	
Index Funds	-36.95
Active Funds	-28.70

Source: Morningstar, Inc. 30-Nov.-02

The dramatic flow into passive approaches has also changed the dynamics of the market. According to Goldman Sachs, "nearly 40% of US equity assets under management are held in passive vehicles, which is more than twice the level just seen a decade ago. Together, equity ETF's and passive mutual funds hold 13% of the S&P 500, up from 9% in 2013."[5] According to the Wall Street Journal, Vanguard alone has at least a 5% stake in 468 components of the S&P 500. This dynamic may have price discovery implications when it comes to selling large positions. Since passive vehicles do not trade on fundamentals, the sentiment, or direction of flow from the fund companies will have an outsized impact on trade values. When everyone is buying there isn't much of a concern; however, if that changes…

Observations

For the individual investor that would like to participate in the equity market, passive investing may be a prudent choice. Most individual investors do not have the resources to hire investment professionals to manage their assets and thus will make their own selections. The fees are low, turnover is modest, and there is no real need to 'manage' the portfolio; simply set it and forget it. It is important to remember, however, that the Index fund will buy everything in the Index regardless of the quality of the company or its line of business. Investors are becoming increasingly sensitive about where their capital is being allocated and are less tolerant of certain business practices. Buying the entirety of the 'market' may not be palatable to many investors. Although there are many socially responsible and ESG indices available which have a plethora of decision rules to determine what makes the grade, a fair amount of research is required to find the right fit. Many of these indices only determine suitability of the socially responsible or ESG standards and do not consider investment criteria. Collaboration Capital utilizes a proprietary ESG approach that integrates ESG metrics with fundamental investment criteria to create suitable portfolios of high quality names.

As noted above, there are environments in which passive investment proves to be a great choice and other environments where it falls short by a significant margin. The recent strength of the equity market has made for a good time to utilize low cost index funds. Should there be a correction or a market re-allocation of risk, however, passive broad market strategies will likely not be the top performers. Investors would be better prepared by having quality active management of their portfolios to minimize losses in any meaningful market drawdown.

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GEORGE W. ROONEY, JR., CFA
Chief Investment Officer
Collaboration Capital, LLC

1 John C. Bogle, Financial Analyst Journal, Viewpoint, January/February 2016
2 Investment Company Institute, 2017 Investment Company Fact Book, A review of Trends and Activities in the Investment Company Industry, 57th edition
3 Bloomberg News, May 12, 2017 "There Are Now More Indices Than Stocks"
4 Jonathon Barnes, Active vs. Passive Investing – How the old debate is affecting today's investment strategies. CFA Magazine Jan/Feb 2003
5 Goldman Sachs; Global Markets Institute|2017, Directors' dilemma: responding to the rise of passive investing, January 9, 2017