Active vs. Passive Management: Key Considerations for Making an Informed Choice

Tom Grant is the Treasurer for Mountain Side Day School. As a seasoned investor and business owner, Tom believes that investment advisors should use active managers for 75%–80% of investment portfolios. He feels strongly about this but is willing to have a dialogue with the School’s investment advisor, Steve Jones.

Tom asks, “So, what is the percentage of active management in our portfolio?” Steve explains, “We are currently using both active and passive managers in the portfolio. The percentage of active managers is approximately 25% of the total portfolio because investment committee members expressed a desire to see performance closely match sector benchmarks. Also, at our first meeting, there was a consensus that we should minimize cost.”

Tom looked somewhat puzzled, “But, if we are invested so heavily in passive solutions, why do we need an advisor?” Steve responded, “Tom, modern portfolio theory proves that a significant amount of your returns are actually generated from the asset allocation not manager selection. The selection of managers and your organization’s investment philosophy are important and we are committed to working with you on both of these important aspects of managing your portfolio. In times of recent market volatility when the fundamentals are no longer working as we might expect, we find that placing passive managers in highly efficient asset classes and using active managers in less efficient asset classes is a solid approach. We are happy to explore this in greater detail with you and the rest of the committee.”

The scenario described above takes place often in not-for-profit board rooms as trustees grapple with active vs. passive investment management decisions. Most boards and investment committees, usually with the help of an investment advisor or consultant, spend time creating an investment policy statement (or reviewing an existing one), assessing the effectiveness of the asset allocation, evaluating manager performance, setting benchmarks to measure success and overseeing transactions. (For more information about benchmarks, please reference Benchmarking Basics: a Fiduciary Perspective available at www.suntrust.com/nonprofitinsights).

One of the major decisions that a not-for-profit organization must make is whether to use active or passive investment vehicles. This topic has been particularly noteworthy recently, as the high correlations within domestic equity markets and coordinated activities of central banks have made it difficult for active managers to beat their benchmarks. A recent Investment News article reported that based on a universe of more than 2,300 active funds with more than $5.5 trillion in assets, 67% underperformed their benchmark in the third quarter of 2015, with more than one-third, or 34%, underperforming by at least 250 basis points, or 2.5%.

A definition

What exactly is active vs. passive investing? A passive approach establishes the types of stocks a fund owns and then owns all of the stocks that meet those criteria. It does not attempt to identify opportunistic investments to improve performance. While index funds are not the only form of passive investing, they are the most well-known. An index fund defines the stocks (or bonds) it owns by owning the same stocks as those that are included in a known and measured index, such as the S&P 500 or the Russell 1000.

Active managers attempt to outperform a designated market index on a risk-adjusted basis by making specific investments that exploit market inefficiencies. For example, an active manager may look for securities that are over or under valued by employing quantitative measures and attempting to anticipate long-term macroeconomic trends.

The Great Debate

There are arguments to be made on both sides of the active vs. passive investing debate.

Active managers have the potential to outperform their benchmarks by overweighting and underweighting their
portfolios versus the benchmark holdings, as well as by holding securities that are not included in the benchmark. Active managers generally charge higher fees than passive managers. And, despite their best efforts, active managers sometimes underperform their asset class benchmarks.

Passive managers generally produce performance that is very close to their benchmarks. In turn, they charge lower fees than active managers since, in most cases, their investments simply match the index’s holdings. Passive managers cannot raise cash in a market downturn to take advantage of opportunistic, tactical strategies. Their performance will almost always lag the benchmark by a slight amount because of fees. In general, passive investment strategies are more tax-efficient than active strategies because they have lower turnover than the typical active manager.

Many reasons have been given for the difficulties faced by active managers, but we believe that one of the root causes stemmed from the global financial crisis, which began in 2007-2008. Governments and central banks around the world took coordinated fiscal and monetary policy steps to stem the crisis. In general, the net effect of these actions caused global economies to move in similar directions, and there was less focus on the fundamentals of global sectors and stocks. As the cost of capital for companies declined with the decrease in interest rates, there was little differentiation between individual companies and less focus on the core businesses. This lack of differentiation led to a high correlation between individual stocks, which typically is a challenging environment for active managers. When stocks move together (high correlation) it is difficult for an active manager focused on security selection to beat a benchmark.

Figure 1 shows the percentage of peer group mutual funds that equity benchmarks outperformed over the last 1, 3, and 5 years as of December 2015. For example, the S&P 500 was at the 16th percentile of the Morningstar peer group for the three years ending December 31, 2015—or said differently, the benchmark would have beaten 84% of actively managed Large Cap Core Equity mutual funds. While these results appear daunting, it is interesting to note that the median active manager in two classifications, Large and Small Cap Value, finished ahead of the benchmark and several categories were within striking distance. This is an improvement over 2014 when every benchmark finished ahead of the median manager. Finally, keep in mind that the benchmark returns are not adjusted for fees while the peer group results are net of fees.

**Figure 1: Percent of Mutual Fund Peers that Equity Benchmarks Outperformed as of 12/31/15.**

Data source: Morningstar Direct

**What’s the right mix?**

When facing this decision, not-for-profit organizations and their boards must evaluate all aspects of the issue. One major consideration is the organization’s investment philosophy. Three key concerns that guide the active vs. passive discussion are outlined below.

**Less Volatility**

Some not-for-profit organizations have a low tolerance for volatility. They have difficulty explaining outsized gains and losses to stakeholders. They also tend to look at portfolio performance in terms of a spending policy that supports the organization with “real money” that has a dedicated purpose. In particular, a down year that negatively impacts a portfolio by 15% may not be tolerable if the organization relies heavily on investment proceeds for administration or programs. The fear of outsized losses was a common sentiment in 2008 – 2009 when domestic equity markets fell rapidly. As boards faced portfolios that sustained losses as high as 50%, it was easy to understand their predicament. (The S&P 500 declined 50% during the
bursting of the “Tech Bubble” from 2000-2003 and then again in 2008-2009.) A false assumption is that passive investments are less volatile. A portfolio of all passive investments can still be a very volatile portfolio, because those investments will move up and down with the underlying benchmark. The only volatility that the committee is reducing by using all passive investments is the performance of the portfolio to its benchmark.

If this sounds like a familiar concern, we urge your board or committee to review your investment policy statement (IPS) and decide if the current asset allocation is appropriate for your goals and risk tolerances. Indexing by itself does not reduce volatility in a portfolio, although it can contain the performance swings to the levels experienced by the indices themselves and eliminate the outperformance or underperformance experienced by active managers.

**Simplification of the investment process**

In contrast to the example above, there are not-for-profit organizations that prefer to minimize the investment decisions that they make to focus exclusively on their mission or to simplify the investment process. Endowment management is complex. It requires expertise, skill, and patience. But it is important to remember that moving a portfolio to passive investments does not mean that there are no more investment-related decisions to make. Delegating investment management to an outside consultant or investment advisor is one way to minimize the burden of managing an endowment. However, whether to use active or passive managers remains one of the many choices for which a board or investment committee is responsible. Sometimes a move to passive investing can lull a board or investment committee into a sense of false security, as they assume that the portfolio does not need their full attention anymore. This is not true, as the portfolio must still be allocated among asset classes (equity vs. fixed, domestic vs. international, etc.) and then tactically rebalanced. The IPS should be reviewed once a year to ensure that it reflects the investment objectives and risk tolerance of the organization. Oversight committees and investment advisors still have plenty of work to do after a portfolio is moved to passive vehicles.

**Lower fees**

Fee conscious not-for-profits often mandate the lowest fees possible on investment portfolios. Passive management is one way to achieve this goal. In addition to a consulting or advisory fee, organizations pay money managers a fund fee that covers operating expenses. Fees for an actively managed fund averaged .64% and passive funds averaged .20% according to the Morningstar 2015 Fee Study. Committees must balance the need to minimize fees with all other investment-related factors to reach the best solution for their organization.

**Our philosophy: Mission First**

Our approach is to provide best-in-class asset management so that our not-for-profit clients can focus on their charitable mission. Our mandate is to deliver a competitive investment offering for our clients with both active and passive strategies across a broad selection of asset classes. While we believe in active management, our philosophy is that passive and “passive-plus” options should be available as well. Our process rests upon finding those active managers that we feel have the ability to deliver the investment results we expect over the long term.

Active managers continued to struggle versus their benchmarks during 2015 as only 46% of active equity mutual funds were able to beat their indices according to Lipper. This represents a substantial improvement over 2014 when just 30% of active funds finished ahead of their benchmarks. While 2015 was a better year for active managers, many still struggled.

The decision to use active management, passive management or a blend of both is important. It is an evolving discussion that can be adjusted as organizational needs, the economy and financial markets change. But, it is important to remember that it is only one step in the investment process.

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<thead>
<tr>
<th>Active Management</th>
<th>Passive Management</th>
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<tbody>
<tr>
<td>Higher fees</td>
<td>Lower fees</td>
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<tr>
<td>Can outperform benchmark, especially in inefficient market sectors</td>
<td>Will match performance of benchmark, less fees</td>
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<tr>
<td>Might underperform benchmark</td>
<td>Will match performance of benchmark, less fees</td>
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<tr>
<td>Available for all market segments</td>
<td>Limited to market segments with liquid, investable benchmarks</td>
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<tr>
<td>Not always tax efficient due to higher turnover</td>
<td>Usually more tax efficient because of low turnover</td>
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<tr>
<td>Can raise cash in a downturn</td>
<td>Will always be fully invested</td>
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For more information about active and passive investing, contact your SunTrust relationship manager or investment advisor. You may also contact us by phone 866.223.1499.

Please visit us at www.suntrust.com/foundationsandendowments or www.suntrust.com/nonprofitinsights

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1 As of December 31, 2015


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