Active vs. Passive Management

CanterburyConsulting | January 2017

Investors should consider their objectives, time horizons, tax sensitivities, and aversion to tracking error before choosing one over the other

Introduction

The active versus passive investment management discussion has intensified as of late due to active management's recent inability to outpace their passive benchmarks. Some may have a knee-jerk inclination to fire an underperforming manager, but the data show that investors are better off staying the course. A 2012 study by Towers Watson that simulated 10,000 different scenarios found that over a three-year period, institutions that fired underperforming managers ultimately underperformed institutions that stayed committed to their managers. Managers with high active share, like those that Canterbury prefers, will look especially different from their benchmarks. The more a manager varies from its benchmark, the higher the likelihood of extended periods of under- and out-performance. Performance itself should never be the sole determinant for firing a manager. Instead, investors must understand why performance is suffering and determine if it is likely to persist. This paper explores the reasons why active managers suffer bouts of underperformance and seeks to educate investors on the appropriateness of active and passive investments in their portfolios.

What is Active and Passive Management?

Passive investment strategies are rules based and typically track indexes like the S&P 500. Active managers are investment experts who build portfolios

Features	Passive Management	Active Management
Goal	Replicate the performance of a benchmark	Outperform a benchmark
Potential for Above Market Returns	No	Yes
Potential for Below Market Returns	Yes (after fees)	Yes
Potential for Drawdown Protection	No	Yes
Fees	Generally Lower	Generally Higher
Tax Efficiency	More Tax Efficient	Less Tax Efficient

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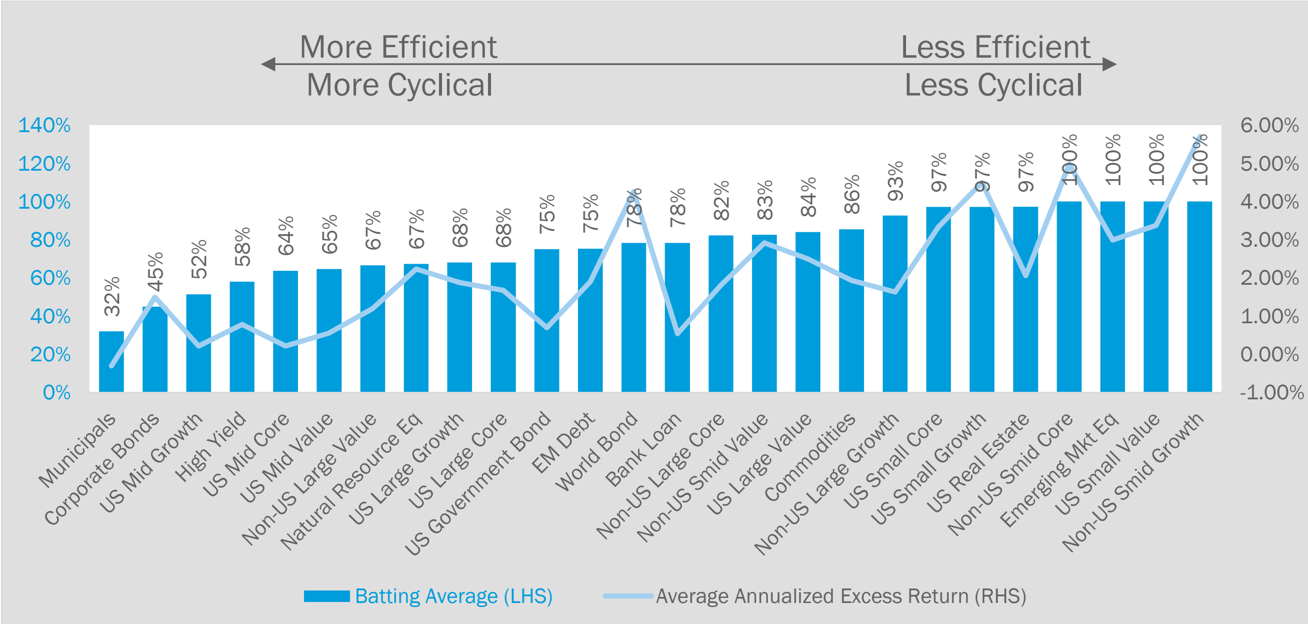
consisting of the most attractive investments in a universe, according to their own processes (irrespective of the benchmark).

Passive management has proven to be a viable strategy and has recently gained market share versus active management. It stresses low costs, tax efficiency, and the concept of market efficiency. Passive management gives investors cheap exposure to the market without the potential for above-market returns; after accounting for fees, it almost guarantees below-market returns. Active management, on the other hand, has the potential to generate both above-market and below-market returns.

Market Efficiency

The Efficient Market Hypothesis (EMH), in its strong form, says that markets are efficient, security prices reflect their fair value, and active management can't generate excess returns. There is a degree of truth to the EMH, but it varies by asset class. We explore several different asset classes to uncover the median active manager's batting average (% of periods it produces positive excess returns against its benchmark) and average annualized excess return over three-year rolling periods. On average, less efficient categories have the best chance of outperforming their respective benchmarks on a consistent basis. These categories tend to be non-U.S. or niche, which are less researched by U.S. investors. The categories that have the most difficulty outperforming



their respective benchmarks on a consistent basis tend to be more cyclical in nature. This is because it is more difficult for managers to forecast future earnings or prices in more cyclical markets.

Performance was analyzed on a gross-of-fees basis to better compare across asset classes the theoretical ability of active managers to outperform the market. When using active managers, Canterbury generally recommends using managers with excess (gross-of-fees) return expectations that are at least double their fees. This will give investors a cushion if a manager does not perform in line with expectations or is out of favor for an extended period of time.

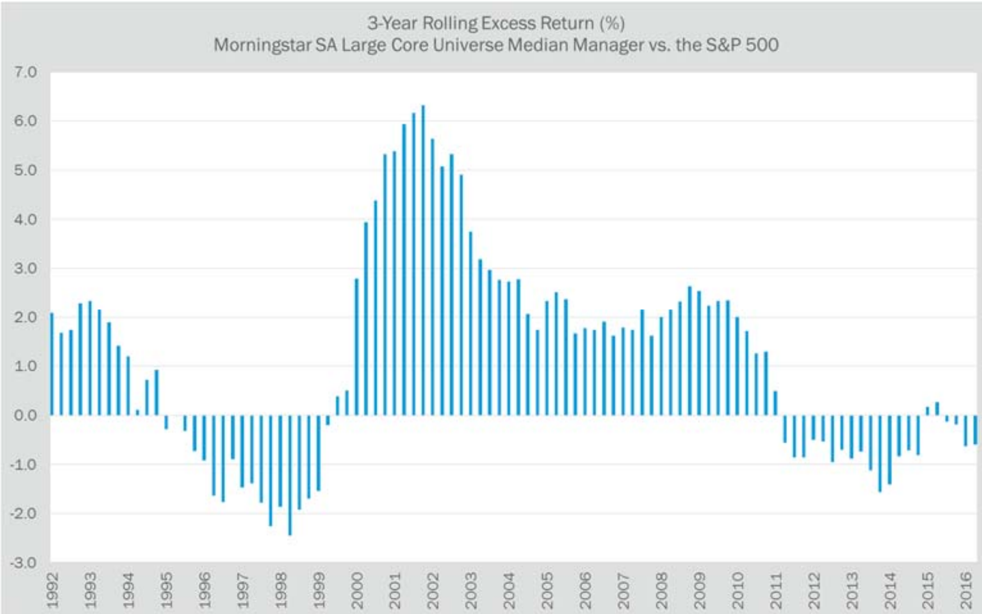
Markets are not perfectly efficient, and they probably never will be, but that in itself isn't a stamp of approval for active management. Managers must be able to capitalize on these inefficiencies and deliver results that consistently are above benchmark. We expect active managers in some asset classes to be able to do this; however, they aren't going to do it over every time period. Excess returns tend to occur in cycles, and investors should expect sustained periods of underperformance and outperformance. We will take a look at a few of the market conditions that cause these cycles in relative underperformance, to help manage investor expectations:

1) **Bull Markets:** Active managers are generally more conservative and take less market risk. Active manager betas, on average, are less than 1.0 (in bull, bear, and full market cycles), and their upside and downside captures are less than 100%. Less market sensitivity will mathematically equate to underperformance in up markets and outperformance in down markets, which has been the case. Conversely, if you risk adjust these returns (solve for alpha), active managers will outperform in bull markets and underperform in bear markets.

2) **Irrational Exuberance:** Active managers tend to do much better when markets are rational. In rational markets, fundamentals matter and security prices move toward their fair value. In irrationally exuberant markets, we see security prices move independently of fundamentals toward bubble levels (think tech in the late '90s). The majority of active managers believe their processes allow them to uncover mispriced securities, but this process does not work during periods of irrational exuberance, when mispriced securities become more mispriced.

3) **Interest Rates and Central Bank Easing:** Active managers are expected to struggle in ultra-low interest rate environments where access to capital is easy. It allows companies that are struggling financially to cheaply refinance their debt well out into the future, which in turn increases their solvency and stock price without regard for business fundamentals. Active managers who have a quality bias typically avoid these types of companies. Most experts feel

that as interest rates rise, fundamentals should matter more, as dispersion between good and bad companies increases.



Investors should not attempt to time the market when it comes to choosing active versus passive investing. Cycles are hard to predict and can last longer or shorter than anyone anticipates. It is our recommendation that investors commit long term to whatever investment strategy they choose, whether that be active, passive, or a diversified combination of both.

Median Managers

Sometimes too much emphasis is placed on the average. Just because you average a speed of 65 MPH when driving on the freeway, doesn't mean you would expect to drive 65 MPH on the 405 Freeway during rush hour. Different scenarios drive (no pun intended) different expectations. As a firm, we attempt to understand our strategies in such depth that their performance relative to our expectations is more important than their performance relative to a benchmark in the short term. Furthermore, we allocate a lot of resources to our manager due-diligence process, to identify investment managers that we expect to perform above median. We understand it's impossible for them to be in the top quartile every month, quarter, or year, but we strive to find those managers that will be there over full market cycles. Our due-diligence process is both quantitative and qualitative. We will screen on factors that have had predictive power in choosing exceptional managers such as manager tenure, expenses, volatility, downside capture, and alpha over previous cycles. Even more important than these quantitative factors are the people, philosophies, and processes our managers employ. If an active manager does not have a value proposition — a competitive advantage or edge versus its benchmark and peers — we will not consider them as an investment for our clients.

Investment Horizon

An investor's time horizon plays an integral role in the decision to invest passively or actively. The data suggest that active managers have a higher probability of success over longer time periods. The frequency in which the median large core manager outperforms the S&P 500 increases from 62% to 79% when extending the holding period from one year to five years. Canterbury would advise investors with a holding period of a year or less to utilize passive management as a quick and effective way to get market exposure.

Management Fees

Passive management generally offers lower fees relative to active management. For example, Vanguard offers an S&P 500 ETF and mutual fund, each with an expense ratio of four basis points. Separately managed accounts for similar strategies can be had for less than 15 bps. This is in stark contrast to some actively managed large cap mutual funds that have expense ratios closer to one percent

Passive strategies that track the same index have similar objectives, so investors should generally invest in the one with the lowest fees (all else being equal). Fees for active management can vary widely, as can the quality of the managers. This makes it more difficult to choose the appropriate manager, but fees should play a role in that decision.

Tax Sensitivity

Passive investment strategies will generally incur less of a tax burden than active strategies, and in certain cases (a separate account optimized for tax-loss harvesting), can generate tax assets (sometimes referred to as tax alpha). Most passive strategies will replicate market-cap weighted indexes that take a mostly buy-and-hold approach, thereby generating very little in the way of capital gains. Active managers attempt to add value through buying and selling securities to lock in gains and mitigate risk, which creates turnover. The higher an active manager's turnover, the more likely they are to generate capital gains (especially in upward-trending markets) and be less tax efficient.

Conclusion

Active and passive management strategies serve different roles in investor portfolios, and neither is better than the other. Active management, with proper due diligence, has the ability to produce above-market returns. Passive management creates a level of consistency that allows investors to invest in products that more easily meet their expectations. Investors should consider their objectives, time horizons, tax sensitivities, and aversion to tracking error before choosing one over the other.

About Canterbury

Canterbury Consulting is a leading investment advisory firm, overseeing $17.5 billion as of December 31, 2016, for foundations, endowments, individuals, and families. Founded in 1988, the Company designs and manages custom investment programs aligned with each client's goals. Canterbury acts as the investment office for its diverse clients and provides objective investment advice, asset allocation, manager selection, risk management, implementation, and performance measurement. Canterbury Consulting strives to deliver performance and service that exceeds the needs and expectations of its clients.

Sources

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Data on excess returns was provided by Morningstar Direct for the last 20 years ending 3/31/17. The Morningstar median category manager represented median active management and was compared against industry standard benchmarks which represented passive management.

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