ACTIVE VERSUS PASSIVE INVESTING
TABLE OF CONTENTS

In this white paper:

Introduction 3
Definitions 3
Comparison of Past Performance 3
The Advantages of Passive Management 4
The Drawbacks of Passive Management 4
The Advantages of Active Management 5
The Drawbacks of Active Management 5
Additional Observations 6
A Reasonable Strategy Going Forward 7
ACTIVE VERSUS PASSIVE INVESTING

Introduction
The debate that began several decades ago over the merits and shortcomings of active versus passive investment management is ongoing. Reports on the topic by investment professionals and academics continue to be published unabated, and seem to be one of the investment world’s more popular literary pursuits. While there is hardly a need to add another voice to the discussion, it is our belief that Abbot Downing should define its position as part of our investment philosophy for the benefit of our clients.

Definitions
The investor who practices active management selects individual securities for purchase or sale usually based on fundamental research and/or by utilizing a broad array of quantitative methods. By contrast, the passive investor buys an entire index such as the Standard & Poor’s 500 (S&P 500), simply to match its performance. Both active and passive products are available, enabling investors to take either approach to gain exposure to a full range of stock and bond markets, investment styles, geographic regions, and sectors.

Passive investing can be accomplished by using index funds or exchange-traded funds (ETFs), both of which have been in existence for some time. Vanguard launched the first index fund in 1975, and State Street Global introduced the first ETF in 1993. From those beginnings, passive funds have grown to account for over 40% of total U.S. equity investments, split almost evenly between mutual funds and ETFs. Even among institutional investors, passive strategies are gaining popularity and account for about 27% to 29% of assets. They will likely continue to win over adherents, particularly during periods of underperformance by active managers.

Comparison of Past Performance
Academic studies and literature typically support passive management, especially in the highly efficient large cap indexes. Simply stated, such studies have sought to prove that active investment managers are incapable of beating “the market” over the long term, using empirical evidence to support that position. In contrast, the active management community has challenged that claim principally by choosing time periods that favor their constituency, or by noting its success in inefficient markets.

Some examples from recent history demonstrate the variations in passive/active performance for large cap stocks over relatively short time periods. In support of passive management, the S&P 500 outperformed 95% of large cap equity core managers from 2002 to 2017. On the bond side, passive funds prevailed over 75% of active competitors for the 15-year period ending in 2017, principally owing to the superior performance of U.S. Treasuries.

However, active managers in the U.S. equity space have had their share of success as well. Between 2003 and 2010 a majority of the universe of domestic equity funds outperformed the benchmark S&P 1500 in five of those eight years. This example clearly demonstrates the importance of starting and ending dates. If one measures performance over the 10-year period beginning in 1997, passive management wins; move forward a year and active management comes out ahead.

Longer-term results calculated by our consultant, Callan, reflect the performance of actively managed mutual funds over several time frames. According to Callan, outperformance has been difficult to come by in the post-crisis recovery. In fact, looking over the 10-year period beginning June 30, 2018, the median manager was able to outperform the benchmark in only six of the 18 strategies tracked. Looking further back, the numbers improve slightly. For the 20-year period,
over long periods of time are in no small part the result of low fees and expenses. The passive investor also has the luxury of avoiding the challenges and costs associated with selecting successful active managers. We have recently seen that even the most experienced professionals can stumble, calling into question whether it is possible to select those who can consistently outperform in an increasingly complex world.

The Drawbacks of Passive Management

Perhaps one of the most significant drawbacks of passive management is that it requires the investor to accept the configuration of the index and its holdings, regardless of their quality or inherent risks. The S&P 500 is managed by a committee which considers—among many factors—market capitalization, sector representation, liquidity, and positive earnings. The committee then adjusts the holdings regularly. By contrast, the Russell indexes are reconstituted once a year “to

outperformance was achieved in nine of the 16 strategies that had a track record of at least 20 years. Callan’s full performance analysis is summarized in the above table.

Those seeking clear conclusions in the active versus passive debate will probably take little comfort in these performance comparisons. Clearly, advocates of passive management are supported by compelling evidence that markets cannot be beaten over the long haul, especially net of fees and taxes. However, there have been sustained periods of time when active managers have delivered superior relative returns and certain asset classes have demonstrated the ability to add value.

The Advantages of Passive Management

By investing passively, the investor gains exposure to broadly diversified lists of stocks or bonds that target specific investment styles in a tax-efficient manner. The performance advantages

### Active Versus Passive Outperformance, By Strategy as of June 30, 2018

<table>
<thead>
<tr>
<th>Peer Group</th>
<th>Benchmark Used</th>
<th>Last Quarter</th>
<th>Last Year</th>
<th>Last 3 Years</th>
<th>Last 5 Years</th>
<th>Last 7 Years</th>
<th>Last 10 Years</th>
<th>Last 15 Years</th>
<th>Last 20 Years</th>
</tr>
</thead>
<tbody>
<tr>
<td>Callan Large Cap Core MF</td>
<td>S&amp;P: 500</td>
<td>-0.78</td>
<td>-1.17</td>
<td>-1.89</td>
<td>-1.40</td>
<td>-1.45</td>
<td>-1.25</td>
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<td>-0.65</td>
</tr>
<tr>
<td>Callan Large Cap Growth MF</td>
<td>Russell:1000 Growth</td>
<td>0.14</td>
<td>0.71</td>
<td>1.52</td>
<td>0.55</td>
<td>0.33</td>
<td>(0.44)</td>
<td>0.89</td>
<td>0.02</td>
</tr>
<tr>
<td>Callan Lg Cap Value MF</td>
<td>Russell:1000 Value</td>
<td>0.55</td>
<td>3.55</td>
<td>0.25</td>
<td>(0.22)</td>
<td>(0.52)</td>
<td>(0.39)</td>
<td>(0.24)</td>
<td>(0.50)</td>
</tr>
<tr>
<td>Callan Mid Cap Core MF</td>
<td>Russell:Midcap Index</td>
<td>-0.38</td>
<td>1.21</td>
<td>1.37</td>
<td>1.55</td>
<td>1.55</td>
<td>0.10</td>
<td>1.15</td>
<td>0.81</td>
</tr>
<tr>
<td>Callan Mid Cap Growth MF</td>
<td>Russell:Midcap Growth</td>
<td>0.80</td>
<td>0.69</td>
<td>0.99</td>
<td>0.13</td>
<td>1.07</td>
<td>0.74</td>
<td>0.69</td>
<td>0.33</td>
</tr>
<tr>
<td>Callan Mid Cap Value MF</td>
<td>Russell:Midcap Value</td>
<td>0.66</td>
<td>0.32</td>
<td>1.57</td>
<td>0.20</td>
<td>1.67</td>
<td>0.14</td>
<td>1.48</td>
<td>0.17</td>
</tr>
<tr>
<td>Callan Small Cap Core MF</td>
<td>Russell:2000 Index</td>
<td>-1.87</td>
<td>3.55</td>
<td>1.65</td>
<td>1.45</td>
<td>1.30</td>
<td>0.86</td>
<td>0.48</td>
<td>0.46</td>
</tr>
<tr>
<td>Callan Sm Cap Growth MF</td>
<td>Russell:2000 Growth</td>
<td>1.13</td>
<td>3.25</td>
<td>0.17</td>
<td>0.54</td>
<td>0.57</td>
<td>0.61</td>
<td>0.25</td>
<td>1.26</td>
</tr>
<tr>
<td>Callan Sm Cap Value MF</td>
<td>Russell:2000 Value</td>
<td>-2.88</td>
<td>0.86</td>
<td>2.03</td>
<td>0.36</td>
<td>0.72</td>
<td>0.04</td>
<td>0.16</td>
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<tr>
<td>Callan Global Equity MF</td>
<td>MSCI:World</td>
<td>-0.77</td>
<td>0.65</td>
<td>1.00</td>
<td>0.67</td>
<td>0.62</td>
<td>0.17</td>
<td>0.16</td>
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<tr>
<td>Callan Non US Equity MF</td>
<td>MSCI:EAFE</td>
<td>0.75</td>
<td>0.29</td>
<td>0.42</td>
<td>0.10</td>
<td>0.16</td>
<td>0.29</td>
<td>0.13</td>
<td>0.18</td>
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<tr>
<td>Callan Intl Small Cap MF</td>
<td>MSCI:EAFE Small Cap</td>
<td>1.08</td>
<td>1.43</td>
<td>2.07</td>
<td>1.86</td>
<td>0.92</td>
<td>0.34</td>
<td>0.19</td>
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<tr>
<td>Callan Emerging Equity MF</td>
<td>MSCI:EM</td>
<td>1.34</td>
<td>0.85</td>
<td>0.59</td>
<td>0.34</td>
<td>0.12</td>
<td>0.33</td>
<td>0.25</td>
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<tr>
<td>Callan Core Bond MF</td>
<td>Bloomberg:Aggregate</td>
<td>0.11</td>
<td>0.23</td>
<td>0.26</td>
<td>0.29</td>
<td>0.12</td>
<td>0.19</td>
<td>0.16</td>
<td>0.33</td>
</tr>
<tr>
<td>Callan Core Plus MF</td>
<td>Bloomberg:Aggregate</td>
<td>0.22</td>
<td>0.12</td>
<td>0.09</td>
<td>0.17</td>
<td>0.37</td>
<td>0.52</td>
<td>0.20</td>
<td>0.08</td>
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<td>Callan High Yield MF</td>
<td>Bloomberg:Corporate High Yld</td>
<td>0.42</td>
<td>0.82</td>
<td>1.57</td>
<td>1.21</td>
<td>1.30</td>
<td>0.66</td>
<td>1.23</td>
<td>0.10</td>
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<tr>
<td>Callan Intl Fixed Inc MF</td>
<td>Bloomberg:Glob Agg ex USD</td>
<td>1.19</td>
<td>2.25</td>
<td>1.21</td>
<td>0.03</td>
<td>0.96</td>
<td>0.13</td>
<td>0.44</td>
<td>0.30</td>
</tr>
<tr>
<td>Callan Real Estate REIT</td>
<td>FTSE:NAREIT Equity Index</td>
<td>1.47</td>
<td>0.98</td>
<td>0.41</td>
<td>0.60</td>
<td>0.58</td>
<td>0.72</td>
<td>0.92</td>
<td>1.24</td>
</tr>
</tbody>
</table>

Source: Callan Associates

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ensure new and growing equities are reflected.” Companies operating at a loss are included; and in some cases can be a material portion of a Russell index. In the case of bonds, some indexes do not account for defaults until they occur and some occasionally contain illiquid securities.

The investor in passive products also assumes the weightings assigned to individual securities. On the equity side, by definition, the largest stocks become larger since money is allocated by market capitalization in most indexes. (An exception is the Dow Jones Industrial Average which is price-weighted.) This leads to an emphasis on companies or sectors that are performing well, forcing one to assume material risks associated with concentration. For example, more than 30% of the S&P 500 was invested in the energy sector in the 1970s and in technology and telecommunications in the 1990s, and 20% in financials just a couple of years ago. The subsequent collapse of those sectors was painful for large cap passive portfolios.

As for individual companies, passive management exposes investors to similar risks. For example, tech stocks have been a big driver of the returns generated recently. The five FAANG stocks (Facebook, Apple, Amazon, Netflix, and Google) represented 12% of the S&P 500 index and 27% of the Nasdaq index in August 2018. That’s a large concentration in a single sector, passive investors can’t always assume they are getting a diversified group of stock. Or as another example, value-minded investors would never consider owning a stock with an exorbitant Price/Earnings ratio, while the P/E ratio for both Netflix and Amazon are well above 100. As a passive investor, you don’t have the option to remove exposures that don’t align with your investment philosophy.

In our view, there is a specific lesson implicit in this data. The passive investor must recognize that there are occasions when the diversification sought through an index is an illusion and that the accompanying risks can be formidable.

Lastly, because index funds and ETFs charge a management fee, a passive investor must know their investment will never outperform the benchmark.

The Advantages of Active Management

Along with the possibility of catching a sustained ride during a period when passive indexes underperform, there is solid evidence that active management may sometimes be an appropriate investment option. As a starting point, the aforementioned conclusion by Callan that actively managed portfolios in inefficient markets have consistently beaten their indexed counterparts (and may continue to do so), is widely accepted.

Additionally, many investors may not find acceptable the notion that ownership of stocks or bonds and all sectors in their portfolios must be entirely based on their size and consequent weighting in an index. They may take exception to investing in a portfolio that includes companies of low quality, those losing money or in bankruptcy, those in businesses that offend them, overly-competitive industries, poorly managed companies, or those that do not pay dividends. They may prefer to focus on—with a professional manager or on their own—a unique set of objectives, adopting a strategy that reflects their values, investment criteria, and, importantly, unique tax circumstances. They may even be willing to entrust managers with the authority to carry meaningful cash positions under certain conditions.

An investor’s chances of successfully meeting his or her investment objectives through active portfolio management are increased by selecting top-performing managers. At Abbot Downing, we seek managers with strong investment functions, a long-term record of above-average results, a solid investment philosophy and strategy that has been practiced successfully and consistently, and rigorous risk control. We work diligently to identify, retain, and then closely monitor a broad list of such managers, aiming for the very best.

The Drawbacks of Active Management

Due to underperformance relative to passive alternatives, active managers have been, and continue to be, under enormous pressure to deliver results that justify their fees and other expenses. This has led to a radical change in the way money has been invested over the years. Managers, fearful
of being out of top performing individual securities or sectors, frequently cling closely to their assigned benchmark, almost guaranteeing mediocre relative results at best. Many are justifiably labeled “closet indexers” as they invest defensively to avoid major errors.

Other managers sometimes choose a different tactic by straying from assigned benchmarks, sometimes markedly. For example, they may shift assets to a competing style (called style drift), or to larger or smaller stocks than authorized, violating their official mandate. They may even deviate from their own stated strategy, especially during times of meaningful and sustained underperformance.

Finally, there are risks related to the active management firm itself. It may encounter internal problems such as the loss of personnel or clients, lagging performance, a strategy or style that is out of favor, significant changes in ownership, or a change in its investment philosophy.

Additional Observations

Before presenting our own conclusions in the active versus passive debate, there are a few additional observations that are relevant.

• Active/passive studies do not typically measure performance results on a risk-adjusted basis. In a perfect world, investors would consider differences among securities with regard to size, quality, liquidity, and volatility when comparing active and passive strategies. Investors should weigh the impact of cash in actively managed portfolios. One could argue that this liquid component lowers risk but it also negatively impacts performance results during rising markets. This has surely accounted for some of the underperformance by active managers over the long term.

• In many cases, a perfectly comparable benchmark is not available. For example, a high-quality-oriented mid cap growth stock manager will not invest in companies losing money but is benchmarked to an index which can sometimes have as much as 40% in unprofitable businesses. Another example: a small cap growth manager invests exclusively in dividend-paying companies but is judged against an index that contains mostly those that do not distribute dividends.

• Tracking error is defined as the extent to which a portfolio’s performance deviates from its benchmark. Even index funds and ETFs exhibit tracking error, although to a lesser degree than their active counterparts. The culprits: expenses, fees, transaction costs (relatively high with smaller capitalization stocks and emerging markets), and, in the case of ETFs, supply/demand factors that sometimes result in wide short-term disparities between the ETF and its underlying securities.

• Earlier, this paper touched on some of the risks contained in indexes such as bloated positions in individual securities, sectors, and geographic regions. Investors must decide whether the ways in which these indexes are configured are appropriate based on their own philosophy or, for that matter, whether index performance is even relevant to what they are trying to achieve.

• Active management affords investors the opportunity to customize their portfolios. On the equity side, for example, multiple managers in a particular style can be selected to complement each other with different strategies and tactics. One manager can provide a high quality, low risk, broadly diversified portfolio while another produces a lower quality, higher risk, concentrated list of stocks.

• Hedge funds are one example of a strategy that uses active management. Hedge funds use complex strategies and a host of other sophisticated investment and trading activities with the intent to exploit market inefficiencies. These strategies are typically less regulated and not as liquid as traditional mutual funds, and are available only to qualified investors.

Modern Portfolio Theory (MPT) has been grounded in the belief that markets are efficient and that active managers are incapable of outperforming indexes as a result. However, this assertion gets called into question when markets display violent swings, driven by fear and seemingly irrational behavior on the part of investors. We leave it to the academics to continue the debate but remain open to the premise that there are inefficiently priced securities and asset classes that can be exploited by able investment professionals.
Even William Sharpe, one of the early proponents of MPT, responded to a question about whether investments should be confined solely to index funds with a resounding “no.”

A Reasonable Strategy Going Forward

Passive management is gaining market share, especially among institutions, for good reason. Long-term results have favored this strategy, most notably among large capitalization stocks and in bonds as well. What’s more, investors have been inundated with advice by the media and academia to invest passively after watching active managers perform poorly during much of the period following the Global Financial Crisis of 2008 and 2009.

We agree that passive management can be effectively utilized by investors, especially when they are considering investments in the highly efficient large cap universe. Clearly, this strategy is preferable to selecting active managers who are “closet indexers” struggling to perform net of fees, expenses, and taxes. We believe that indexing is also appropriate for those investors who seek broad diversification, are comfortable with the configuration of indexes, and can live with their drawbacks.

At the same time, there is a role for active management as well, even beyond the inefficient markets referred to earlier. Indexes are far from perfect and may not accurately reflect a manager’s strategy or target universe or, for that matter, the investor’s objectives. Moreover, as we have pointed out, the performance of active and passive strategies runs in cycles. In the aftermath of the recent outperformance by growth stocks, the contrarian-minded investor might reasonably conclude that the time is ripe for value-oriented active managers to excel.

Active managers might also be able to exploit what promises to be a different and undoubtedly more complex economic and investment environment than anything we have witnessed in our lifetimes. They will be expected to deal with a dramatically changed political and financial landscape that is likely to include shifting rules and regulations for financial institutions, exploding government deficits and obligations, and an ever-evolving global policy regime, to cite a few examples. At the other extreme, we anticipate there will be great opportunities for those able to figure out what specific industries and companies will be able to benefit from, expanding populations, changing demographics, new technologies, alternative energy trends, and the like.

In summary, we conclude that the active versus passive debate does not yield a clear-cut solution that would eliminate one or the other. As illustrated in this paper, there are too many variables on both sides that raise questions while offering no concrete answers. At Abbot Downing, we support several passive management solutions and select and monitor a broad array of active investment managers across the asset class spectrum. At the same time, we continue to explore whether there might be a place for customized benchmarks that would help us more accurately evaluate both active and passive products.
Endnotes


6 Standard & Poor’s, 12/09/2009.