Passively managed equity funds have exploded in popularity in recent years, thanks to the perception that they charge low fees while providing market returns with market risk. The true story is much more complicated, because performance, fees, and portfolio turnover can vary widely among funds billing themselves as “passively managed.” Investors need to look beneath the hood and make sure the strategy they seek is the strategy they get.

**What Is Active Share?**
Active share is a metric that quantifies the size of the bet that active managers are taking relative to their benchmarks. Active share looks at portfolio holdings (stocks, bonds, etc.) and how they differ from the holdings of the benchmark index. For example, are there stocks in the manager’s fund that aren’t in the index? Are there larger or smaller weights in certain stocks compared to the weights of those same stocks in the index? The active share of a portfolio may vary from zero percent for an index fund that exactly mirrors the benchmark to 100 percent for a portfolio with no overlap. In short, active share focuses on stock selection—the conviction of a manager to veer away from the weightings of the index.

**Active Share Revisited**
In 2010, Jensen published a white paper titled “Mutual Funds through the Lens of ‘Active Share’” (Mertens and Calamar 2010). In this paper, we explored active share, a novel metric for evaluating mutual fund managers based on the similarities between their portfolio holdings and the stock market index the fund uses as a benchmark. Active share enables investors to determine if an investment manager is truly investing with conviction or merely copying an index, also known as “closet indexing.”

What differentiates a passive strategy from an active one? Generally speaking, a passive fund tries to replicate the performance and characteristics of a stock market index. Actively managed funds seek to outperform an index through portfolio management decisions, such as stock selection and/or risk management. Importantly, investors considering both types of strategies need to ensure they know which active funds aren’t truly active and which passive funds aren’t truly passive.

**The Growth of Passively Managed Funds**
As shown in figure 1, passive funds have grown considerably as a percent of total fund assets, though the marketplace is still dominated by traditional actively managed funds. Exchange-traded funds (ETFs) have become a popular passive fund vehicle, though they have yet to catch on with actively managed funds. This is likely because ETFs are required to make daily holdings disclosures, which some active fund managers balk at supplying due to the fear that another fund manager might deduce and copy their strategy. Further, performance trends from active ETFs have not been encouraging, although it is still in the early days and relatively few active ETF offerings are available (Rompotis 2009).

Despite lower market share, passive funds have grown considerably faster than active funds. The annual organic growth rates (or, growth in assets excluding larger market movements) for passive funds are more than double the rate of active funds (see figure 2).
The Case for Passive Investing

The primary argument for passive investing is that the higher fees charged by active managers are not justified because active managers, on average, do not consistently outperform their benchmark indexes after fees and expenses are considered. In a vacuum, this argument is valid until we consider that even the most perfectly managed passive fund, one that delivers a precise market return, is guaranteed to underperform if it charges even $0.01 in fees or expenses. Active funds, on the other hand, at least have the possibility of outperforming the index.

Another factor driving the perceived superiority of passive management is the phenomenon known as “performance chasing.” When investors withdraw money from active managers who fail to beat their benchmarks, they frequently invest the proceeds with managers that have provided better returns, often on a short-term basis (Phillips et al. 2013; Bagnoli and Watts 2000). The most damaging consequence of chasing performance is that, because very few (if any) managers outperform in every market environment, performance chasers can end up buying high and selling low. Once their new investment manager's performance slips (as market conditions change), they lose faith and move on to the next “hot” investment opportunity.

Performance chasing thus contributes to the perception that the average active manager underperforms because the calculations of “averages of all active managers” are typically dollar-weighted and these popular, over-bought funds receive the highest weights.

Additionally, it is difficult to get a handle on how active an active manager really is without inspecting their portfolio holdings. A number of self-described active managers are really closet indexers, constructing portfolios with a large number of stocks that differ very little from those in the index. If these closet indexers are included in the sum of active managers, they will lower the average outperformance and further support the claim that “the average active manager does not outperform.”

Performance Considerations

Taken together, this evidence may explain why researchers have found that some active managers, particularly the most concentrated, high-conviction managers, actually have outperformed the index over time, even after fees (Cohen et al. 2009; Kacperczyk et al. 2005; Di Mascio 2013; Williams 2013; Cremers and Petajisto 2009; Petajisto 2013).

Mertens and Calamar (2010) highlighted research from Cremers and Petajisto (2009), which suggested that high-conviction active managers outperform over time and low-conviction closet indexers tend to trail their benchmark indexes. Petajisto (2013) found that the most active funds outperformed their benchmarks after all fees and expenses while closet indexers did not, and that these patterns held up across different time periods and within different market capitalization strategies.

Despite these findings, Petajisto (2013) also found that closet indexing has become more popular over time, especially with larger funds and during times of high volatility. This may explain why the average mutual fund in his study underperformed, even though the most active funds outperformed.

Looking at a large pool of mutual funds, divided up not by active share but simply by those managers describing themselves as active or passive, we reached conclusions similar to Petajisto (2013), Mertens and Calamar (2010), and those of other academic researchers.\(^1\)

Figure 3 shows the best and worst actively managed funds—and an interesting pattern emerges. In figure 3, we see that the best and worst active funds, measured by their respective top and bottom deciles, are fairly evenly spaced above and below their benchmarks. In other words, they outperform and underperform with about the
same levels of magnitude. For passive funds, however, things look quite different (see figure 4).

Interestingly, while the best passive funds might barely beat their benchmarks (usually by deviating from the benchmark holdings), the worst passive funds tend to fall significantly short of their benchmarks. We attribute this to the recent introduction of a variety of higher-fee passive funds, as well as the popularity (and overcrowding) in the passive fund marketplace. Taken together, the largest passive funds are finding it increasingly difficult to trade their positions efficiently: As fund sizes increase (the top three passive funds in our search each have assets well in excess of $100 billion) it becomes more difficult for the fund to manage liquidity and trading (Chen et al. 2004).

While the same trading issues affect large active funds, active managers have more options. For example, they can spread liquidity by investing in more stocks, trade their positions more slowly, or simply choose not to buy a stock (passive funds are required to buy a new stock when it is added to an index), making it more difficult for other investors to predict their trades and front-run those funds.

Arguably, the most important issue to note is that the performance differences between active and passive managers can be substantial. As shown in figures 3 and 4, the median passive fund slightly underperformed its benchmark due to fees, generally speaking. But an active fund can substantially beat or miss its benchmark based on the manager’s skill and/or if the fund’s holdings vary meaningfully from its benchmark.

While departing from an index can lead to short-term periods of relative underperformance, most active managers’ ultimate goal is to beat the benchmark over the long run. At Jenson, we believe that by building a high-conviction portfolio of high-quality companies, we can help investors preserve more capital during market downturns. Our approach to active management differs from many of our riskier peers, but there is a growing body of evidence suggesting that outperformance by high-active-share managers comes primarily from the same downside protection we seek to achieve (Williams 2013).

Therefore, investors must decide if the potential to outperform a benchmark over the long term justifies the higher fees charged by active managers. For most investors, these decisions cannot simply be made in a vacuum, as asset allocation among different strategies and asset classes requires careful thought, planning, and customization for each investor’s needs, goals, and risk tolerance.

Passive Funds Are Not Always Passive; Active Funds Are Not Always Active

Due to the variety of funds available, it can be difficult for investors to navigate the plethora of investing options. Morningstar, for example, currently identifies 76 different passively managed mutual funds benchmarked to the S&P 500 index.2
Prior to the availability of index funds, investors would have to incur significant trading and portfolio management costs if they wanted to own every stock in an index.
However, the benefits from diversification only apply if the stocks are not perfectly correlated. If an index fund has 500 stocks that are less than perfectly correlated, the theory goes, the investor will achieve the average return of those stocks but with below-average risk—with risk defined simply as the standard deviation (volatility) of returns (Elton and Gruber 1977).

As always, there are some differences between theory and practice: The theory of diversification is based on random, equally weighted stock selection. However, in practice this is not the case because index funds are almost always weighted based on company size, resulting in positions more heavily concentrated in larger companies. Further, the stocks are not selected at random for all indexes, particularly the S&P 500 Index and the Dow Jones Industrial Average, where the stocks are selected by committee vote.

Importantly, since the 2008 downturn, correlations have increased between stock returns and mutual fund returns, and between mutual fund returns and their benchmarks (Blanchett 2013). Many possible causes for this growing correlation have been investigated: increases in algorithmic trading, which now makes up about three-quarters of daily trading volume and can cause increased correlation among stocks (Huh 2011); increases in the popularity of index funds, which buy or sell all stocks in their index at once, pressuring prices upward or downward (Barberis et al. 2005); and spikes in overall stock market volatility, which tend to be associated with increased correlations. Recall that during the second half of 2008, correlations between many publicly traded asset classes (stocks, bonds, etc.) increased dramatically as investors sold whatever they could to seek the safety of cash (Philips et al. 2012).

Unfortunately, the higher the correlation between a fund’s holdings, the smaller benefit the investor receives from diversification. As correlations approach 1.0, the index behaves more like a single stock. This is an important issue for many index funds, because researchers have found that as soon as a stock is added to a popular index, its correlation with that index increases substantially (Philips et al. 2012). If correlations continue to grow in times of trouble (economic or otherwise, and they certainly have in the past), then investors lose or reduce the benefit of diversification during the time when it is most needed.

Consequently, a highly diversified passive fund is not necessarily the path to a lower volatility portfolio; figure 7 shows there is little difference in the median standard deviation of returns between active funds and passive funds. Individual funds, however, can be found with lower volatility.

In general then, the diversification benefit from an index fund must come from the large number of holdings and not the absolute standard deviation. After all, if one of 500 companies fails, it should be less damaging to the portfolio than if one of only 50 companies fails. However, because indexes typically are not equally weighted, and the stocks are not randomly selected, this benefit is lessened if the company that falters happens to be one of the larger holdings in the index fund.

In many parts of the world, stock indexes, and even economies, can be dominated by a few large companies. In the S&P 500 Index, the five largest companies typically make up about 10 percent of the index’s weight. In other indexes, however, particularly in emerging markets, the five largest companies can make up more than 40 percent of the index, and often these five companies are concentrated in the same industry or type of business as well. As such, blindly weighting indexes by company size can lead to reduced diversification and expose investors to significant single-company risk.

For example, at its peak in late 2012 Apple Inc. made up nearly 5 percent of the S&P 500 Index. Apple’s stock price later declined, surprising many investors with the large impact that it had on these diversified index funds. Because index funds typically do not have any overlay of analysis or risk management, they always will be subject to this risk. Instead, we believe it is wiser to select a fund manager holding a smaller number of companies, but who understands each company thoroughly, and can actively manage risk, industry exposures, and individual company exposures.
Do Passive Funds Provide Greater Tax Efficiency?

In general, passive funds do tend to have lower tax costs than many active funds, especially if these funds are delivered in an ETF format instead of a traditional mutual fund. Compared with active funds, passive funds typically have lower portfolio turnover, as index constituents rarely change and generate fewer realized capital gains. ETF structures for passive funds enhance this advantage due to their immunity to the tax consequences of inflows and outflows. For example, if a mutual fund experiences a redemption, the fund typically must sell shares of the underlying stocks to fund the withdrawal, which may create a tax event for the other investors in the fund. In the case of an ETF, however, when one investor decides to redeem their shares, they simply sell the share of the ETF on the secondary market, and the tax event is experienced only by the single investor.

However, with regard to active funds as a whole, the picture can be brighter for long-term investors in certain active funds. There are many active funds available, including the Jensen Quality Growth Fund, offering relatively low portfolio turnover. The Fund's average turnover over its past five years is 16.13 percent. It may not be a surprise to learn that, due to the downturn in 2008, active managers actually have a lower median tax cost ratio over the past five years due to tax-loss carry forwards.

Final Thoughts

Passive strategies continue to gain popularity with investors, there is clearly an element of “you get what you pay for” across the spectrum of investing options. A passive fund may be less expensive than an active fund, but it may be limited in its ability to provide meaningful diversification, risk reduction, or additional tax benefits. Certainly there is very little chance that a passive fund is going to beat the market. Further, passive funds aren’t exactly a set-it-and-forget-it investment option. Proper due diligence on the part of the investor is still required.

Meanwhile, academic research indicates that the once-maligned active funds actu-
ally can be very good investments—lending credence to a truly active investment approach. As we have seen, many of the usual generalizations about active funds and passive funds may not hold up to closer inspection and depend greatly on the particular fund and how it is managed.

As a component of a larger portfolio, however, a passive fund may be an appropriate choice due to its low operating expenses. When combined with selected high-conviction active funds, active and passive funds can potentially be used to construct larger portfolios with relatively low correlation between different asset classes.

Irrespective of the fund type, both passive and active funds require the same level of due diligence, thanks to the vast universe of funds available. It is possible, however, to find those diamonds in the rough: active funds with a consistent investment strategy, a high-conviction philosophy, a long track record, an experienced management team, reasonable fees, and long-term returns above the benchmark.

Not all active strategies may fit this bill, nor will they be appropriate for all investors. At Jensen we believe that our high-conviction Quality Growth Fund’s portfolio of 25 to 30 quality businesses can provide long-term capital appreciation with less risk than the broader market. In particular, we believe that our focused, low-volatility strategy can potentially reduce risk and preserve more capital during market downturns.

In addition, individual business risk is reduced and future opportunities are maximized by selecting companies with durable competitive advantages that consistently produce returns in excess of the cost of capital. By focusing on the long-term investment horizon, we believe we can minimize trading costs and tax events for our fund shareholders, and that our portfolio companies can deliver superior risk-adjusted returns to the long-term investor.

**Endnotes**

1. A search for U.S. open-end mutual funds, identified as neither “index,” “enhanced index,” nor “fund of funds,” with only the oldest (primary) share class, and classified by Morningstar to fall in one of the nine U.S. open-end mutual fund style categories, yielded 2,042 funds.

2. A search for U.S. open-end mutual funds, identified as either “index” or “enhanced index,” but not “fund of funds,” with only the oldest (primary) share class, and classified by Morningstar to fall in one of the nine U.S. open-end mutual fund style categories, yielded 214 funds. ETFs were not included in this comparison search because of the low availability of data and current difficulty in consistently identifying “active” and “passive” ETFs.

3. Turnover is a measure of a fund’s trading activity, which is calculated by taking the lesser of the fund’s purchases or sales (excluding all securities with maturities of less than one year, i.e., cash) and dividing by average monthly net assets. The resulting percentage approximates the percentage of the portfolio’s holdings that have changed over the past year; however, a turnover ratio of 100 percent or more does not necessarily suggest that all securities in the portfolio have been traded. Morningstar gathers turnover ratios directly from each fund’s annual report.

4. See endnote 1.

**References**


**Disclosures**

The Fund’s investment objectives, risks, charges, and expenses must be considered carefully before investing. The prospectus contains this and other important information about the investment company, and it may be obtained by calling 1-800-992-4144, or by visiting www.jenseninvestment.com. Read it carefully before investing.

All factual information contained in this paper is derived from sources which Jensen believes are reliable, but Jensen cannot guarantee complete accuracy.

Any charts, graphics, or formulas contained in this piece are only for the purpose of illustration. The views of Jensen Investment Management expressed herein are not intended to be a forecast of future events, a guarantee of future results, nor investment advice. Diversification does not assure a profit or protect against a loss in a declining market. Past performance does not guarantee future results.

The Jensen Quality Growth Fund is non-diversified, meaning that it may concentrate its assets in fewer individual holdings than a diversified fund, and therefore is more exposed to individual stock volatility than a diversified fund.

**Investing involves risks; loss of principal is possible.** The Jensen Quality Growth Fund did not hold any shares of Apple, Inc. as of 12/31/2013.

The S&P 500 Index is a market value weighted index consisting of 500 stocks chosen for market size, liquidity, and industry group representation. The Index is unmanaged, and one cannot invest directly in the Index.

The Dow Jones Industrial Average: (DJI) The average price of 30 selected industrial stocks, often used as a measure of general market trends.

Standard Deviation: Is applied to the annual rate of return of an investment to measure the investment’s volatility.

Active Share: The greater the difference between the asset composition of the fund and its benchmark, the greater the active share.

Correlation: Statistical measure of how two securities move in relation to each other. Active investing generally has higher management fees because of the manager’s increased level of involvement while passive investing generally has lower management and operating fees. Investing in both actively and passively managed mutual funds involves risk, and principal loss is possible.
Both actively and passively managed mutual funds generally have daily liquidity. There are no guarantees regarding the performance of actively and passively managed mutual funds. Actively managed mutual funds may have higher portfolio turnover than passively managed funds. Excessive turnover can limit returns and can incur capital gains.

Exchange-Traded Funds (ETFs) are securities that track an index, a commodity or basket of assets like an index fund, but trade like a stock on an exchange. ETF’s experience price changes throughout the day as they are bought and sold. Mutual Funds are structured and maintained to match their investment objectives and generally are priced and traded only once a day at the market close. ETF’s may have lower expenses than a mutual fund, and both generally offer daily liquidity. There are no guarantees regarding the performance of Mutual Funds or ETF’s. Tax features may vary based on individual circumstances. Consult a tax professional for further guidance.

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