**THE MIND OF THE MARKET OR PROFESSIONAL MONEY MANAGERS:**

**Which Is Smarter?**

*By Amy LaFrance and John Drachman*

Active managers labor on the principle that markets are not always efficient, so acquisition and analysis of information can identify mispriced securities. Passive investing is based on the efficient markets hypothesis, which states that prices reflect all publicly available information; passive investors rely on the market to determine prices, then buy and sell securities proportional to their weight in the index.

A decade of data from Strategic Insight Simfund databases show that investments made according to common benchmarks or indexes outperformed the best efforts of highly credentialed money managers 80 percent of the time. Similarly, passively managed index mutual funds and passively managed exchange-traded products (ETPs) outsized actively managed mutual funds and actively managed ETPs more often than not.

Exchange-traded products include registered alternatives, exchange-traded notes, and the 1,400 exchange-traded funds (ETFs) that cover just about every asset class in the market. In contrast, the United States alone has more than 10,000 mutual funds. Despite the launch of separate accounts, ETPs, and other competing products, the mutual fund industry remains healthy and fund ownership continues to grow.

This article compares two principal indexed or passive strategies—retail ETPs and index-based mutual funds—and two principal active strategies—active mutual funds and newly emerging active ETPs—with regard to asset growth, flows, and performance.11 We examine the comparative growth patterns of these four asset categories against recent market history and look at which asset classes investors favored during the time periods indicated.

**Performance Matters**

As shown in table 1, during the worst sell-off in 2008, active mutual funds finished first in performance. In fact, from 2008 through 2013, active mutual funds outperformed passive ETPs every year. Passive mutual funds, however, outperformed active mutual funds in four of the six years for the same time period. Active ETPs finished last throughout except for one bright spot in 2011 when they finished in the #2 spot.

The impact of quantitative easing on stabilizing the global credit system may have helped temper the markets and stimulate greater investor participation. Accordingly, neither active nor passive investing could outstrip the market’s thunderous energy in each of the past four years, when the S&P 500 Index handily outperformed the models shown in table 1.

Investors that allocate assets between U.S. and international securities may have

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**Table 1: Passive vs. Active Investments Ranked by Year-to-Year Category Performance Categories**

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<tbody>
<tr>
<td>1</td>
<td>15.06%</td>
<td>11.06%</td>
<td>19.40%</td>
<td>15.26%</td>
<td>–28.43%</td>
<td>29.43%</td>
<td>15.06%</td>
<td>2.11%</td>
<td>16.00%</td>
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<tr>
<td>2</td>
<td>13.02%</td>
<td>7.51%</td>
<td>15.79%</td>
<td>7.50%</td>
<td>–30.84%</td>
<td>27.06%</td>
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<td>–0.02%</td>
<td>13.71%</td>
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<tr>
<td>3</td>
<td>11.21%</td>
<td>6.58%</td>
<td>14.61%</td>
<td>5.57%</td>
<td>–32.09%</td>
<td>26.46%</td>
<td>13.48%</td>
<td>–1.29%</td>
<td>12.44%</td>
<td>14.73%</td>
</tr>
<tr>
<td>4</td>
<td>10.88%</td>
<td>4.91%</td>
<td>12.40%</td>
<td>5.49%</td>
<td>–37.00%</td>
<td>24.49%</td>
<td>11.80%</td>
<td>–1.62%</td>
<td>11.23%</td>
<td>6.30%</td>
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<td>5</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>14.32%</td>
<td>8.12%</td>
<td>–7.23</td>
<td>7.08%</td>
<td>5.45%</td>
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* 2009 is the first year with data available for Active ETPs.
* Source: Strategic Insight Simfund

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greater potential benefits if they include passive exposure. Loring Ward Chief Investment Strategist Joni L. Clark, in a report that described international diversification during 2000–2010, noted that passive portfolios diversified in international asset classes generated more stable returns than active managers, particularly if portfolios were rebalanced regularly.2 Active funds accounted for four times the asset flows of passive investments by the end of 2013, but active funds’ annual rate of increase was considerably below that of passive ETPs and passive mutual funds. For the eight-year period ending in 2013, the rate of increase doubled for international equity asset flows to passive investments. For active funds during the same time period, the rate of increase was only 2 percent.3

The track record of passive mutual funds, which were introduced in 1975, is considerably shorter than that of modern mutual funds, which were established in the 1920s. Still, the tax and cost efficiencies of passive investments have shaken up the active management industry.

If we can assume, however, that only a small percentage of managers provides meaningful value at any one time, the actual impact of passive management in a world dominated by active managers is still in debate. The longer-term value-added qualities of the passive approach will be based, in part, on how well the passive side of the equation can differentiate itself across investment types to be sustainable in greater product numbers.

Dueling Philosophies
The argument for a passive approach may not stand up against the top 10 percent of active management providers, but the majority of professional managers are facing the perception that their analytical methods are considered by a growing number of institutions and investors as antiquated, expensive, and inefficient.

Proponents of passive approaches continually make the case that paying professionals just isn’t worth it. Their energetic, well-organized educational campaigns contrast starkly with the lackluster advocacy of active managers that face strong competition for assets under management. For example, consider Daniel Weiskopf’s educational blog at AccessETFsolutions, which addresses investor misconceptions about ETPs.4

The blog’s introduction states: “Most ETF investors never think about how an ETF works. The perception is that ETFs are ‘passively managed to an index’ and are on auto-pilot, but behind the scenes portfolio managers, index providers and legal experts are managing the process to make sure that an ETF works effectively and efficiently.”

Bear Markets and Passive Investments
How much of the success of passive investments is due to market conditions? One definition of a secular bear market is a period that crosses a number of business cycles characterized by sustained compression in price-to-earnings (P/E) ratios and below-average inflation-adjusted returns.5 By that definition, the U.S. economy has been ambling through a bear market since 2000.

Clearly this prolonged condition has diminished the credibility of active management claims and contributed to the attractiveness of passive investing’s lower costs and built-in tax efficiencies. Since 1950, the length of a bull market in the United States has averaged 54 months, as gauged by the S&P 500.

Investment professionals likely will continue to diversify portfolios with strategies that marry active and passive investment management, in proportions that will depend on the strength of each during bull and bear market conditions.

In the meantime, the $9 trillion-plus mutual fund industry will predominate for the near future despite the appeal of index-based investing’s own substantial $3.2 trillion industry.

Over the past eight years, however, the rising influence of passive investments has changed the face of the asset management universe considerably.

As economic growth weakened in 2005 and business investment and consumer spending slowed abruptly, passive investments made up about one-sixth of all investments, as shown in figure 1.

By 2013, a year when the federal government shut down for 16 days, the city of Detroit filed for bankruptcy, and the nation’s economy recorded anemic growth, the S&P 500 Index delivered its best year...
since 1997. Reflecting the strong influence of underlying indexes, passive investments gained sharply, as shown in figure 2. Their percentages increased in aggregate to about one-quarter of the investment universe.

The Time Line
The modern mutual fund originated in Boston in 1924 with the creation of the Massachusetts Investors Trust, which went public in 1928 and eventually became the mutual fund firm known today as MFS Investment Management.

In 1973, in response to academic research suggesting the advantages of passive investing, Wells Fargo and American National Bank each launched index mutual funds for institutional customers. Vanguard President John Bogle followed in 1975 with the first public index mutual fund, which critics derisively called “Bogle’s folly.” Now known as the Vanguard 500, it tracked the S&P 500 and reached $100 billion in 1999. Vanguard today serves as an ambassador for passive investing strategies.

The first ETF, the S&P 500 Depository Receipt (SPDR) began trading in January 1993, and it’s still one of the most actively traded ETFs.

ETPs made a meaningful appearance in 1995, when assets totaled a modest $1.05 billion (see table 2). At that same time, passive index-based mutual funds represented 50 times more asset strength at $53.90 billion. Active mutual funds, in contrast, dominated the market at $1.85 trillion.

By 2000, actively managed funds climbed to $4.06 trillion, more than doubling assets under management. Passive ETPs, however, increased assets by a factor of 65 to reach $65.70 billion, and passive mutual funds grew seven-fold to more than $352.51 billion. By this time, market pioneers were thinking of ways to combine the product advantages of the ETP with the strategic advantages of active management.

By 2005, the rate of active-fund growth had slowed considerably, adding just 25 percent over the previous five years to create total assets of $5.47 trillion. Meanwhile, ETPs grew by a factor of five to $302.19 billion and index mutual funds increased by about two-thirds to reach $567.05 billion.

ETPs reached a turning point in 2010, exceeding the $1-trillion barrier and surpassing the total assets of index-based funds, which reached $935.72 billion. During the same time period, active funds added another $1.5 trillion to total assets to reach $6.99 trillion, and a fledgling investment concept—the actively managed ETP, first introduced in 2008—climbed to $3.01 billion in 2010. An actively managed ETP still has a benchmark index, but managers may change sector allocations, market-time trades, or deviate from the index as they see fit. This produces investment returns that will not perfectly mirror the underlying index.

By the end of 2013, the market for ETPs appeared to be settling into an established groove. With total assets at $1.65 trillion, ETPs had managed to improve asset strength by two-thirds. Index mutual funds grew to $1.57 trillion. Active mutual fund assets increased by about 14 percent to close the year at $9.18 trillion.

When the Market Broke
To simplify the comparison between passive and active investing, figure 3 shows passive ETPs and passive mutual funds combined and labeled “Passive,” and active ETPs and active mutual funds combined and labeled “Active.”

In January 2008, the global stock markets suffered their largest fall since September 11, 2001, due primarily to fears that the proposed U.S. stimulus package would not be enough to prevent a large recession. By September 2008, Fannie Mae and Freddie Mac and the more than $5 trillion of mortgage-backed securities they held were taken over by the U.S. government.
In October 2008, the U.S. Congress passed a $700-billion financial sector bailout. Meanwhile, developing countries faced problems caused by food, fuel, and financial crises. The stock markets intermittently continued to decline through December 2008.

Passive investments lost approximately $300 billion in 2008, declining just more than 25 percent from the previous year. The active category, however, dropped almost 40 percent, to lose a staggering $2.5 trillion in assets for the same period. Losses occurred from the impact of the market declines on the underlying assets as well as through redemptions due to flight-to-safety efforts.

To gauge how many of the losses were due to redemptions, we also compared asset flows. Figure 4 shows the full impact of the market break and the difference in investor attitudes toward passive and active strategies. This is not to say that passive investing is better than active management during times of crisis; in a well-diversified portfolio both strategies have important roles. Still, investor discontent with professional managers spurred a run for the exits: Some $220.81 billion in active management redemptions occurred in 2008. During the same period, in contrast, the asset flows for passive strategies increased by about $9 billion.

Relative Holdings by Investment Category
Passive management is most common in the equity market, where index funds track a stock market index, but it is becoming more common in other investment types, including bonds, commodities, and hedge funds. Today, thousands of different index funds are tracking benchmarks around the world. The two firms with the largest amounts of money under management, Barclays Global Investors and State Street Corp., primarily engage in passive management strategies and utilize many of these other benchmarks.

Table 3 shows strong similarities between the passive and active components of six investment categories. All categories show relatively large holdings in domestic equity and international/global equity for their first and second choices. Corporate bonds were the third largest category, followed by tax-free investments, international/global bonds, and U.S. government securities.

Expense Ratio as a Predictor of Passive Performance
Considerable evidence shows that the odds of achieving a return that outperforms a majority of similar investors are increased if investors simply aim to seek the lowest possible cost for a given strategy.

For example, in 2002 Strategic Insight evaluated a variety of fund metrics, including past performance, Morningstar rating, alpha, and beta, in search of possible performance indicators. In the study, a fund’s expense ratio proved to be the most reliable predictor of its future performance. Low-cost funds delivered above-average performances for all of the periods examined. Vanguard undertook a similar study and evaluated a fund’s size, age, turnover, and expense ratio, and concluded that the expense ratio was the only significant factor in determining future alpha. In addition, Vanguard showed that using a fund’s Morningstar star rating as a guide to future performance was less reliable than using the fund’s expense ratio.

Practically speaking, a fund’s expense ratio is a valuable guide (although not a sure thing), because the expense ratio is one of the few measurements that impact performance that investors can access in advance of purchasing shares.

The rise of the ETP has caused active managers to review pricing policies, and many
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formed passive mutual funds. Even so, very rarely has a single top-performing active manager consistently outperformed the market. The challenge for investors is to identify the better-performing managers and stay with them through up and down markets.

Probably the most important role an indexed product can bring to a portfolio is its level of predictability. Of all the variables in the marketplace, at least two are dependable ETP attributes. First, you know the expense ratio, so you have a transparent understanding of the investment's cost and its impact on performance. Second, when an investment vehicle is based on an index, a specific portfolio allocation or mandate becomes more predictable. Accordingly, you have more control over the portfolio construction process. If you are looking to substitute a specific mandate that isn't delivering, or complement a portfolio with another portfolio choice to optimize risk-adjusted return, ETPs can build in a level of assurance that your selection will stay style pure.

In either case, indexed investing provides a valuable measure of predictability and transparency in the unpredictable world of the global macro-economy.

Amy LaFrance is director of mutual fund research at Strategic Insight. She earned a

Table 4: Passive vs. Active Strategies—Variable Annuities Total Assets; 1990–2013 ($ Billions)

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<tr>
<td>Passive</td>
<td>$0.65</td>
<td>$8.31</td>
<td>$60.76</td>
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<td>$0.00</td>
<td>$0.04</td>
<td>$0.11</td>
<td>$0.17</td>
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<td>Int’l/Global Bond</td>
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<td>$0.00</td>
<td>$0.00</td>
<td>$0.00</td>
<td>$0.00</td>
<td>$0.00</td>
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<tr>
<td>Int’l/Global Equity</td>
<td>$0.02</td>
<td>$0.36</td>
<td>$1.14</td>
<td>$4.58</td>
<td>$12.39</td>
<td>$11.66</td>
<td>$11.71</td>
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<tr>
<td>Active</td>
<td>$64.08</td>
<td>$274.67</td>
<td>$798.09</td>
<td>$997.73</td>
<td>$1,244.12</td>
<td>$1,218.38</td>
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<td>Corporate Bond</td>
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<td>$240.36</td>
<td>$256.24</td>
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<td>Domestic Equity</td>
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<td>Government Bond</td>
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<td>Int’l/Global Bond</td>
<td>$0.10</td>
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<td>Int’l/Global Equity</td>
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<td>$1,359.64</td>
<td>$1,332.83</td>
<td>$1,493.32</td>
<td>$1,712.94</td>
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Source: Strategic Insight Simfund

have reduced overall expense ratios to become more competitive.

As more newcomers have joined the passive market, passive providers themselves have succumbed to pricing pressure. Vanguard, Fidelity, SSGA, and BlackRock all have lowered the expense ratios of existing passive strategies and transferred that savings to shareholders in the form of enhanced performance. Nonetheless, these are firms with considerable scale. Not all passive providers can accommodate such pricing pressure, especially if they wish to enter emerging, frontier, or niche markets.

The Rise of ETF-Funded Variable Annuities
The point at which a traditionally expensive product meets an ultra-low-cost investment vehicle gets attention. That’s exactly what has happened since insurance carriers began including ETFs in insurance contracts for variable annuities (VA). ETFs represent about 10 percent of the VA market and are concentrated in corporate bonds and international/global equity.

But that is about to change if the insurance carriers have their way. For several years, a handful of insurers have offered ETFs as part of packaged asset-allocation portfolios. Traditionally, the marketing of VAs was driven by the additional riders that offered a wide variety of additional benefits such as the popular living benefit provision.

Following the 2008 crash, the industry is trying to limit liability by adding investment restrictions, and VA carriers have been promoting more bond ETFs to customers in an attempt to lower the customer’s risk exposure.

Whether policyholders will add willingly to fixed-income positions over the long term remains to be seen. For now, though, as shown in table 4, total assets in corporate bond portfolios have been increasing steadily.

Conclusion
Since the early 1970s, indexing has grown rapidly because the strategy can provide a low-cost option to gain investment exposure to a wide variety of market benchmarks. Of course, as we saw in table 1, no vehicle modeled after an index will be a precise mirror image of that index.

All passive, indexed investments have an important role to play, but they cannot be expected to outperform 100 percent of actively managed funds over a particular time period. In each of the past four calendar years, active mutual funds still outperformed ETPs—although they underperformed passive mutual funds. Even so, very rarely has a single top-performing active manager consistently outperformed the market. The challenge for investors is to identify the better-performing managers and stay with them through up and down markets.

Probably the most important role an indexed product can bring to a portfolio is its level of predictability. Of all the variables in the marketplace, at least two are dependable ETP attributes. First, you know the expense ratio, so you have a transparent understanding of the investment’s cost and its impact on performance. Second, when an investment vehicle is based on an index, a specific portfolio allocation or mandate becomes more predictable. Accordingly, you have more control over the portfolio construction process. If you are looking to substitute a specific mandate that isn’t delivering, or complement a portfolio with another portfolio choice to optimize risk-adjusted return, ETPs can build in a level of assurance that your selection will stay style pure. In either case, indexed investing provides a valuable measure of predictability and transparency in the unpredictable world of the global macro-economy.

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This is the most common hypothesis test, because they do not want to lose business

Competing investment managers care

Hedge funds have enjoyed a certain mys-

Endnotes

1 An active ETP is an exchange-traded portfolio that has a manager or team deciding the underlying portfolio allocation or otherwise not following a passive investment strategy.


