Partner Talk®

June 2017

Active *and* Passive, Not Active vs. Passive

Richard J. T. (Jonesy) Lerch

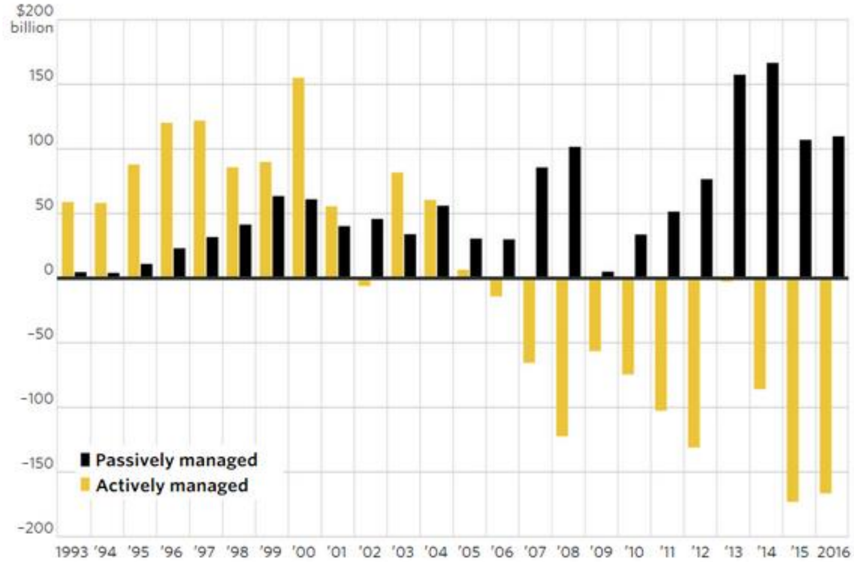
rlerch@prudentmanagement.com

We have received a lot of questions recently about active vs. passive investment management. This may not come as a surprise as the financial media has run many stories on this topic over the past few years. Variations of the headline *Active Management is Dead* have been published by multiple media outlets leading to this notion becoming an accepted conviction by many.

It makes sense given that, since the financial crisis, widely followed equity indices such as the S&P 500 have been performing extremely well. In fact, from 12/31/2008 to 12/31/2016 the S&P 500 is up 151% with not one negative calendar-year return during that entire period. In this type of market environment, with the tendency of stocks to rise in unison with unusually low volatility, it is very difficult for active managers, who try to outperform the market by being different from it, to outperform. They do not get rewarded for doing the kind of research that enables them to pick winners and avoid losers like they would in markets that are more discriminating as to the quality of individual companies.

Not surprisingly, over this same time period, investors have chosen to invest their money in passively managed, or index funds, rather than actively managed funds. According to Morningstar, over the last two years, investors have pulled nearly $600 billion from actively-managed US funds and put almost $1 trillion into passive vehicles.

Net flows of U.S. stock mutual and exchange-traded funds



Source: Morningstar

But, does this mean that the end of active management is near? Or, does it mean that active management has no place in investors' portfolios? We would argue that the answer to both of these questions is "no". We believe that prudent investors benefit from owning both approaches, as each has positives and negatives that, when combined, complement each other -- much like stocks and bonds when combined in the same portfolio can lead to better long-term performance.

Passive, or index, funds play an important role in PMA's clients' portfolios. Approximately 30% of a typical client's total portfolio will be made up of index funds in each of our equity investment categories: international equities, aggressive equities, and conservative equities. Index funds allow us, with nominal expense, to own broad and highly diversified sectors of the market. They also allow us, with nominal expense, to gain access to certain sectors of the market in which we are not able to find compelling actively managed funds. Owning index funds also allows our clients to participate in the outperformance that passively managed funds achieve relative to actively managed funds in market periods like we are currently experiencing. However, one thing investors need to keep in mind is that index funds are not without cost. And, because passive index funds charge a fee, they cannot outperform the market.

Actively managed funds are an important component of PMA's investors' success as well, but only those that, like low-cost index funds, are offered at a lower expense. Cost is one of several key components to achieving that success. Low cost contributes to higher returns and helps identify managers who are likely to out-perform. A recent study by Morningstar, a leading provider of independent investment research, found that the 20% lowest expense funds outperformed the 20% highest expense funds in every asset class and in every time period included in the study.

At PMA, we have focused on cost as one of the primary components of our manager search process since the firm was founded in 1982. PMA's search process is substantially weighted in favor of funds with lower asset weighted expense ratios in each asset class.

Even if you have identified an active manager with low management fees, however, the odds of outperforming the market are still long. And, ultimately, the reason to own actively managed funds really boils down to one thing - performance. Is the manager able to beat the market or a relevant index over the long-term?

In addition to considering the management fees charged by mutual fund managers, an investor needs a process to identify talented portfolio managers with understandable investment strategies, long time horizons and a strong process for controlling risk. PMA has a quantitative and qualitative evaluation process intended to find the best performing, most consistent and most efficient managers in each sector of the market.

One of the key attributes to this process is having the patience to stick with active managers even during periods of underperformance. Even the most successful managers will have periods in which they underperform. According to an analysis done by Vanguard, of the 2,202 active equity funds in existence at the start of 2001, 476 outperformed. But, 98% of those 476 outperforming funds underperformed in at least 4 out of the 15 years ended December 31, 2015. Therefore, investors must be willing to endure periods during which the actively managed funds they own will underperform. The recent past is one of those periods.

As long as we recognize that the markets will not continue to go up with relatively low volatility forever, we can understand that the benefit of owning actively managed funds will return. PMA believes that no investor can predict the future and, as a result, that market timing doesn't work. We also believe that manager-timing doesn't work either. When the current trend of stocks moving upward in unison ends, active managers looking to capitalize on pricing discrepancies should benefit. Therefore, we will continue to invest with both active *and* passive managers, who consistently meet our standards, to achieve better long-term risk-adjusted returns for our clients.