THE RETIREMENT GROUP LLC
PARTNERS IN RETIREMENT

ACTIVE VS. PASSIVE

INVESTING

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What is Passive Investing?

Index or benchmark investing are forms of passive investing where an investor tries to mimic the returns of the market as closely as possible. Passive investors are often believers of the efficient market hypothesis, where making a better return than the market is theorized to be impossible, and instead favors the market's long run average return. In order to match the market, indexers buy into ETFs and mutual funds that are designed to directly track the major stock indices. Many of these index tracking funds contain many of the largest companies in proportion to the market capitalization in the market. This means that indexers hold a lot of the largest stocks, driving up the price and multiples, while leaving out many quality companies from their portfolio. This creates a momentum effect in which they hold increasingly large positions in companies that everyone else is holding, leaving no room to earn excess returns.

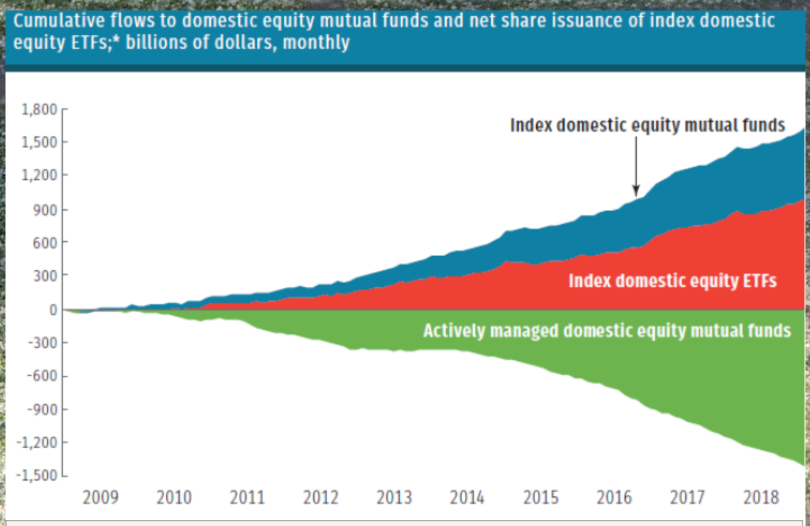
The move into passive funds could create an environment where the markets become incompetent at distinguishing idiosyncratic value. "The paradox is that you need active management to make the markets efficient," said Princeton professor Burton Malkiel.

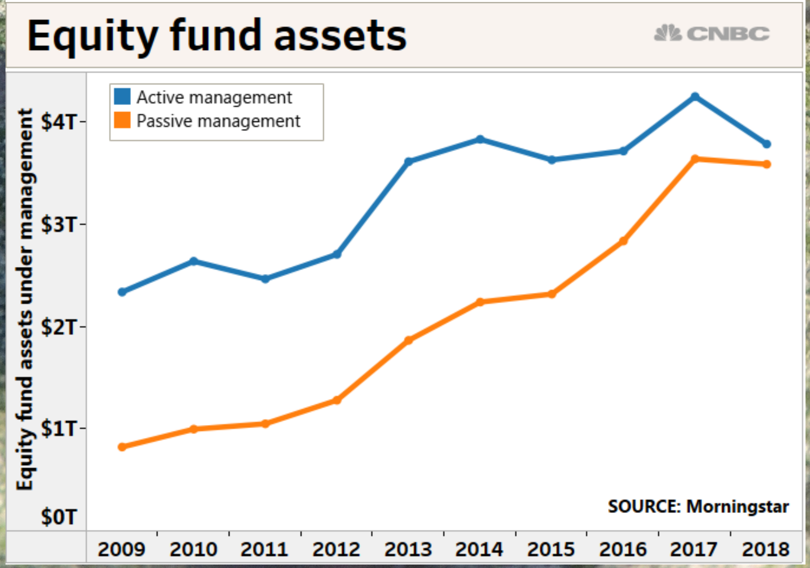
There are managers who actively employ different strategies to consistently outperform the market, hold less risk than the market, or both. Active managers believe that through research or superior technique, they can beat the efficient market hypothesis. While there have been many periods where active managers as a group has achieved consistent excess returns, there have also been many periods where they have not. This has lead to a debate over which is the superior method, finding quality active managers who can beat the market or indexing to the market and hoping there is no market downturn.

What is the Current Trend?

In a market commentary by FPA Capital, there has been a growing number of flows from active managers to passive investment vehicles such as ETFs and index mutual funds with no strategy to beat the market.

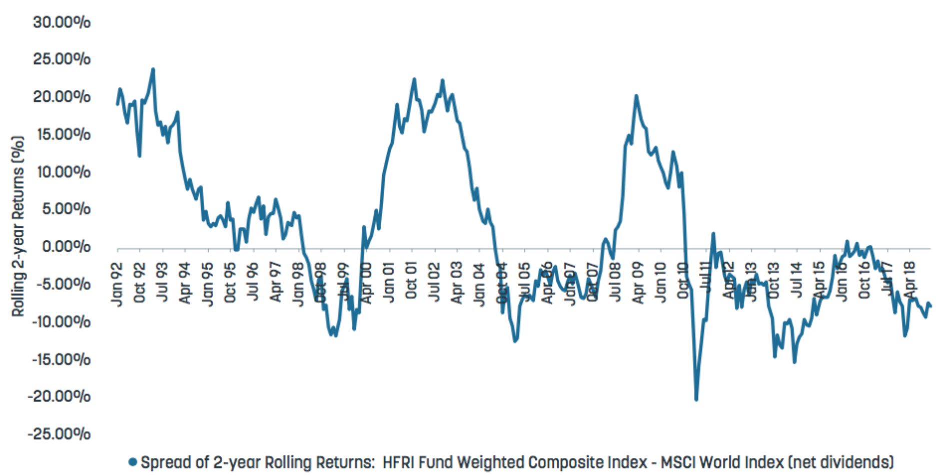
Concurrently, the number of listed companies is shrinking while the cumulative market cap and ETF listings is growing. Also, while the market cap of these companies grew recently, the net income of these companies declined even more. The higher the stock prices of these companies rise, without the fundamentals to back it up, the harder they stand to fall. This will leave opportunity for active managers who do their research and know which companies will be able to weather the storm.





The chart below compares the performance of actively managed funds in the US to a passive investment in the broad world index over the last 26 years. This illustration shows how the rolling 2-year returns of the HFRI Fund Weighted Composite Index surpassed the performance of the MSCI World Index in the early ’90s, in the early ’00s, and again in 2009 by an average of 20%, with relative underperformance more recently.

Comparative Performance: Active vs. Passive Strategies

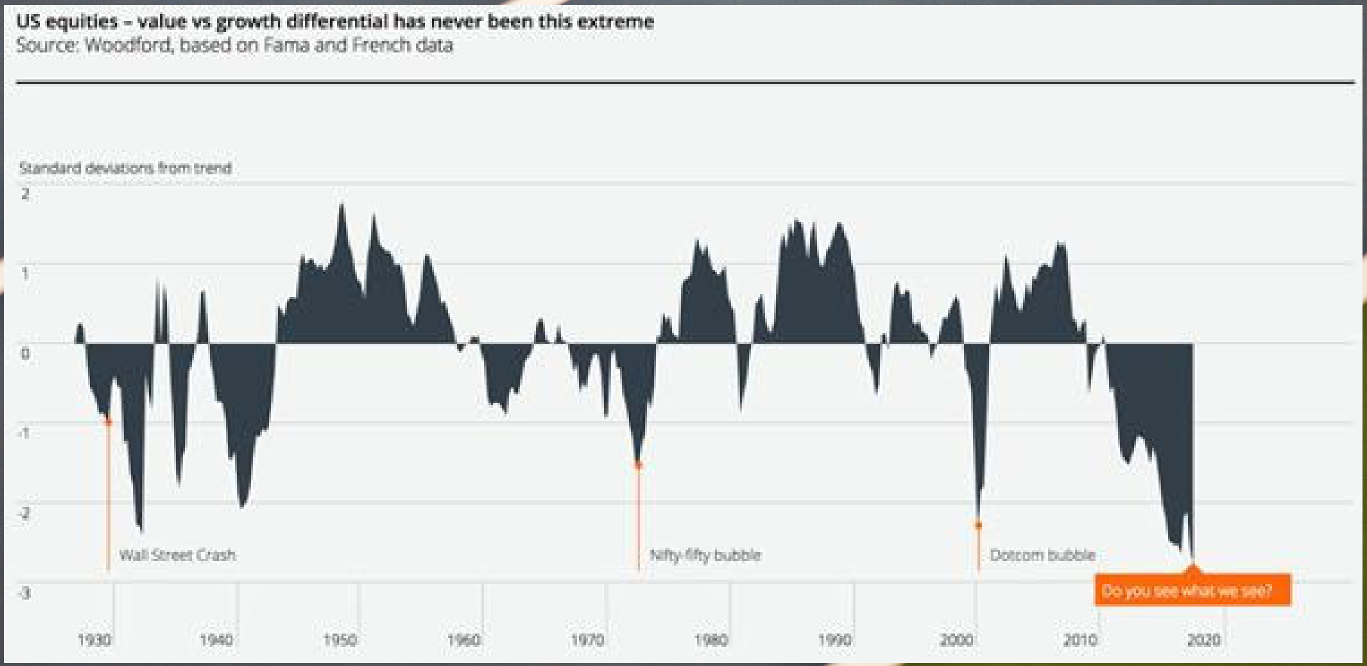


Source: Hedge Fund Research Inc, MSCI Inc, and iCapital calculations

Look at the ups and downs of this chart it is easy to spot two things. First, it is easy to see how cyclical the outperformance is between active and passive styles. There tends to be a few years of one outperforming the other until the opposite comes true. Second, active managers tend to have higher returns than broad indexes in recessionary periods.This benefits investors because the risk threshold is lower than passive funds.

Value vs. Growth

Even though historical data is not always indicative of the future, based on this chart it could be easily asserted that there may be a period of outperformance by active managers in the near future. If it is believed that active management will reach period of outperformance, which style of active management will be best. Active strategies can generally be classified into two broad groups: growth and value. Managers with a “value” approach look for stocks with low price-to-earnings/book value/revenue multiples, while managers with a “growth” style look for stocks with high price-to-earnings/book value/revenue multiples. Typically, value stocks tend to be those that have fallen out of favor with the market, but still have strong fundamentals, while growth stocks are the most exciting, popular companies.The chart below compares the relative performance differential between growth stocks and value stocks.



Value vs. Growth

This chart is similar to the fist in that it is easily apparent the cyclical nature that exists here. Periods of value outperformance has been met with subsequent outperformance by growth and vice versa. Secondly, growth stocks have performed significantly better than value stocks from 2009 to present. Although there isn't enough data yet, we could be reaching a peak where value starts to make a comeback. It's too early to tell if this will reverse and give value stocks the chance to outperform growth in the next few years.

The Bull Market

One of the factors that could be contributing to the underperformance of value for so long has been the on going bull market leading to inflated valuations. Companies such as Tesla and Snapchat have experienced massive valuations even without posting positive earnings. Since posting positive earnings for the first time in 2018, Tesla's stock price has fluctuated dramatically but overall not much change. In terms of market cap, they have exceeded Ford and GM.. For example, Tesla Motors sold 245,162 cars in 2018 and commands a market cap of $56.09 million, while Ford sold 5.982 million cars, just in the U.S., but has a market cap of only $34.91 billion.

Tesla has been selling for approximately 5.5x its revenues on average for the past 5 years, which means that Tesla would need to pay its investors every penny it earned,paying no taxes, no salaries, no general expenses, in a dividend each year. It would need to do this for 5.5 straight years to justify its stock price right now.

The market as a whole has been overvalued having a P/E of 25 compared with a historic average P/E of 16. Looking at the table below, market tends to perform better over the next ten years when the market P/E is below the average of 16, and tends to have poor performance when P/Es are inflated above average.

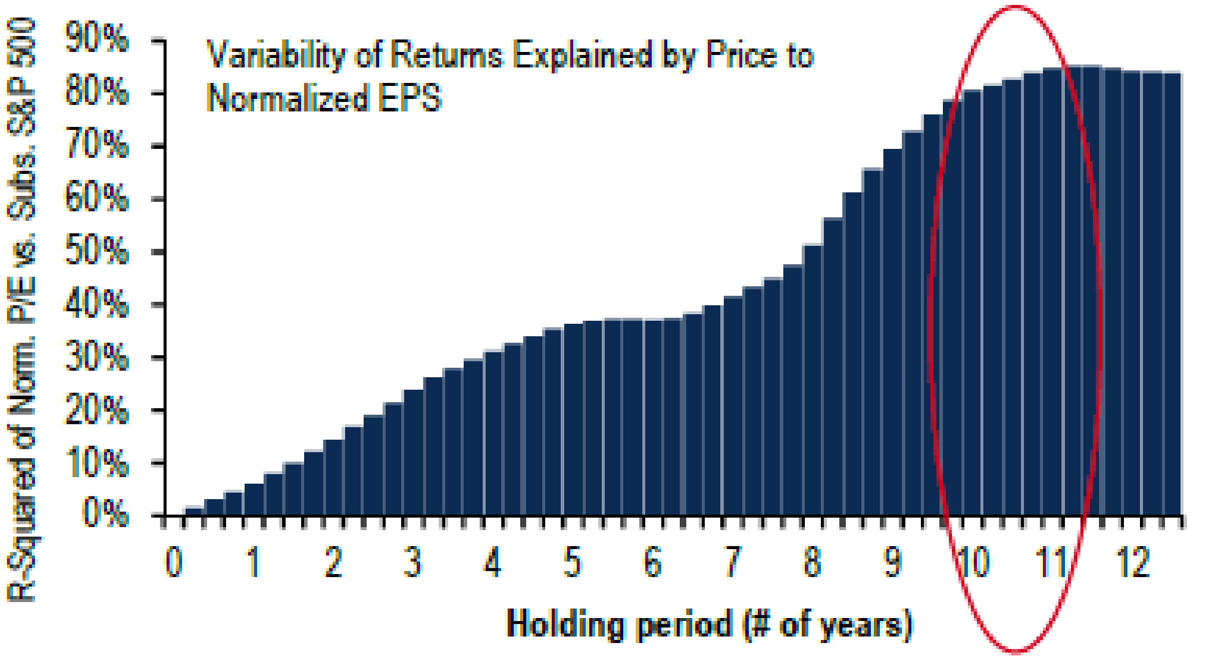
	PE Range	10Y Returns	Max (10Y Returns)	Min (10Y Returns)	Datapoints	Time Spent by Nifty in PE Band	Standard Deviation
10-Year Analysis	Below 12	17.8%	20.5%	12.6%	53	2.1%	2.5%
	Between 12 & 15	16.3%	20.3%	9.1%	688	27.4%	2.5%
	Between 15 & 18	14.5%	19.1%	8.7%	614	24.5%	2.8%
	Between 18 & 21	11.7%	18.0%	7.5%	695	27.7%	3.3%
	Between 21 & 24	11.1%	15.9%	6.6%	311	12.4%	3.1%
	Between 24 & 27	9.6%	13.8%	5.3%	113	4.5%	3.3%
	Above 27	8.1%	11.6%	5.2%	35	1.4%	2.8%

Based on this data it would be reasonable to assume that these high P/E stocks that have been climbing based on their story will soon experience a market correction, while those companies that are cheap relative to earnings will come back into favor and valuations will normalize. Fundamental investing is far from the grave. Given how little attention is being paid to fundamentals, we believe there are an abundance of opportunities. Furthermore, there is evidence that the longer the holding period, the more effective it is. Valuations explain almost 90% of the S&P 500's return variability over a ten year time horizon.

Note: 80+ years of data gathered

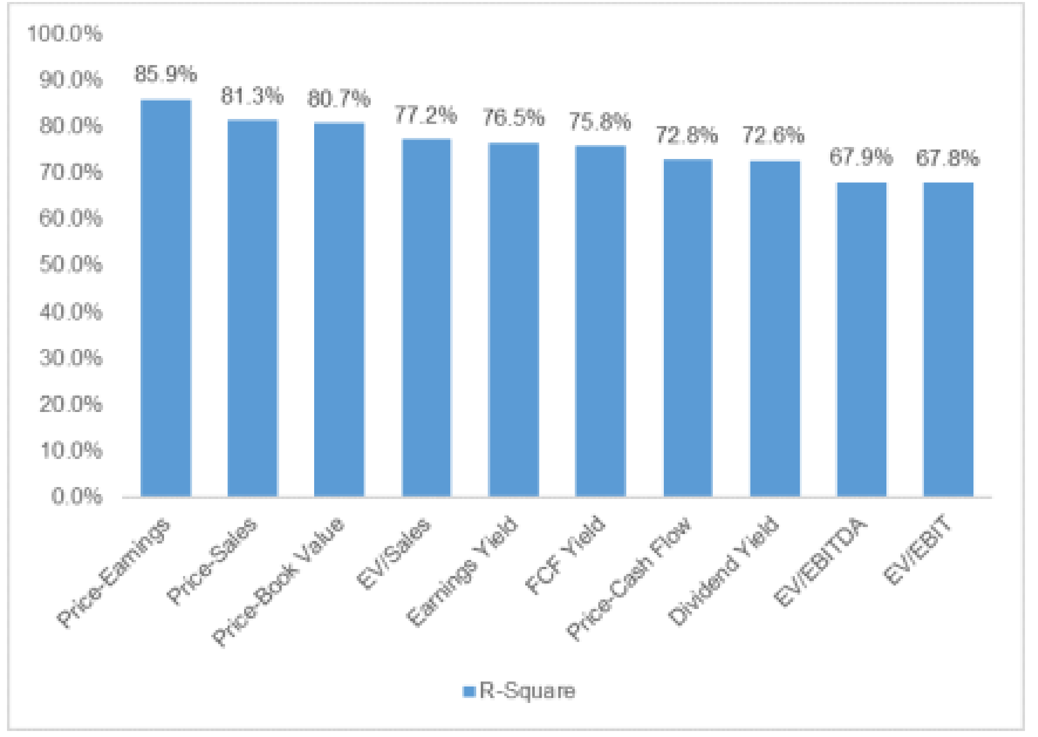
Chart 13: Valuation is all that matters in the long-term

Normalized P/E's predictive power on S&P 500 returns



Source S&P, BofA Merrill Lynch US Equity & US Quant Strategy

Normalized Investing



Although we are in a period where passive and growth investing are outperforming active and value investing, based on our expectations we believe this will turn around and revert to the mean over the years ahead. The shift in assets toward these growth stocks is creating a great opportunity for long-term, fundamental investing. It also stands to reason that expensive growth stocks today comprise most of the passive index. In simple terms, this means that the cheaper value stocks being ignored by investors are likely much safer investments than the most popular stocks loved by investors. While it would appear to be common sense to most people to buy at a discount instead of a premium, it is at odds with the current trends which is making discounts deeper and will create even larger opportunities for active value managers to pick winners. Active managers will be needed to find these stocks as labeling a stock a “value stock” isn’t as simple as looking at its P/E or P/B (even though these can be valuable indicators). A quality active manager will go beyond that and really evaluate a company’s fundamentals to make a decision. In other words, they will focus more on the economic reality than accounting entries.

Note: The chart above displays the predicive power of different valuation metrics. It shows the percentage of variation in a metric that explains variation in stock prices

The Value of Active Managers

Indexers put too much stock in strength-in-numbers strategy, but what happens when people realize these large valued growth companies are not able to meet expectations? This is why investing in good companies with strong fundamentals, or trusting in active managers who are able to pick the good companies from the bad, has been a successful strategy for investing over the long run. If you average all the active managers, they will do about average while charging a higher fee than the index. It is up to the allocator to find those few active managers that have a disciplined process that makes sense. Finding active managers with a great process will always be a challenge as they are in the minority, but the opportunities for active managers are growing as the number of people trying to beat the market is shrinking.

	Active Investing	Passive Investing
Pros	• Performance can outpace the index • Manager can protect portfolio from downside risk • Trading activity can be based on research and not solely by index changes • Manager can take advantage of market inefficiencies	• Performance is typically in-line with the index • Management fees associated with a passive strategy are generally lower • Performance may outpace some active strategies • Strategy may be more tax efficient
Cons	• Strategy may underperform the index • Expense of implementing an active strategy is generally higher • Strategy may provide fewer tax advantages should trading frequency be higher • Strategy generally generates higher tracking error	• Performance often lags that of the index by fees • Strategy lacks potential of downside protection in negative market environments • Trading activity is initiated by changes to the index and not based on research • Costs associated with replicating indices can be high

Conclusion

It is reasonable to believe things might continue on the current path for a while. It is also reasonable to believe a renewed preference for value and fundamental investing is already underway. The ability to accurately time when the psychology shifts from growth to value is unknowable. Regardless of when this happens, the balance of history is on the side of high quality companies purchased at cheap prices – in other words, value.

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http://www.incomeresearch.com/active-vs-passive-management/

For more Financial information, check out these resources...

Tips for Preventing Fraud

Value Investing Strategy

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