The advantages of actively managed funds

WHY THE PLAYING FIELD IS TIPPING IN FAVOUR OF ACTIVE MANAGEMENT

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Why should an investor consider an actively managed investment product rather than a likely lower cost passively managed alternative? It’s an important question investors should ask, but equally important is finding out “what’s in it for me?” Continued...
As we explore answers to both questions, it’s necessary to understand that collective opinions on this subject vary. However, the vast majority of opinions focus narrowly on the typical cost advantages of passively managed products in relation to the record of active managers’ performance versus their benchmarks. These simplistic comparisons of cost and performance fail to acknowledge that for many (and perhaps most) investors, absolute performance is only one of many possible objectives in their investing strategy.

High on the list of alternative objectives is risk management, and there is much to be said regarding the possible advantages active products have over passive ones in this respect. Actively-managed products may also provide advantages in terms of tax planning or even non-financial objectives, such as promoting workplace equality or environmental sustainability.

Even in regard to the fundamental question of relative returns, the answer is not quite as settled as many pundits would have you believe. Furthermore, as the investing community and regulators never cease to remind us, past performance does not guarantee future returns. There are many reasons to believe that changing conditions in financial markets, and even changes in the structure of markets, are leading to an environment more favourable to active outperformance.

Terminology: ETF ≠ passive

First, let’s clarify some terminology. The choice between active and passive is not synonymous with mutual funds versus exchange-traded funds (ETFs). Mutual funds and ETFs are two different types of packages within which a portfolio of investments may be assembled and managed, just as compact discs, cassette tapes, and digital music libraries are different packages within which you can hold a collection of songs. Each type of packaging has its own advantages and disadvantages stemming from its legal and structural characteristics (e.g., ease of buying and selling, reporting requirements, liquidity, etc.).

Both active and passive strategies may be found packaged as ETFs, and both active and passive strategies may be packaged as mutual funds.

Active management and passive management are differing styles of executing an investment strategy within those packages. While ETFs initially found their foothold in the marketplace by offering passive strategies, increasingly that’s not the case. Both active and passive strategies may be found packaged as ETFs, and both active and passive strategies may be packaged as mutual funds. This means the “what’s in it for me?” question depends on personal investment objectives, tax considerations, cash flow needs, time horizons, risk tolerance, etc. Setting aside the question of which “package” is best suited to your needs, this paper looks at the advantages of an actively-managed investment portfolio versus a passive one, whatever the form it takes.

Performance may not be your only objective

Investment performance and cost are important considerations for all investors, but they aren’t the only ones when choosing between investment alternatives. Many investors cite other objectives at play.

Better risk management

Managing risk – either protecting against capital losses, or smoothing out the ups and downs of portfolio performance – is for many investors the primary
investment objective. Actively managed portfolios can offer greater flexibility to protect wealth throughout a market cycle, particularly during market downturns. The more passive the strategy, the more an investor is unnecessarily exposed to performance-crushing returns during a decline. Active managers are able to minimize losses by avoiding securities of troubled companies, and by avoiding dangerous overconcentration in particular sectors or regions.

Furthermore, many active strategies have greater flexibility to utilize other risk management tools, such as hedging currencies, buying put options, or retaining cash to lessen volatility and provide a buffer against redemptions. This ability to maintain a cash reserve during difficult market conditions is important for a couple of reasons. One, the manager is not forced to liquidate positions at inopportune times to meet investors’ demands; and two, the manager is able to exploit opportunities that arise when sell-offs create mispricing in securities. The more investors use passive strategies, the more inefficiencies in markets, and thus opportunities for active managers, are likely to arise.

**Flexibility to manage after-tax returns**

Just as active management allows for an expanded tool kit for managing risk, so too does it allow greater flexibility in managing after-tax returns. For example, unlike a passive, index-based portfolio, an active manager can implement loss harvesting to maximize after-tax returns.

**Allowing pursuit of expressive” objectives**

Using your investing strategy to express your values or belief systems is becoming increasingly important to many investors, especially millennials. Whether it is rewarding particular companies for their environmental practices and workplace diversity programs, or avoiding companies with ethically questionable products or practices, satisfying the expressive objectives of investors is the entire basis of ESG (environmental, social, governance) responsible investing.

Passively managed investment products can be structured to pursue an ESG strategy, but rely on algorithmic formulas or ESG scores to define their investable universe. An active approach to ESG investing provides flexibility to make discretionary judgements in a rapidly changing landscape.

**Behavioural advantages**

Investor behaviour can be more important to overall investment outcomes than the actual performance of investment portfolios, and active management may provide advantages in guiding that behaviour. It is fairly well accepted that the track records of most individual investors in market timing are horrible. In aggregate, investors tend to buy high and sell low. Many investors, after selling low and feeling “burned”, resist re-engaging with the market until long after a recovery has taken hold and much of the potential return opportunity is past. If active management can help “smooth the ride”, or avoid unintentional over-concentrations in specific stocks, industries or geographies, and thus take some of the downside risk out of a portfolio, it can help keep investors from panicking and exiting the market at the worst possible time.

A study by Boston-based DALBAR Inc. found that even during periods when passive investment funds outperformed active ones, the average investor in the active funds outperformed their passive counterparts (*Active versus passive investor returns*, DALBAR Inc., March 2017). Why? DALBAR concluded that investors in actively managed products knew professionals were watching over their products for them, and were therefore less inclined to make rash decisions.

Passive investors, on the other hand, were more likely to panic because no one was watching out for them.
“Investment results are more dependent on investor behaviour than on fund performance,” the DALBAR report says.

The performance record

Let’s turn our attention now to the more ubiquitous debate about relative performance of passive versus active products. The widely repeated premise is simply that active managers on average underperform their passive counterparts, thus making passive products a better value due to their typical lower cost. There are a number of problems with this premise.

Market return ≠ average investor return

A common (but flawed) argument holds that since all investors taken together make up the market by definition, then the market return must be the average investors’ return. Hence, if active investors incur higher costs, their average net return must be lower than the market return. In other words, they’re structurally incapable of outperforming passive managers, on average.

While passive investing may offer a degree of protection against the risk of underperforming a benchmark, it also guarantees the surrender of any possibility of outperforming.

The logical fallacy of this argument is easy to demonstrate. Take for example a market comprised of just two investors with vastly different sums invested, and biased towards different types of investments. In almost no scenario will the arithmetic average of the two investors’ returns be numerically equal to the ‘market’ return.

In fact, in the U.S., traditional mutual funds account for less than 24% of ownership of corporate equities, and exchange-traded funds less than 6%. Individual households own almost 40% of U.S. equities directly, foreign investors 15%, and state and local government employee retirement funds 6%. After that come private pension funds, brokers and dealers, insurance companies, and various other types of financial institutions. Among

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**Percentage large cap active managers outperforming benchmark**

*AS AT OCT 31, 2017. BENCHMARK BASED ON RUSSELL 1000 FOR ALL FUNDS PRIOR TO 2015; R1000 FOR CORE FUNDS, R1000 VALUE FOR VALUE FUNDS, R1000 GROWTH FOR GROWTH FUNDS 2015 AND ONWARD.
and between each of these groups are entities with many different variables.

Therefore, to suggest that the average return experience of any one subgroup (e.g., mutual funds) must be equal to that of the market, is clearly wrong. There exists broad scope for active managers to outperform, or underperform, market averages and benchmarks, depending on the circumstances. While passive investing may offer a degree of protection against the risk of underperforming a benchmark, it also guarantees the surrender of any possibility of outperforming.

But as a matter of history, don’t most active managers underperform?

Many advocates of passive investing point to the seeming inability of most actively managed funds to match or beat their index benchmarks. For example, an analysis by Bank of America Merrill Lynch found that in only two of the last dozen years did more than half of U.S.-based active large-cap stock fund managers beat their benchmarks (Figure 1).

In fact, beginning with the financial crisis in 2008, U.S. active large cap managers failed, on average, to beat their benchmarks for nine years in a row, after fees. Yet in eight of the 13 years in Figure 1, more than half of funds beat their benchmarks before fees. While this may look to bolster the case for passively managed funds, it also suggests that the trend to lower fees could help the fortunes of active managers. According to the Investment Company Institute, average expense ratios for equity funds have already fallen by more than 20% since the financial crisis (Sean Collins and James Duvall, Trends in the Expenses and Fees of Funds, 2016, ICI Research Perspective 23, No. 3, May 2017).

Further complicating the issue is that until recently, most actively managed products (typically mutual funds) had the investor’s cost of acquisition embedded in quoted returns, since costs of compensating brokers and dealers were part of the management expense charged to the fund. In contrast, most passively managed products (typically ETFs) are bought and sold in a similar manner to individual stocks, with

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**FIGURE 2**

Rolling 5yr returns – Difference Between Avg. Peer Group Return and S&P/TSX

*Source: Morningstar, Investors Group. (As at Nov 30, 2017)*
per-unit commissions paid by investors on top of the cost of the fund shares themselves (although many mutual funds are now acquired in fee-based accounts that separate distribution costs from other charges). Comparisons of active and passive strategies still often fail to fully and adequately account for costs of acquisition and disposition (i.e., commissions paid to sell a passive ETF at end of holding period) to reflect true net returns to investors.

Moreover, this striking extended period of passive outperformance may be just part of a more cyclical phenomenon over the longer term. Figure 2 presents the difference between Morningstar’s Canadian equity group average return and the return of the benchmark S&P/TSX Composite index on a rolling five-year basis. Viewed over this longer time frame, the relative performance of active managers as a group appears to wax and wane over multi-year periods.

According to the Morningstar data, the average performance of the actively managed Canadian equity group (Canadian Investment Funds Standards Committee (CIFSC) category) has exceeded that of the benchmark S&P/TSX index 59% of the time since 1980. Top quartile funds in the same category outperformed the index 80% of the time.

The role of “active share”
A final observation regarding the historical record is that most studies of active versus passive funds looked only at average equity funds, without making distinctions between those that were truly active and those that were not. Many so-called actively managed investment funds deviate very little from their benchmarks, taking only minor over-weights or under-weights in individual names or sector exposures.

A more discriminating study in 2009 by Martijn Cremers and Antti Petajisto found that investment funds that were truly active, taking positions that significantly deviated from their benchmarks, were able to outperform those benchmark indices both before and after expenses. (K.J. Martijn Cremers & Antti Petajisto, “How active is your fund manager? A new measure that predicts performance”, March 31, 2009, Review of Financial Studies 22, 3329-3365.)

Is the tide turning in favour of active management relative performance?

Whatever your views on the past relative performance debate, there are many reasons to believe market conditions are growing more favourable to active management.

01 | Higher interest rates and the end of extraordinary central bank easy money policies will widen the differences between winners and losers.

It is generally agreed that central banks around the world are now finally and clearly on a path to interest rate “normalization” (see Get ready for normal, I.G. Investment Strategy Group, September 2017.) Simply put, the extraordinarily low interest rate policies, quantitative easing (QE) programs, and other actions taken by major global central banks since the 2008 financial crisis, injected massive amounts of liquidity to asset markets that essentially lifted all boats. Easy monetary policies kept weak companies in business by offering cheap and indiscriminate access to debt financing. With the tightening of monetary policy, the unwinding of QE, and (hopefully) the long-awaited re-appearance of inflation, the cost of debt will rise and become variable again, putting a strain on the profitability of indebted companies and creating greater distinctions between corporations producing good and poor financial results.
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Dispersions of returns and the resulting lower stock correlations will increase the likelihood stock pickers, or active managers, can find opportunities to improve returns by exercising discretionary selection (correlation refers to the tendency of stock price movements to be related, to rise and fall in tandem). Correlations between stocks in the S&P 500 have already declined significantly since interest rates inflected higher in 2016. In fact, correlations are now lower that they have been since 2001 and are near record lows (Figure 3). And as seen in Figure 1, active managers in 2017 are once again outperforming their benchmarks.

02 | Rapid technological change and an environment of low nominal growth both contribute to the creation of winner-take-all markets.

The unprecedented pace of technological change feeds the establishment of market dominance through market share growth, economies of scale, and cost advantages. Many economists and investors believe we have entered a second “machine age”, where many traditional industries will experience rapid disruption and enormous wealth will accrue to the successful disruptors (see The Second Machine Age: Work, Progress, and Prosperity in a Time of Brilliant Technologies, by Erik Brynjolfsson & Andrew McAfee, W.W. Norton & Co., 2014). There is no question earnings of public corporations have become more concentrated. In 1975 the percentage of total income of all publically traded U.S. companies that came from the top 100 companies was 49%. By 1995 that had grown slightly to 53%. But by 2015 the top 100 firms garnered 84% of

According to a USA Today analysis of S&P 500 data for 2015, over half the index’s total earnings was generated by just 28 companies (Matt Krantz, *Six percent of companies make 50% of U.S. profit*, USA Today, March 3, 2016). As income generation becomes more concentrated, naturally so too does stock performance. The most obvious example of this phenomenon is the remarkable growth and recent stock market performance of the so-called FANG stocks (Facebook, Amazon, Netflix, Google (Alphabet) - many would also add Apple and Microsoft to this list). As at the end of October, the S&P 500 technology sector was up more than 37% year-to-date, driven by these mega cap names. The natural advantages of these winners become even more pronounced in times of weak economic growth. The more market performance is concentrated in handfuls of companies, the more fertile the ground for picking winners. Just as importantly, investment outperformance also becomes a function of avoiding the losers.

**03 | The growth of indexed (passive) assets may sow the seeds of its underperformance.**

The announcement of a company being admitted to an index creates a spike in demand for the stock from passive investors who now need to acquire positions. But interestingly, a study by Amherst College and the Board of Governors of the Federal Reserve System found that the bulk of the gain, typically around 7%, occurs between the time the admission was announced and the effective date of entry into the index, as speculators bid up prices in anticipation of passive investor demand (*The S&P 500 Effect: Not such good news in the long run*, by Daniel Cooper and Geoffrey Woglom, FEDS Working Paper No. 2002-48, October 2002). Cooper and Woglom also found that the excess returns generally reversed shortly after the index addition. The authors suggest, as have others including Professor Jeremy Siegel of the Wharton School, that the rapid growth of passive investing leads to companies entering benchmarks at inflated prices, thus lowering potential future returns for all passive investors participating. The greater the flows into passive strategies, the greater and more frequent the arbitrage opportunities for active or discretionary managers. Furthermore, the greater the share of managed assets that rest in the hands of passive investors, the fewer active participants there will likely be. The result? More opportunity for active managers making discretionary decisions.

**04 | Access to IPOs may become more of a differentiating factor.**

Securities sold in initial public offerings (IPOs) are, on average, sold at a discount to the price they begin trading at in the secondary markets, allowing early investors the opportunity to buy the new shares cheaply. Holders of passive strategy products typically do not share in these opportunities. Many passive strategies will not consider investing in a company until its stock is included in the benchmark index upon which the strategy is based, and indices typically will not include a new member stock until the expiry of a minimum time period after the IPO. Others may not be able to participate for technical reasons. Market makers for ETFs (the typical vehicles for passive strategies) generally want to stay market neutral by shorting the holdings of the ETFs they sponsor in
According to Dealogic, the average size of U.S.-listed IPOs in 2017 YTD (*Nov. 15) is more than 20% higher than either of the last two years, the highest since 2008 and the fourth highest on record (Domenico Positano, *US-listed IPOs have reached three-year high*, Dealogic Research, November 30, 2017). The greater the size of the IPO, the greater the relative size of the opportunity missed by passive investors.

**Summary**

There is room for both active and passive products in an investor’s portfolio. Passive strategies may offer lower costs and at times better performance, but they can add risk in terms of maintaining adequate diversification and managing volatility. Active strategies can provide investment managers more tools to deal with risks, as well as satisfy investment objectives beyond the simplistic approach of risk versus return. A conversation with an advisor will determine not just what risks can be tolerated and what return is envisioned, but what other objectives might be relevant. Only then can a portfolio be constructed with the right strategy to satisfy an investor’s unique needs.

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