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Should Investors Go Passive?

Active versus passive remains one of the longest running financial debates. Is active management a relic of the past, and if so, why do investors continue to pay fees to a manager when they can just buy an index fund instead?

December 18, 2020

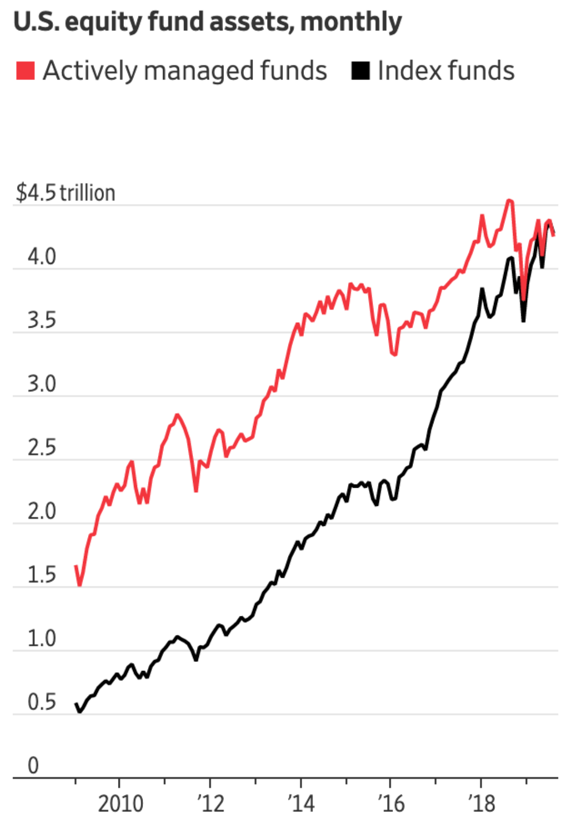
Active vs. Passive

Active investing attempts to outperform a benchmark or mitigate a risk. For example, a manager aiming to beat the S&P 500 may own a higher percentage of technology stocks than the S&P 500 if her analysis concludes that the sector should do better than consensus expectations. Another manager may shift from stocks to cash to avoid a recession.

The goal of passive investing is to track a benchmark rather than beat it. Meaning, an S&P 500 index fund's objective is to return the exact same performance as the S&P 500, no better or worse.

Thanks to years of strong financial markets and frustration from active manager fees, passive funds have gained significant share of investors' wallets. The chart to the right depicts this explosive growth since the financial crisis, and 2021 could end up being the year when assets in passive funds exceed active ones.

This evolution is prompting investors to ask if they should consider going passive as well. However, comparing recent returns is not enough to say that one strategy is better than another. Active managers tend to do more than beat benchmarks, so it is important to consider these other virtues before deciding. Here is a three-question test that can help determine if going passive is a viable option.



Note: Mutual funds and exchange-traded funds
Source: Morningstar

Do You Need Income?

If you require income from investments to pay bills, then you are most likely not a candidate for passive investing. Currently, the dividend yield on the State Street S&P 500 index fund (ticker: SPY) is 1.53%. The yield on the iShares Barclays Aggregate Bond index fund (ticker: AGG) is 2.20%[1].

Therefore, no mathematical combination of the two could beat most broad measures of inflation (currently just below 2%) after taxes. For retirees that face medical costs, grocery bills, and rents that continue to rise faster than headline inflation numbers, it's doubtful that this income stream can come anywhere close to what's needed.

Do You Have Time?

Younger people typically select cheaper healthcare plans with less coverage because they tend to be healthier. However, as the insured get older, they often move to more expensive and comprehensive plans.

The same applies to investing. Younger investors rarely need the expertise and associated cost of an active manager because they have decades before they will access their nest egg. This runway provides some protection from volatility.

A good rule of thumb for passive investing is a minimum holding period of ten years because a decade tends to be enough time to capture a full cycle from boom to bust. If a recession were to happen, the investor will hopefully gain enough to endure a sharp decline late in the cycle or have time to recover from one early on.

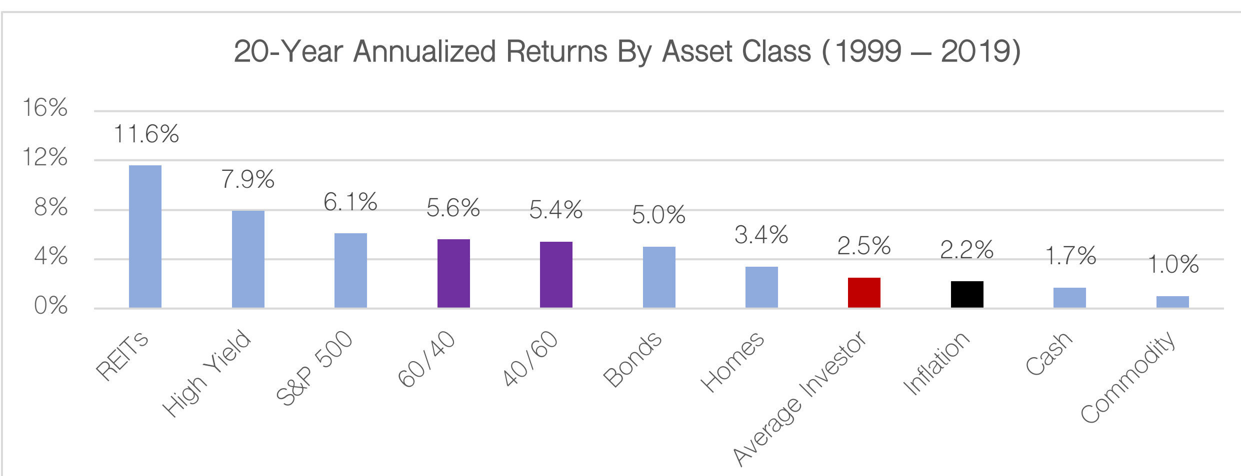
Hence, only those who do not need income from their investments and have at least ten years before needing to sell a single dollar should continue to the third test.

Can You Keep It Together?

A common misconception is that going passive is easy. Simply sell all actively managed funds and replace them with one or more index funds. However, index funds and passive investing are not synonymous, nor is there anything easy about passive investing.

Index funds are a vehicle, not a strategy. They are used as much by active investors as they are by passive ones. Since they offer cheap exposure to asset classes, sectors, and styles, active investors use them for tactical asset allocation (moving from stocks to bonds) and hedging (protecting against unexpected events).

Passive investors use index funds but hold through thick and thin. If the S&P 500 falls



Source: J.P. Morgan Asset Management – Guide to the Markets, 4Q 2020, As of September 30, 2020

50%, as it did during the financial crisis, they do not sell. This discipline is anything but easy and can test the resolve of even the most astute investors.

The chart above shows the annualized returns over a 20-year period for various asset classes. The average investor (red bar) not only earned a fraction of a balanced portfolio (purple bars), they also barely beat inflation (black bar).

Most investors underperform because they chase performance and sell into panic. Therefore, ask yourself if you can sleep at night when the next crisis whipsaws the stock market. Because it's one thing to say you can tolerate a downturn, but it's an entirely different thing to take that ride. If you are susceptible to panicking, then pass on passive investing.

The Bottom Line

I lived near Miami in the early 1990s and vividly remember Hurricane Andrew. The devastation inspired several neighbors to purchase hurricane insurance. They saw how bad it could get and were willing to pay a premium to feel safe and secure. Fast forward the clock five years, and not a single hurricane hit. The same neighbors who yearned for security began asking why they kept paying the premiums and ultimately canceled their policies.

I feel like this is analogous to investors leaving active management today. The financial crisis was a tragic event, but it ended a while ago. Since then, the economy recovered, the stock market has ripped, and investors now question paying for active management just as homeowners questioned their insurance premiums (although the volatility in 2020 may serve as a reminder to some).

My concern is that so many who moved to passive would have failed the test above. The Capital Group is one of the largest asset managers in the world, and they conducted a survey that produced two alarming statistics[2]:

1. Roughly 80% of investors between 50 and 64 years old and 75% of those over 65 consider protecting gains from market downturns a priority.
2. Only 53% of respondents were aware that index funds expose investors to the full ups and downs of the market.

If the majority values protection, but only half realize that index funds provide no protection, then a big chunk of the assets moving into passive strategies could be misaligned with those investors' financial objectives. The chart below further complicates this debate by showing that while passive has outperformed active since 2012, the long-term story is more cyclical.

In the end, I do not think that "active versus passive" is a worthwhile debate. One is not better than the other because they both have their place. Just be sure that you are not putting a right shoe on a left foot.

Most millennials have as much reason to pay an active manager as homeowners in Iowa have to protect against a hurricane. However, a retiree who relies on income from investments, does not have a couple decades before needing to sell, or cannot sleep at night during periods of heightened volatility is a poor candidate for passive.

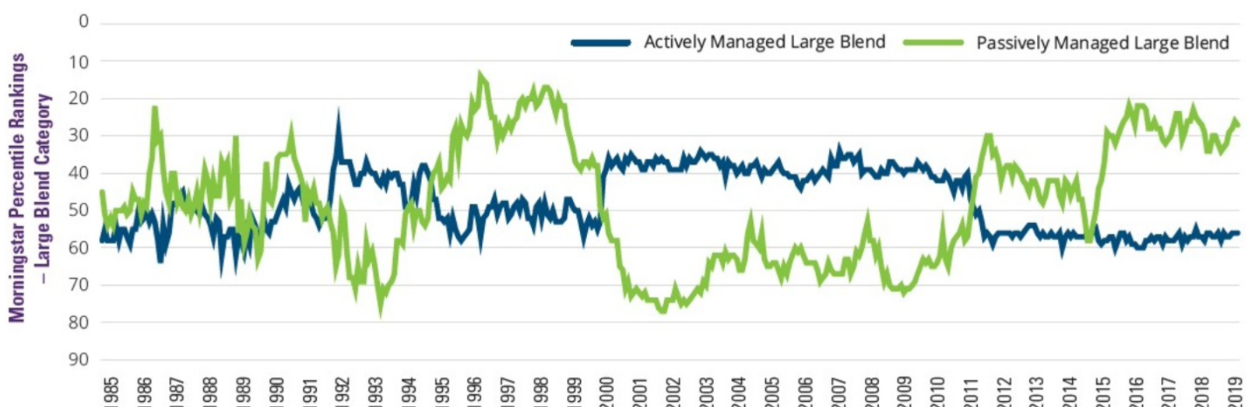
The bottom line is that passive investing is an excellent option for some, but it is most certainly not appropriate for everyone.

Sincerely,

Mike Sorrentino, CFA

Chief Investment Officer

Active and Passive Outperformance Trends Are Cyclical
Rolling Monthly 3-Year Periods (1986 to 2019)



Data Sources: Morningstar and Hartford Funds, 2/20

Sources

1 Bloomberg, As of 12/17/2020

2 https://www.thecapitalgroup.com/content/dam/cgc/shared-content/documents/articles/WisdomOfExperienceSurveyReportFinal-1-21-16.pdf

Disclosures