The Roles for Active and Passive Investments

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Investment Strategy Insights

The debate over active versus passive investments and the relative usefulness of each has persisted for years. Passive investments, where portfolios are designed specifically to track a benchmark index (which is typically market capitalization weighted) like the S&P 500, have become increasingly popular as exchange traded funds (ETFs) provide a simple, low-cost way to implement this strategy. The rise of ETF investing, coupled with generally poor relative performance from active equity managers in recent years, has caused many to assume that active management is a futile endeavor.

Given evidence from recent data, these explanations seem plausible, but in our view they are also somewhat simplistic. We don't think the active versus passive debate has a simple answer, but is dependent on the amount of opportunity that active managers have at any point in time and whether they are positioned to take advantage of those opportunities. We utilize active management in portfolios accordingly, and seek to identify managers who are well positioned and incentivized to deliver strong relative performance.

With regard to the amount of opportunity available at any given point in time, we closely monitor measures of disparity among individual stock and bond returns, or dispersion. We define dispersion as the standard deviation across security returns within a given benchmark index.[1] If the returns of individual stocks within a given index have no dispersion among them, then active managers cannot meaningfully distinguish their returns from those of the benchmark before fees.

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For more information on Fiduciary Trust visit:

www.FidTrustCo.com

or contact:

Rick Tyson
tyson@fiduciary-trust.com
617-292-6799

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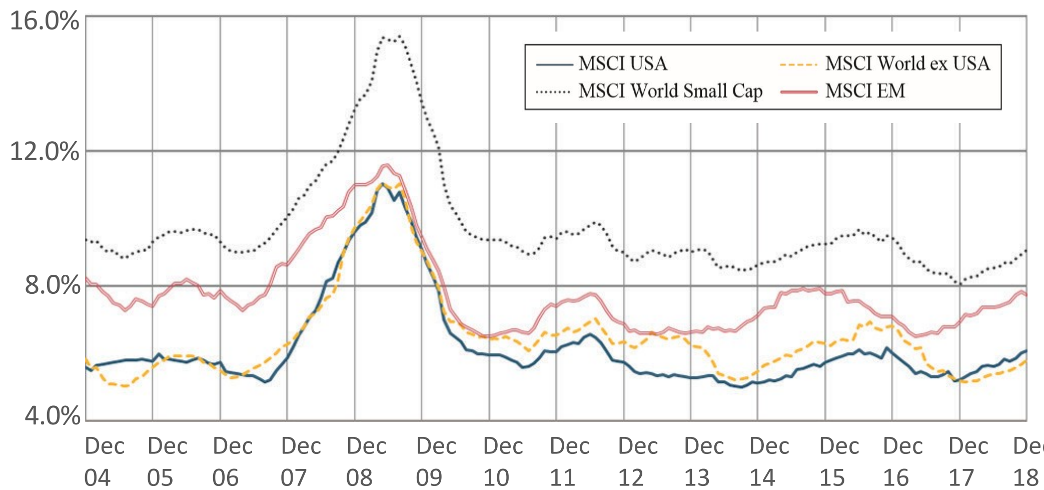
An extreme example that might help illustrate this is Treasury bills, a segment of the bond market that exhibits almost no volatility and little differentiation among issues. If two investors participated in the bills market, their respective investment outcomes would be nearly identical even if they had vastly different knowledge and investment skill. It is these less differentiated, lower dispersion markets where it makes sense to keep expenses as low as possible in gaining investment exposure, as opposed to trying to wring out extra return through active management.

While there is minimal dispersion among Treasury bill issues, there are greater dispersion levels in other asset classes, creating varying levels of opportunity for active managers to exploit. We have also seen dispersion levels within particular asset classes change over time, adding an additional layer of complexity to choosing where to implement active management within an investment program at different points in time. Below is a chart depicting levels of dispersion for various equity indexes over fourteen years.

Exhibit A: Dispersion in Total Returns by Equity Index



Source: MSCI, Fiduciary Trust Company. Cross-sectional volatility is defined as the standard deviation of a set of asset returns over a period of time. MSCI USA measures large and mid-cap equities, MSCI World ex USA measures international developed large cap equities, MSCI World Small Cap equities measures small cap equities globally, and MSCI EM measures emerging markets equities.

As you can see, levels of dispersion vary considerably over time, and appear to increase in more volatile markets. Additionally, dispersion is consistently higher for small and international indices than for large domestic ones, implying greater opportunity among those markets. This differential is well aligned with investment experience and intuition. All else held equal, it makes more sense to utilize active management in smaller and/or international markets.

While we have spent time highlighting dispersion and think it is important, it is not the only measure of an active manager's opportunities that we follow. Other helpful measures of opportunity include the concentration of the benchmark index, average correlation among constituents, dispersion of fundamental characteristics like valuations or profitability metrics, and number of securities within an index. Each of these factors helps determine the amount of latitude a manager has to deviate from the benchmark in an attempt to generate alpha.[2] We also find it useful to understand how much analyst coverage exists among various asset classes, and what percent of daily trading volume is constituted by professional versus retail investors. A stock market that has significant research resources dedicated to its coverage and is mostly trafficked in by professional investors is unlikely to offer much in the way of interesting alpha-generating opportunities, regardless of what quantitative metrics might imply.

Morningstar frequently reports what percentage of actively managed funds outperform passive funds over a given time period, and a recent representative snapshot of those results can be found below. Higher numbers indicate that investors would be better served by holding active investments, while lower numbers indicate the opposite.

We take a more nuanced approach to active versus passive allocations

Exhibit B: Active Funds' Success Rate by Morningstar Category

	1-Year	3-Year	5-Year
U.S. Large Blend	35%	24%	11%
U.S. Large Value	34%	25%	16%
U.S. Large Growth	44%	34%	28%
U.S. Mid-Blend	58%	30%	13%
U.S. Mid-Value	59%	29%	26%
U.S. Mid-Growth	72%	66%	53%
U.S. Small Blend	46%	27%	22%
U.S. Small Value	47%	34%	32%
U.S. Small Growth	75%	57%	48%
Foreign Large Blend	58%	35%	33%
Foreign Large Value	30%	24%	27%
Foreign Small-Mid-Blend	55%	31%	27%
World Large Stock	54%	34%	30%
Diversified Emerging Markets	68%	49%	46%
Europe Stock	53%	30%	19%
U.S. Real Estate	70%	34%	38%
Global Real Estate	66%	47%	33%
Intermediate Core Bond	37%	39%	40%
Corporate Bond	26%	60%	60%
High-Yield Bond	60%	56%	49%

Source: Morningstar, Fiduciary Trust Company. Blue figures indicate that over 50% of active funds outperformed passive funds. Data as of Dec. 31, 2019.

As you can see, results vary dramatically across asset classes and time periods. Active growth managers have tended to be more effective than value managers when compared to appropriate benchmarks, and in the U.S., active managers focused on smaller companies have generally fared better than their counterparts. International actively managed funds (particularly in emerging markets) have also had more success in generating outperformance. We do not think this data means that internationally based investors are more talented than domestic ones, or that growth fund managers have some inherent analytical advantage over value managers. Instead, it seems clear that the opportunity set available to managers is greater in those markets, which coincides nicely with market intuition and the dispersion data displayed previously.

Author

Harison S. Sidhu, CFA, FRM

Given that the opportunity set available to active management varies across asset classes, and we can gather statistics that measure the size of the opportunity, we take a more nuanced approach to active versus passive allocations. Where it seems unlikely that a manager can outperform his or her benchmark after fees, we happily invest in passive, low-cost vehicles to gain efficient market exposure. Where it does seem possible to use active management as a tool to generate excess returns, we perform significant due diligence to try to identify those managers that are likely to add value over time. Our unique open architecture format enables us to employ this blended approach, which we expect to serve investors more favorably than a one-size-fits-all method of investing.

Our investment approach is not only informed by our investment philosophy, including our approach to passive and active investments, but is importantly driven by our focus on our clients' best interests. We therefore do not receive compensation from proprietary investment products or third-party investment managers for directing investments to their funds, thereby eliminating real or perceived conflicts of interest. This further enables us to invest in what we believe will deliver the best results for our clients. ■

[1] Standard deviation is a statistical measure of how spread out measurements are in a data set from the average value.

[2] Alpha refers to an investment's return relative to its benchmark.

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