Sterling Advisors

THE MARKET MATTERS

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Passive or Active Investing? Pick Two.

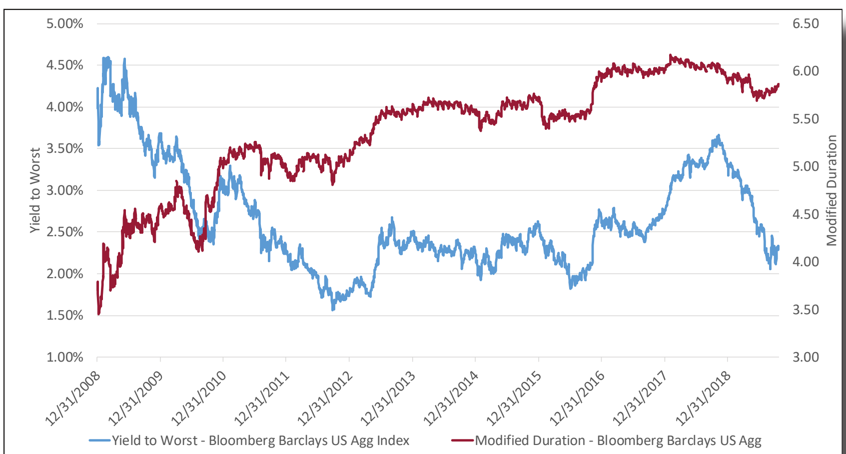
Passive or active? It's a ubiquitous question. The investment management style one chooses can dramatically impact portfolio behavior. A little over a month ago, Michael Burry (of The Big Short fame, who correctly bet against the mortgage industry in 2008) caused a stir when he claimed he had identified the next big bubble in U.S. markets – passive investments. His prediction is predicated on the belief that massive inflows into passive investment strategies are inflating the prices of equities and bonds held in these indices. Burry fears the ballooning mutual funds and ETFs won't be able to accommodate the flipside of the trade, when strong inflows inevitably turn to outflows. In other words, the dance hall has become jam-packed while the size of its exit has remained the same – a bad combination if/when the music stops. If Burry's estimation is correct, this dislocation leaves the market vulnerable. DoubleLine Capital CEO Jeffrey Gundlach made similar observations in December on CNBC's *Halftime Report,* claiming indexing had reached "mania status" and investors in passive strategies and robo solutions were exhibiting "herding behavior." To be sure, the flow of cash into index funds and ETFs has been astounding. On May 19, *Institutional Investor* reported assets under management of passive and active U.S. stock funds had reached parity (Segal, *Institutional Investor*). Moody's predicts more total assets in the U.S. will be invested in passive funds than active by 2021. But we also have to consider the source of these "bubble" claims. Burry and Gundlach both run huge, actively managed investment funds. They have strong incentives to defend the value of active management and caution against the risks of passive investing.

Let's back up and lay out some informal definitions. A passive investment strategy typically seeks to invest in all the underlying constituents of a given index and hold them long-term. Trading within the fund only occurs when a company or issuer is added to or removed from the index. No alpha-seeking changes are made in an index fund. Therefore, passive strategies don't need a traditional portfolio manager exercising his or her discretion. Also, trading activity tends to be dramatically lower in passive strategies versus active. This serves to lower fees and expenses, often to a great degree. Conversely, the purpose of an active fund: pick an appropriate benchmark and beat it, either with superior timing, effective credit research, or through some other method that gives the portfolio manager an advantage over the market. A plethora of white papers have shown empirically that active asset managers – equity, bond, or otherwise – very rarely outperform their benchmarks or indices on a consistent, long-term basis. A big reason for that is the costs of active management. An active fund manager must be right more than they are wrong to an extent that outpaces the market – and then at least covers the fees it charges. These fees are a major drag on performance, particularly in non-traditional or illiquid investment strategies that can carry huge fee structures. The cost-effectiveness of passive strategies and fund managers' inability to consistently beat their indices are the primary drivers of the seismic shift toward passive.

But that's not the whole story. I think the grizzled veterans of the industry do a poor job of understanding the newer generations' investment mindsets. Those in the sub-40 age bracket grew up in an environment of mistrust towards financial institutions. Millions of households were disrupted by job loss and wealth destruction in the late 2000s. Children in their formative years underwent tough lessons about our economic fragility. Those kids are now in their 20s and 30s, having been raised in an era of unprecedented technological advancement and convenience. They're instrumental in the growing favor of cheap, passive investment solutions that reduce the role of these financial entities, all from the convenience of their smartphones. Of course, it's not just Gen X, Millennials, and Gen Z. Warren Buffet plans to put 90% of his estate into an S&P 500 index fund when he dies. Plenty of older investors too believe the best investment bet in the history of the world has been on U.S. growth, plain and simple. If you can lay that bet with virtually no cost, even better. Passive appeals to a deep pool of market participants.

But we must not abandon the power of diversification. Yes, between equities and fixed income, but optimal diversification goes well beyond that. We can diversify into less-traditional asset classes, diversify geographically, diversify industries, and yes, diversify investment style. A mix of passive and active management offers distinct benefits. Some degree of exposure to the S&P 500's large-cap names is prudent for the majority of global investors. Based on the long-term underperformance by most money managers, using an index fund here is probably sufficient. The underlying securities are extremely liquid, reducing the threat of Michael Burry's "exit door" fears. But the "herding" mentality Gundlach highlighted creates opportunity for active strategies. With the growth of passive solutions, the financial management industry has been consolidated by the resultant fee compression (a good thing for investors) and lower demand. It also means fewer eyes are searching for arbitrage and relative value. The explosion of passive strategies has actually narrowed the scope of investment mandates. That creates opportunity – particularly in places like international equity and debt markets, U.S. small cap, sector-specific funds and ETFs – which lack the S&P 500's liquidity and its ease of access to information. If index funds have, in fact, inflated the valuations of the index's constituents, then they are expensive. Other asset classes and investment areas that cannot be indexed as efficiently offer a chance to outperform.

Passive investing has another pitfall – it may not be as "turn-key" as investors may think. For example, take AGG (iShares Core U.S. Aggregate Bond ETF), which passively mimics the Bloomberg Barclays US Aggregate Bond Index. That index is a mix of Treasuries, government-related and corporate securities, MBS, ABS and CMBS. It is highly liquid and now costs just 0.05% per annum to use. But those who bought AGG in the wake of the financial crisis for safety and took a "set it and forget it" approach were unknowingly subjected to the index's dramatic transformation. At the end of 2008, the Agg Index's modified duration was roughly 3.7 years and yielded 4.0%. Today, its duration sits at 5.9 years and yields 2.3% (Bloomberg). The Agg Index's yield characteristics have dramatically declined as many of its investors have aged and need more current income from their investment portfolio. Meanwhile, its duration has extended more than 59%, meaning a parallel shift in the U.S. yield curve of 100 basis points, would result in a +/- 2.2% difference in price performance between now and what an investor would have experienced roughly 11 years ago (Bloomberg). More volatility, less yield. Fortunately, the duration extension has occurred in a falling rate environment and resulted in strong price performance for the index and AGG. That won't always be the case. These are risks that must be monitored, managed, and diversified. In this instance, purely passive investing is insufficient.



A healthy blend of cost-effective, passive solutions and alpha-seeking investment strategies placed with reasonably priced, trusted managers offers another form of diversification that can inject balance in a portfolio. This is a founding philosophy behind BB&T Scott & Stringfellow's Global Core ETF Strategies. Global Core invests strategically in passive, liquid, cost-effective ETFs but overlays active management to take advantage of shorter-term, tactical opportunities. We believe strategies like Global Core are the future of the industry, because they offer the cost efficiency of passive strategies while delivering thoughtful active oversight.

The investment industry is home to roughly $74 trillion assets under management, according to Boston Consulting Group's most recent report. Active management dominated this space for decades. Technology and demographics have disrupted the status quo and thrown jet fuel on passive investing. But passive solutions are really just playing catch-up and benefiting from a new, growing audience. This is not the death of active investment. If anything, the shift creates more active management opportunities away from the crowds huddled around the world's largest investment indices. But if the question is "Passive or Active?" the prudent answer is typically both.