ABBOT DOWNING

Active Versus Passive Investing

Written by:

Robert Whitehead, CFA
Director, Asset Management

Reviewed by:

Douglas W. Evans, CFA, CIMA
Senior Managing Director, Asset Management

Steve Bobo
Director, Asset Management

In This White Paper:

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Introduction

The debate that began several decades ago over the merits and shortcomings of active versus passive management is ongoing. Reports on the topic by investment professionals and academics continue to be published unabated, and seem to be one of the investment world's more popular literary pursuits. While there is hardly a need to add another voice to the discussion, it is our belief that Abbot Downing should define its position as part of our investment philosophy for the benefit of our clients.

Definitions

The investor who practices active management selects individual securities for purchase or sale usually based on fundamental research and/or by utilizing a broad array of quantitative methods. By contrast, the passive investor buys an entire index such as the Standard & Poor's 500 (S&P 500), simply to match its performance. Both active and passive products are available, enabling investors to take either approach in order to gain exposure to a full range of stock and bond markets, investment styles, geographic regions and sectors.

Passive investing can be accomplished by using index funds or exchange-traded funds (ETFs), both of which have been in existence for some time. Vanguard launched the first index fund in 1975, and State Street Global introduced the first ETF in 1993. From those beginnings, passive alternatives have grown to account for about 20 percent of total invested assets, split almost evenly between mutual funds and ETFs[1]. Passive strategies among institutional investors have gained market share and now account for more than 40 percent of institutional assets.[2] They will likely continue to win over adherents, particularly during periods of underperformance by active managers.

The Records

Academic studies and literature overwhelmingly support passive management, especially in the highly efficient large cap indexes. Simply stated, such studies have sought to prove that investment managers are incapable of beating "the market" over the long term, using empirical evidence to support that position. In contrast, the active management community has challenged that claim principally by choosing time periods that favor their constituency, or by noting its success in inefficient markets.

Some random examples from recent history demonstrate the variations in passive/active performance for large cap stocks over relatively short time periods. In support of passive management, the S&P 500 outperformed 95 percent of large cap equity core managers from 1992 to 1998 and also prevailed for the ten years ending in 2006.[3] From 1984 to 2008, 70 percent of large cap mutual funds fell short of their benchmarks.[4] On the bond side, passive funds prevailed against 85 percent of active competitors in 2008 and also for the preceding four years, principally owing to the superior performance of U.S. Treasuries.[5]

However, active managers in the large cap equity space have had their share of success in recent years as well. Between 1998 and 2007, more than half of them beat the S&P 500.[6] This example clearly demonstrates the importance of starting and ending dates. If one measures performance over the ten-year period beginning in 1997, passive management wins; move forward a year and active management comes out ahead. Active management also prevailed during the seven years from 1999 through 2006.

Longer-term results calculated by our consultants, Callan and Rogerscasey, cover 20- and 25-year time frames, respectively, and reach similar conclusions about the benefits of active management. According to both organizations as well as others, active managers have been most successful in small cap and international equities, emerging markets and real estate investment trusts (REITs). Callan's performance analysis is summarized in the following table:

Median Active Manager Average Performance

Annualized Excess Return for Twenty Years Ended March 31, 2012 Excluding Fees

Large Cap Core vs. S&P 500 Index	0.08%
Large Cap Growth vs. Russell 1000 Growth Index	0.31%
Large Cap Value vs. Russell 1000 Value Index	-0.63%
Mid Cap Broad vs. Russell Midcap Index	0.36%
Mid Cap Growth vs. Russell Midcap Growth Index	0.76%
Mid Cap Value vs. Russell Midcap Value Index	-0.18%
Small Cap Broad vs. Russell 2000 Index	2.08%
Small Cap Growth vs. Russell 2000 Growth Index	3.01%
Small Cap Value vs. Russell 2000 Value Index	1.01%
Global Equity vs. MSCI World Index	2.39%
International Broad Equity vs. MSCI EAFE Index	2.14%
International Small Cap vs. MSCI EAFE Small Cap Index	0.89%
Emerging Markets vs. MSCI Emerging Free Index	1.43%
Core Bond vs. Barclays Aggregate Index	0.25%
Core Plus Bond vs. Barclays Aggregate Index	0.70%
High Yield vs. Barclays High Yield Index	0.54%
Non US Fixed vs. Citigroup Non-US Gov Index	0.40%
REITs vs. NAREIT Index	2.00%

Source: Callan Associates presentation "Historical Active Management Premiums by Asset Class & Style"- March 31, 2012

Those seeking clear conclusions in the active versus passive debate will probably take little comfort in these performance comparisons. Clearly, advocates of passive management are supported by compelling evidence that markets cannot be beaten over the long haul, especially net of fees and taxes. However, there have been sustained periods of time when active managers have delivered superior relative returns and certain asset classes in which they have demonstrated the ability to add value.

The Advantages of Passive Management

By investing passively, the investor gains exposure to broadly diversified lists of stocks or bonds that target specific investment styles in the most tax-efficient manner. The performance advantages over long periods of time are in no small part the result of low fees and expenses, as well as limited portfolio turnover that mitigates trading costs and taxes. The passive investor also has the luxury of avoiding the challenges and costs associated with selecting successful active managers. We have recently seen that even the most brilliant and experienced professionals can stumble, calling into question whether it is possible to select those who can consistently outperform in an increasingly complex world.

The Drawbacks of Passive Management

Perhaps the most significant drawback of passive management is that it requires the investor to accept the configuration of indexes, however constructed and regardless of the quality of their individual holdings and inherent risks. The S&P 500 is managed by a committee which considers, among many factors, market capitalizations, sector representation, liquidity and positive earnings; holdings are adjusted regularly. By contrast, the Russell indexes are reconstituted once a year "to ensure new and growing equities are reflected." Companies operating at a loss are included, and in some cases, can be a material portion of a Russell index. In the case of bonds, some indexes do not account for defaults until they occur and occasionally contain illiquid securities.

The investor in passive products also assumes the weightings assigned to individual securities. On the equity side, by definition, the largest stocks become larger since money is allocated by market capitalization in most indexes. (An exception is the Dow Jones Industrial Average which is price-weighted.) This leads to an emphasis on companies or sectors that are in vogue, almost certainly because they are performing well, forcing one to assume material risks associated with concentration. For example, more than 30 percent of the S&P 500 was invested in the energy sector in the 1970s and in technology and telecommunications in the 1990s, and 20 percent in financials just a couple of years ago.[7] The subsequent collapse of those sectors was painful for large cap passive portfolios.

As for individual companies, passive management exposes investors to similar risks. For example, Nortel accounted for 36 percent of the Toronto Stock Exchange's main index in 2000; its market capitalization dropped from a high of $250 billion to less than $50 million at the time of its bankruptcy filing in January 2008.[8] Likewise, in the U.S., the top five mega-stocks accounted for about one-third of the loss in the S&P 500 when the technology bubble burst in 2000.[9] Early that year, Cisco Systems alone was worth more than the total of the 25 top-grade companies including Caterpillar, Minnesota Mining, Federal Express, Aetna, Raytheon, Lilly, McDonald's, JP Morgan and Apple Computer.

In our view, there is a specific lesson implicit in this data. The passive investor must recognize that there are occasions when the diversification sought through an index is an illusion and that the accompanying risks can be formidable.

The Advantages of Active Management

Along with the possibility of catching a sustained ride during a period when passive indexes underperform, there is solid evidence that active management may sometimes be an appropriate investment option. As a starting point, the aforementioned conclusion by Callan and Rogerscasey, that actively-managed portfolios in inefficient markets have consistently beaten their indexed counterparts (and may continue to do so), is widely accepted.

Additionally, many investors may not find acceptable the notion that ownership of stocks or bonds and all sectors in their portfolios must be entirely based on their size and consequent weighting in an index. They may take umbrage at investing in a portfolio that includes low-quality companies, those losing money or are in bankruptcy, those in businesses that offend them, are in overly-competitive businesses, are poorly managed, do not pay dividends, etc. Rather, they may prefer to focus on their own unique set of objectives, either by themselves or through a professional manager, adopting a strategy that reflects their own set of values, investment criteria and, importantly, unique tax circumstances. They may even be willing to entrust managers with the authority to carry meaningful cash positions under certain conditions.

An investor's chances of successfully meeting his or her investment objectives through active portfolio management are increased by selecting managers with impressive credentials. At Abbot Downing, we seek those with strong administrative and investment functions, a long-term record of above-average results, a solid investment philosophy and strategy that has been practiced successfully and consistently, and rigorous risk control. We work diligently to identify, retain and then closely monitor a broad list of such managers, aiming for the very best.

The Drawbacks of Active Management

Due to underperformance relative to passive alternatives, it is a well-known fact that active managers have been, and continue to be, under enormous pressure to deliver results that justify their fees and other expenses. This has led to a radical change in the way money has been invested over the years. Managers, fearful of being out of top performing individual securities or sectors, frequently cling closely to their assigned benchmark, almost guaranteeing mediocre relative results at best. Many are justifiably labeled "closet indexers" as they invest defensively to avoid major errors.

Other managers sometimes choose a different tactic by straying from assigned benchmarks, sometimes markedly. For example, they may shift assets to a competing style (called style drift), or to larger or smaller stocks than authorized, violating their official mandate. They may even deviate from their own stated strategy, especially during times of meaningful and sustained underperformance.

Finally, there are risks related to the active management firm itself. It may encounter internal problems such as the loss of personnel (many times to more lucrative hedge fund positions) or clients, lagging performance, a strategy or style that is out of favor, significant changes in ownership or a change in its investment philosophy.

We believe that investors are better off with passive alternatives than with managers who display these characteristics and tendencies.

Some Additional Observations

Before presenting our own conclusions in the active versus passive debate, there are a few additional observations that may be germane.

- Active/passive studies do not typically measure performance results on a risk-adjusted basis. In a perfect world, investors would consider differences among securities with regard to size, quality, liquidity and volatility when comparing active and passive strategies. Furthermore, they would likely weigh the impact of cash in actively-managed portfolios. One could argue that this liquid component lowers risk but it also negatively impacts performance results during rising markets. This has surely accounted for some of the underperformance by active managers over the long term.
- In many, if not most cases, a perfectly comparable benchmark is not available. One example of many from our universe: a high-quality-oriented mid cap growth stock manager will not invest in companies losing money but is benchmarked to an index which can sometimes have as much as 40 percent in unprofitable businesses. Another example: a small cap growth manager invests exclusively in dividend-paying companies but is judged against an index that contains mostly those that distribute no dividends.
- Tracking error is defined as the extent to which a portfolio's performance deviates from its benchmark, or index. Even index funds and ETFs exhibit tracking error, although to a lesser degree than their active counterparts. The culprits: expenses, fees, transaction costs (relatively high with smaller capitalization stocks and emerging markets) and, in the case of ETFs, supply/demand factors that sometimes result in wide short-term disparities between the ETF and its underlying securities.

- Earlier, this paper touched on some of the risks contained in indexes such as bloated positions in individual securities, sectors, and geographic regions. Investors must decide whether the ways in which these indexes are configured are appropriate based on their own philosophy or, for that matter, whether index performance is even relevant to what they are trying to achieve. It is worth considering the notion that it is doubtful that Warren Buffett, the famed investor who founded and heads Berkshire Hathaway, pays any attention to the performance of his company versus a benchmark. Rather, he focuses on businesses that have a competitive edge, deliver consistently high rates of return, have strong balance sheets and fundamentals and, importantly, those that he understands.
- There are large cap active managers who still believe in the mostly discarded notion that capital preservation should be the cornerstone of one's investment strategy. Many of them tend to do well on a relative basis during declining markets. Their focus is on achieving objectives, not outperforming indexes. In some cases, they clearly spell out that they are index agnostic, the antithesis of the "closet indexer's" investment philosophy.
- Active management affords investors the opportunity to customize their portfolios. On the equity side, for example, multiple managers in a particular style can be selected to complement each other with different strategies and tactics. One manager can provide a high-quality, low risk, broadly diversified portfolio while another produces a lower quality, higher risk, concentrated list of stocks.
- Active managers are all too often subject to onerous restrictions. Investors frequently encroach upon their professional expertise by setting rigid guidelines and limits on how funds are to be invested. In these cases, accountability for results must be shared by both parties.
- Modern Portfolio Theory (MPT) has been grounded in the belief that markets are efficient and that active managers are incapable of outperforming indexes as a result. However, this assertion has once again been called into question over the last couple of years as markets displayed violent swings, driven by fear and seemingly irrational behavior on the part of investors. We leave it to the academics to continue the debate but remain open to the premise that there are inefficiently-priced securities and asset classes that can be exploited by able investment professionals. Even William Sharpe, one of the early proponents of MPT, responded to a question about whether investments should be confined solely to index funds with a "resoundingly no."[10]
- Hedge funds are the most blatant examples of active management, even referred to as "hyperactive" by some. They are best equipped to exploit market inefficiencies through the use of complex strategies involving short selling, leverage, futures contracts, derivatives and a whole host of other investment and trading activities. These funds, actually private partnerships, are typically unregulated and illiquid and are available only to qualified investors.

A Reasonable Strategy Going Forward

Passive management is gaining market share, especially among institutions, for good reason. Long-term results have favored this strategy, most notably among large capitalization stocks and in bonds as well. What's more, investors have been inundated with advice by the media and academia to invest passively after watching their active managers perform poorly over the last three to four years.

We agree that passive management can be effectively utilized by investors, especially when they are considering investments in the highly efficient large cap universe. Clearly, this strategy is preferable to selecting active managers who are "closet indexers" struggling to perform net of fees, expenses and taxes. We believe that it is also appropriate for those investors who seek broad diversification, are comfortable with the configuration of indexes and can live with their drawbacks.

At the same time, there may be an important role for active management as well, even beyond the inefficient markets referred to earlier. Indexes are far from perfect and may not accurately reflect a manager's strategy or target universe or, for that matter, the investor's objectives. Moreover, as we have pointed out, the performance of active and passive strategies runs in cycles. In the aftermath of the recent outperformance by low-quality stocks, the contrarian-minded investor might reasonably conclude that the time is ripe for high-quality-oriented active managers to excel. Good securities have been thrown out with the bad and, at some point, high quality will come back into vogue, reverting to the mean, if you will.

Active managers might also be able to exploit what promises to be a different and undoubtedly more complex economic and investment environment than anything we have witnessed in our lifetimes. They will need to deal with a dramatically changed political and financial landscape that is likely to include as yet unknown rules and regulations for financial institutions, exploding government deficits and obligations and a dramatically weakened consumer, to cite a few examples. At the other extreme, we anticipate that there will be great opportunities for those able to figure out what industries and companies will benefit from globalization, expanding populations, new technologies, alternative energy trends and the like. Selected large cap managers may have a place in this environment, particularly those who focus on high-quality securities and can customize portfolios for investors with particular needs.

In summary, we conclude that the active versus passive debate does not yield a clear-cut solution that would eliminate one or the other. As illustrated in this paper, there are just too many variables on both sides that raise questions while offering no unambiguous answers. We therefore support and recommend several passive management solutions and continue to select and monitor a broad array of active investment managers across the asset class spectrum. At the same time, we continue to explore whether there might be a place for customized benchmarks that would help us more accurately evaluate both active and passive products.

Endnotes

1 Financial Research Corp, 12/31/08

2 "A Comparison of Active & Passive Strategies," Evanson Asset Management, 2009

3 "When Indexing Really Shines," Wall Street Journal, 11/02/09

4 "Passive & Active Management," SPDR University, September 2009

5 "A Discussion with John Bogle," Index Universe, 06/22/09

6 "When Indexing Really Shines," Wall Street Journal, 11/02/09

7 Standard & Poors, 12/09/09

8 Bloomberg, 12/09/09

9 Standard & Poors, 12/09/09

10 Indexed Investing: A Prosaic Way to Beat the Average Investor, William Sharpe, Monterey Insitute of International Studies, May 2002

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