

Active, passive, or smart beta strategies - which is the best investment approach for your portfolio?

With the sustained strong performance of the US stock market since the end of the 2008 financial crisis, many investors have placed more and more of their portfolio assets into "passive" index mutual funds and exchange traded funds (ETFs) designed to track the S&P 500 Index and other stock market proxies. Consequently, some of the largest and most successful "actively" managed mutual funds have seen significant outflows as investors have given up hope that these funds can outperform their cheaper passive fund counterparts. Meanwhile, new variations of "smart beta" funds seem to be introduced regularly and are also gaining interest with investors. So what are these different investment strategies and which is the best approach for one's portfolio?

Passive investment management, generally speaking, attempts to mimic, both in terms of exposure and performance, an established market index. Because all information about the index components are publicly available, there is minimal human action needed to construct and maintain a passive management investment strategy. The passive index fund simply buys - in the same proportions - all of the securities contained in the index it is attempting to replicate. Investors who buy passive management products are content with merely achieving returns that closely track a fund's targeted index, albeit lower than the index, on average, since even passive index funds have management fees and trading costs.

Active investment management differs significantly from passive management in that it involves ongoing security analysis performed by individuals and/or computer modeling to create investment portfolios that attempt to outperform a specific index or other benchmark. To do so, the portfolio manager responsible for running the actively managed fund will focus on a variety of factors including security valuations, company earnings growth, credit quality, business cycles, country economic outlook, inflation and interest rate expectations, etc. The active portfolio manager will intentionally avoid certain companies (or sectors, countries, etc.) within an index that are deemed inferior to enhance relative investment performance, as well as purchase securities that are not part of the index being benchmarked against.

The smart beta strategy is a hybrid between active and passive management. It attempts to build on the passive management approach by implementing a rules-based strategy, making reasoned modifications to a targeted index with the goal of providing better relative performance. These modifications typically try to exploit certain market factors within the targeted index that have historically provided higher returns. Some of the more common market factors include market capitalization (smaller companies have historically outperformed large-capitalization companies over time), valuation

(inexpensive stocks tend to do better relative to pricier growth stocks in the long-run), and quality (companies that have strong balance sheets and generate consistent earnings tend to perform better over time versus highly indebted companies with weak business models).

Understanding the composition characteristics of the major indexes can be helpful in determining when to use an active, passive, or smart beta strategy. For example, the S&P 500 Index is a market capitalization weighted index - meaning that the largest company by market value has the greatest weighting in the index. Thus an inherent characteristic of this index is that it is skewed towards large capitalization stocks. The largest 10 companies constituents presently account for over 17% of the underlying index. Currently, Apple Inc., is the largest U.S. listed company and represents about 4% of the underlying index.

Historically, smaller capitalization companies have outperformed their larger counterparts. If an investor does not desire to have such a large weighting of large capitalization stocks in his portfolio but still wishes to have broad US stock market exposure, he could consider using active funds that focus on smaller companies or smart beta funds that focus on other market factors but still are broadly exposed to the US stock market. As an example, the Guggenheim S&P 500® Equal Weight ETF¹ invests in all the stocks held in the S&P 500 Index, but each holding is weighted the same at 0.20% each. Relative to the market capitalization weighted index of the S&P 500 Index, the equal weighted approach has a larger percentage of mid and smaller capitalization companies. As this investment rebalances each quarter, it also is forced to buy low and sell high. Combine this with smaller US capitalization companies having outperformed their larger peers over the past decade (through 3/31/15), it is not surprising that this equal weighted approach has outperformed the widely followed S&P 500 Index over this period.

Other examples of cases in which an investor who would otherwise seek a passive index approach might consider other strategies include when the underlying index contains things he might not wish to own, such as specific countries, low quality companies, foreign currencies, and economic sectors (eg: energy now, financial firms in 2008, or technology companies during the dot.com bubble from 2000-2002). Active management funds and smart beta strategies allow the investor to avoid or underweight such issues.

Proponents of passive management strategies point out that few active managers have been able consistently outperform their index fund equivalents over the long-run and that identifying those active managers that possess superior skills to outperform in the future is extremely difficult.

Active managers investing in US equities certainly have had a difficult time proving their value since the end of the 2008 financial crisis. The Federal Reserve's policy of maintaining an easy money environment via near-zero interest rates to help stimulate the economy has caused the prices of many stocks to trade at or above their intrinsic valuations. Thus active managers have had few opportunities to uncover undervalued securities. Moreover, this easy money policy has even driven up the prices of unprofitable and high debt companies.

While these low-quality companies are often found in the broad market indexes, active managers typically avoid owning them, and ironically have been penalized (in terms of performance) as a result during this latest bull market. This is due to the fact that during a prolonged liquidity-driven bull market, the performance dispersion between stocks narrows. Thus, individual security analysis, which is the primary benefit offered by active management, becomes fairly meaningless. During such times, the added cost borne by active management almost guarantees that they will underperform their passive fund counterparts.

Skilled active managers stand a better chance to outperform their passive counterparts during times of market volatility and uncertainty when sector and stock performance dispersion increases. Active management may also provide downside protection for investors during significant market selloffs - in part due to the manager's ability to hold cash or rotate to defensive stocks when he believes that markets are overvalued.

An investor's temperament should also be a consideration in the decision of whether to utilize an active, passive, or smart beta approach. Given that active managers must differentiate their portfolios from their benchmarks (or else they will not stand a chance to outperform them) investors using actively-managed funds must be willing to tolerate periods of underperformance relative to the benchmarks while their fund managers' investment decisions take time to play out as planned. If one cannot tolerate extended periods of underperformance, then he might be better off in a passive index fund thus ensuring that he is at least tracking a market-like return.

On the other hand, the dramatic rise in the use of passive funds over the past few years may indicate that many investors are chasing performance and are buying these index funds on emotion instead of long-term conviction. When the next inevitable significant market correction occurs, those same investors may dump their index funds over time as they lose confidence in the passive strategy approach - which may create a long period of poor index performance. One needs to look no further than the prior rise in popularity of US index funds during the 1995 - 1999 period, which was followed by the S&P 500 Index experiencing a 10-year period (March 31, 1999 - March 31, 2009) cumulative loss of over 26%.

While the performance records of many smart beta funds are somewhat limited due to their fairly recent product launches, the data is encouraging and it appears that they can qualify as suitable investments in an investor's portfolio, if used correctly. Some newer niche funds are taking advantage of long recognized market "anomalies" such as outperformance of corporate spin-offs and legal trading by corporate insiders. Thus all three approaches, active, passive and hybrid/smart-beta, can justifiably be part of an investor's portfolio - and in fact these strategies can often complement each other throughout market cycles. This is the method utilized by WESCAP in our diversified global asset allocation strategy.

To sum up, an investor's primary focus should not be whether a fund is actively managed or follows an active, passive, or smart-beta strategy, but rather what are the specific investment's fundamental investment characteristics, risks, and costs within the current and prospective market and economic environment.

Furthermore, it is even more important that an investor's portfolio contains a broadly diversified group of asset classes to maximize its return potential given the amount of risk one is willing to take. The investor must also understand the investment objectives and strategies used by each fund to make sure that each one plays a proper role in the overall composition of an appropriately diversified portfolio. And lastly, the investor must be disciplined and stick with the overall strategy except when making the necessary changes to reflect changes to his or her risk profile and/or goals and objectives.

Footnote:

¹The investment examples included herein have been selected solely to provide a better understanding of the topics discussed in this article. They should not be considered as investment recommendations by WESCAP, nor should their past performance be construed as an indicator of future results.