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Enhanced practice management: The case for combining active and passive strategies

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Executive summary. Today, many financial advisors are moving to a fee-based practice model, away from the traditional commission-based model. One implication of this transition is that advisors may face a greater business impact when clients decide to pull assets or terminate a relationship because of underperformance versus common market indexes. This "client risk" exists because it's often short- to intermediate-term performance that can make or break an account, even if the client is positioned as a long-term investor.

Mitigation of this client risk is an often-overlooked benefit of adding broad-based passively managed investments—index funds or ETFs—to a portfolio primarily comprising actively managed funds.

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Active management risk: Testing an ideal portfolio

To demonstrate some often-overlooked challenges of utilizing actively managed funds, we created an extreme example. We built an equal-weighted portfolio composed of the 20 best-performing actively managed equity mutual funds for the 15 years through December 2011.[1] Over those 15 years, this portfolio would have outperformed the Dow Jones U.S. Total Stock Market Index by 6.3 percentage points annually after fund costs—representing the extreme in excess returns delivered to the client.[2]

Of course, creation of such a portfolio would require perfect foresight; it does not reflect the very real challenges of selecting winning managers. For example, of the 1,392 actively managed equity funds that were available on January 1, 1997, 631 (45%) had disappeared by the end of 2011, either merged or liquidated, and another 410 (29%) underperformed the U.S. stock market for the 15 years. That leaves 351 funds that survived and outperformed, a 26% success rate.

The challenge for both the client and the advisor involves not only the long run—for instance, enduring a 15-year period in which only 26% of funds survive from the start and outperform—but also the short term, when even the best long-term portfolio can fall significantly short of the market. For example, over the 12 months through October 1998, our "Top 20" portfolio trailed the index by more than 15 percentage points. And for the 12 months through December 2011, the portfolio lagged by more than 5 percentage points.

In **Figure 1**, we show the performance of our Top 20 portfolio versus the Dow Jones U.S. Total Stock Market Index, and also what the returns would have been if half the portfolio consisted of the total-market index funds that make up the investable version of the market index.[3] While staying the course with our Top 20 active funds over the full 15 years would have paid off, enduring such significant underperformance in the moment can be trying, to say the least. Compounding the performance volatility of the active portfolio is the dispersion *within* that portfolio. For many advisors, part of their role is to select top-performing funds for their clients. Much of the difficulty in succeeding at this over the long term lies in maintaining conviction in a fund, manager, or style during the inevitable rough patches.

For example, in **Figure 2**, on page 4, we show the number of our Top 20 funds that underperformed the average return for total market index funds; we also show their distribution in terms of the magnitude of their underperformance. In virtually every period a number of funds underperformed, sometimes by significant margins (see, for example, years such as 1998, 2007, and 2011). In calendar year 2011, two funds underperformed by 15 percentage points or more, four by 10–15 percentage points, and three by 5–10 percentage points.

Sticking with such a fund in order to capture the long-term outperformance is easy to imagine in hindsight, but extremely difficult to do in the moment. In addition, if the client can see how the underlying funds are performing, then it's also likely that during these down periods the advisor's strategy

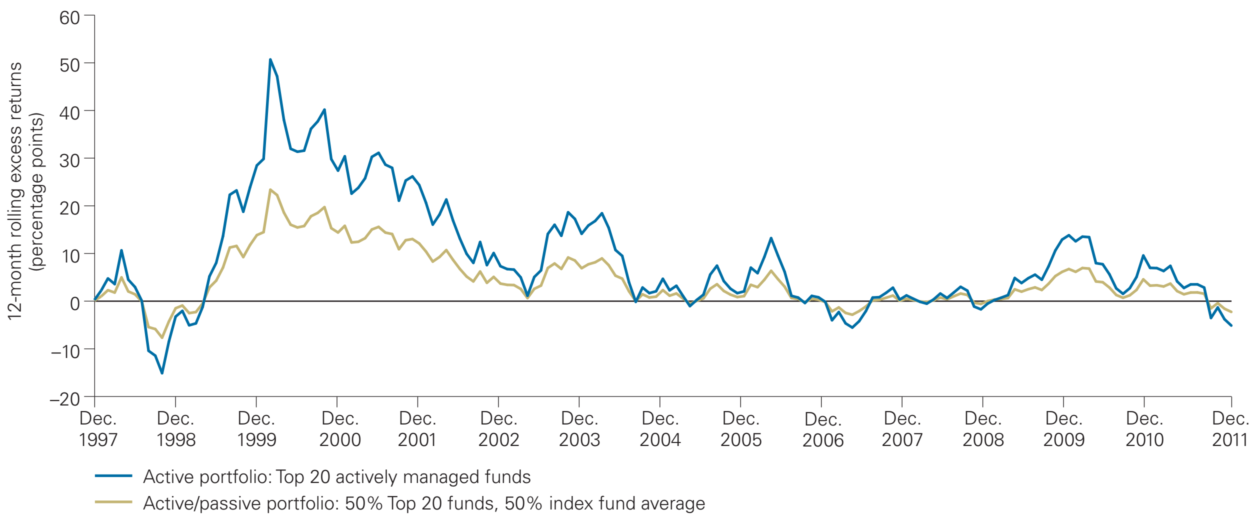
1 Based on data from Morningstar.

2 Our Top 20 funds are among those assigned by Morningstar to one of its nine U.S. equity style boxes; in other words, we have not included any specialty funds in our data. The 20 funds in aggregate may not match the broad market's composition in terms of capitalization or style. To the extent that they do not, our comparison is constructed in favor of active management, because it assumes an ability to identify the top long-term performers 15 years in advance.

3 In choosing our sample of index funds, we focused on funds tracking the MSCI US Broad Market Index, the Dow Jones U.S. Total Stock Market Index, the Russell 3000 Index, and the Wilshire 5000 Total Market Index. We also excluded funds with expense ratios above 25 basis points, because for index funds the expense ratio is the primary determinant of both tracking error and overall portfolio quality.

Figure 1. Combining active and passive holdings can mitigate relative downside risk

This chart compares excess returns over 15 years for two portfolios—one consisting of our Top 20 actively managed funds, the other combining the Top 20 with total-market index funds. The all-active portfolio would have delivered more excess return in good years, but in rocky periods it would have fallen farther. Both portfolios are measured against the Dow Jones U.S. Total Market Index.



Notes: The Top 20 portfolio consists of the 20 actively managed funds with the best performance over the 15 years through December 31, 2011. It is rebalanced annually among the 20 funds. In the active/passive portfolio, the active portion is the Top 20 funds and the passive portion is the average return of a group of total-market index funds. The index group includes funds seeking to track the MSCI US Broad Market Index, the Dow Jones U.S. Total Stock Market Index, the Russell 3000 Index, and the Wilshire 5000 Total Market Index. We excluded index funds with reported expense ratios greater than 25 basis points. For funds with multiple share classes, we used the class with the lowest expense ratio. In the event of a tie between expense ratios, we chose a share class alphabetically. The active/passive portfolio is rebalanced annually.

Source: Vanguard calculations using data from Morningstar.

will be called into question, and the client may start thinking about pulling assets. It's also in these times that the risk control offered by a passively managed strategy can pay dividends.

The benefits of reducing active management risk

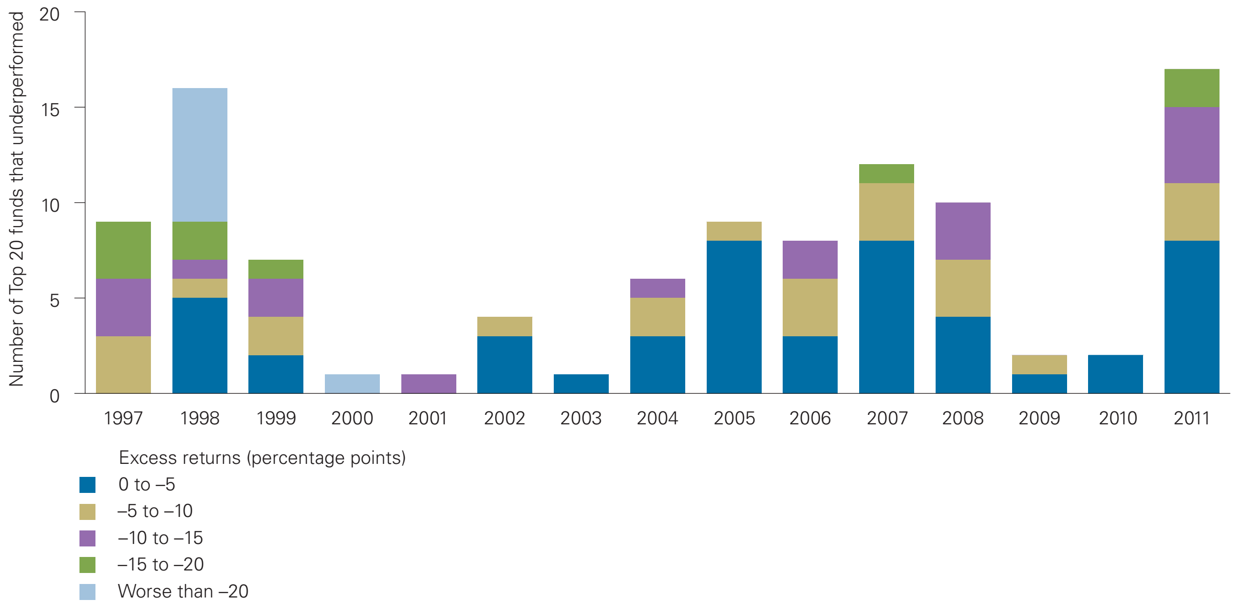
Alongside results for the 100% active portfolio, Figure 1 also shows the excess returns for a 50% active/50% passive portfolio. In this example, the active portion consists of the Top 20 funds, and the passive portion reflects the average return for total market index funds. Two observations are noteworthy: First, as would be expected, the active/passive portfolio produced lower excess returns consistently over time. However, perhaps more important, the active/passive portfolio also reduced relative downside risk—i.e., this portfolio did not trail the benchmark as far during the bull market of the 1990s, nor did it underperform as much in 2011.

Of course, a more likely scenario is one in which the active holdings deliver notably less excess return than those in our ideal portfolio (recall our statistics regarding the success rate of actively managed

Notes on risk: All investing is subject to risk. Past performance is not a guarantee of future results. The performance of an index is not an exact representation of any particular investment, as you cannot invest directly in an index.

Figure 2. The Top 20 active funds display wide dispersion in underperformance

Although our Top 20 funds outperformed over 15 years, at various times many of them lagged the average return for total-market index funds. The bars show how many of the 20 underperformed and also how far behind they were. In 1998, for example, eight of them trailed the index fund average by at least 15 percentage points.



Note: Performance measurement reflects the rolling 12-month return for each Top 20 fund versus the average return for a group of total-market index funds (described in the Notes to Figure 1).

Source: Vanguard calculations using data from Morningstar.

funds over this time period). In that case, mitigating significant underperformance can be even more critical to successful long-term client relationships.

Conclusion

More and more, successful practice management means not only adding new clients but keeping existing clients. In an environment that makes it ever more challenging for actively managed funds to consistently succeed, the role of indexed strategies is gaining in importance. Indeed, to extend our example, suppose an advisor had a set of perfectly behaved clients, who stuck with those Top 20 active funds through good times and bad. Over time, the clients would be pleased with the excess return delivered and might even provide new assets and referrals. However, given the volatile nature of both market and manager performance over the course of those 15 years, consider the likelier reality: During periods when the portfolio significantly underperforms, clients question the advisor's strategy, some pull their assets, and referrals are rare. The further risk to the practice is that in volatile markets and uncertain times, negative reviews can have much more impact than positive referrals. Indexing can help alleviate this asymmetry by truncating the risk of unwise investor behavior and negative feedback loops for the practice.

On top of this notable benefit, passively managed funds can help reduce (sometimes significantly) the all-in portfolio costs to the client and potentially increase tax efficiency. Moreover, adding a slice of passively managed funds or ETFs can help free up resources typically spent on manager research and oversight. These resources can then be redirected to enhancing relationships with existing clients or to courting new clients.

Finally, the advisor who employs passively managed products may be better able to shift client conversations from the sometimes-difficult topic of investment performance to estate and family wealth planning, which are not subject to the risks of the market. These services can be a more reliable base upon which to build an enduring practice.

References

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