Sungarden Investment Research

The Investing Evolution

ACTIVE vs. PASSIVE MANAGEMENT:

WHY THEY BOTH WIN

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Introduction

Retired and retiring investors may be lulling themselves into a false sense of comfort. They do this by adhering to ideals that were originally postulated many years ago, and which today still have some merit. But they have become clichés to point where their foundation is no longer questioned when it needs to be. They are myths which need to be busted.

Which myth are we busting in this research paper? The one that has made its way from the university research lab to the financial planning profession, then the mass-media, and ultimately became ingrained in the mindset of many individual investors. Here's how it usually goes: *"professional (i.e. active) money managers don't beat the S&P 500 Index. Therefore, it is a waste of time and money to pursue returns through professional managers."* The typical figure we hear is that 90% of managers don't beat the S&P 500 Index, but there are certainly variations.

We studied active management, as represented by the entire U.S.-traded mutual fund universe tracked by Morningstar. As a proxy for the S&P 500 Index, widely regarded as the best single gauge of U.S. equity market, we looked at the performance of the Vanguard 500 Index Fund (which obviously is one member of the larger fund universe we studied). We examined it versus four mutual fund "peer groups": all mutual funds (that is, traded in the U.S. – funds of all asset types were included), all stock (equity) funds, all large cap stock funds and all large cap blend funds as classified by Morningstar. We determined how many of these funds were outperformed by the S&P 500 Index during each of six time periods:

- 15 years ending 12/31/13
- 10 years ending 12/31/13
- The last two bull market cycles (see specific dates below – the second one goes through 12/31/13, though it obviously has continued through the first half of 2014).
- The last two bear market cycles (see specific dates below)

For the bull and bear cycles, we tried to set their start/end points to the specific date at which the S&P 500 Index hit its ultimate top or bottom, based on daily closing prices. All fund and performance data was sourced from the Morningstar Direct software system.

The two longer-time periods we chose to analyze are significant for particular reasons. The 10-year period starts at the end of 2003, at which point the dot-com bubble was over and the stock market had started to get its legs back under it. The 15-year period goes back to the end of 1998, when the market was becoming extremely narrow. Tech stocks did well in 1999, and that was about it…and then the first internet bubble ended, with the S&P 500 Index falling three years in a row (2000-2002). These are important parts of these time periods because it is easy to forget today, in the midst of a 5 year bull run in stock prices, how bad things can get.

Survivorship Bias

Using the Morningstar Direct system allowed us to identify any funds that were operating during the time periods studied, but were not open for the entire period. So, if a fund closed down or merged (which often happens due to sustained poor performance), it was included in the study, and was ranked below all funds that did exist for the entire period. Many studies of this type include only the funds that are alive today. This can artificially reduce the number of funds the index (or any other surviving fund) outperformed, since many losers drop out of the rankings altogether. By including ALL funds that existed during the period (even for just a small portion of it), our study is free of "survivorship bias."

Here is a summary of the results:

Percentage of Mutual Funds Outperformed by Vanguard 500 Index Fund (symbol VFINX)

Time Period Studied	Specific Date Range	All Managers	Equity Only	Large Cap Only	Large Cap Blend Only
15 Year Annualized	12/31/1998 -12/31/2013	59%	48%	57%	61%
10 Year Annualized	12/31/1998 - 12/31/2013	71%	56%	68%	68%
Bull Period	10/09/2002 - 10/09/2007	63%	39%	51%	54%
Bull Period	3/9/2009 -12/31/2013	80%	66%	81%	85%
Bear Period	03/24/2000 - 10/09/2002	34%	50%	53%	51%
Bear Period	10/09/2007 - 03/09/2009	38%	59%	53%	59%

Past performance is no assurance of future results; investing in equity markets involves risk, you could lose a significant portion or all of your original investment. See **Important Information About Study** on Pages 8-9.

What We Found

This data shows that **the conventional wisdom on active management vs. S&P 500 Index investing has not been accurate for some time. In reality, they BOTH have usefulness. How they are used should depend on the attitude of the investor, and their opinion about what the most significant investment time frame is to them (and not anyone else!).**

Specifically, there were no time periods in which the S&P 500 outperformed 90% of mutual funds. The index was a middle-of-the-road performer in most of the 24 separate time period/peer group combinations we studied. There is a noticeable tendency for the index to perform better than its active peers during friendlier market environments. During the two bull periods, the index outperformed 80% and 63% of its peers. However, during the down market cycles (bear), the index beat only 34% and 38% of its active management competitors. This is one of the most consistent conclusions we have seen in this and other studies – that active managers, in the aggregate, are effective in curbing some of the losses in the worst of times.

Critics of active management (and oh, there are many!) may look at this data and say that comparing the S&P 500 index fund to all funds instead of just that fund's true peer group is not a fair fight. We think there is some merit to that…yet so often the claim is made that the index beats "active funds" without being specific as to which set of active funds they mean. As this information is disseminated to the non-professional investor, those investors are dealing with incomplete information, and they form opinions based on it. That is dangerous to their wealth. Our study showed that even when we narrowed the peer group from all funds, to all equity funds, then to large cap funds and finally to large blend funds, the relative performance of the index fund did not change dramatically.

When we averaged all 24 combinations of time frame and peer group, the index beat about 60% of funds. That is certainly competitive. But does it make the index the undisputed king of the mountain? No way.

Surprising Company in Our Conclusions

Two studies from a pair influential advocates of passive investing reach similar conclusions. This may come as a surprise to the "index funds are the only way to invest" crowd. But *in "The Truth About Top-Performing Mutual Fund Managers,* by Aaron S. Reynolds, (AAII Journal, July 2011), the author cautions that "Perspective Is Important." Over short periods of time (under five years) active manager performance is inconsistent – the winners don't stay winners from quarter to quarter or year to year. However, by extending the holding period to five years, the managers were able to add value almost 75% of the time. Over seven-year holding periods, more than 80% of them beat their benchmarks.

In *"The Active-Passive Debate: Market Cyclicality and Leadership Volatility"* published by Vanguard Investment Counseling & Research (2009), the authors note that "the market environment can have a greater impact on relative performance than manager skill or even cost differences." This helps explain why our study showed a clear tilt toward active manager outperformance during rough market periods. The environment matters. And as of this writing, stock markets are near all-time highs, global interest rates near generational lows and global central banks have pumped money into the economy at an alarming rate in recent years. In response to this, we think many investors should be considering how important investment process and control over one's outcome (which is a feature of active management) can be.

Final Thoughts

1. **Active and passive management each have potential benefits to investors.** It is NOT a slam-dunk victory for either side. It has more to do with individual preferences and the market environment.

2. **The "90%" claim cannot be substantiated within the most relevant periods we studied over the past 15 years.** The data speaks for itself. There may have been other periods where active fund manager performance was a basement-dweller over significant time periods, but those likely occurred during rabid stock bull markets.

3. Before deciding on whether to employ active management, passive management or a combination, investors should first take a good look in the mirror and, at a minimum, determine these things:

    a. **What do they truly want out of their investment portfolio?** The further they are from their objectives, the more likely chance that indexing may play a helpful role. For those living off of what they have built or within five years of that point, even if they are still in "growth mode," active management is more likely to provide a cushion should markets prove difficult between now and the start of retirement.

b. **What is their personal performance benchmark?** For some it is all about keeping up with the stock market. Others focus on the return they (and their advisor, if they use one) agree is a sensible annualized target. If follows that if this target is achieved, they expect to live comfortably from the portfolio and their other retirement cash flow sources. The more well-heeled investor will simply decide that as long as they can tag along and get a piece of the good markets, but play excellent defense as an overriding priority, they are very content. Bottom-line: different investors define "winning" very differently. This is yet another reason why passive and active management have found their fans over time.
c. **What is their likely reaction to the occasional stomach-turning drops that accompany long-term equity investing?** There are different ways to test for this. Some are useful, others are really just "CYA" moves for investment compliance departments to feel they "know their client." More important than either is the investor's self-evaluation. Just as with seeing a doctor for an ailment, the doctor's efforts are only as good as the patient's ability to communicate about what they feel.
d. **Regarding investment "time horizon," how many and which time periods are most significant to them.** Think of this as an investor's *"allocation by time horizon."* For example, an investor may decide to put the heaviest emphasis on the results of each 3-year period, and somewhat less emphasis (but not zero) on longer-term (e.g. 15 year) periods. A portfolio can be created taking that into account (using index funds, active funds, or as we do at our firm, individual stocks and ETFs). This approach may help balance their desire for return versus fear of loss and long recovery periods. We think this is a better perspective from which to plot your portfolio management strategy, versus "letting it all ride" on what may or may not happen over next decade or two.
e. **If the portfolio is being used for regular cash flow for lifestyle needs, what is the preference for how that cash flow is delivered?** Do they fund those needs in whole or part via portfolio income-generation, or are they OK with regular principal withdrawals. The latter course will likely involve taking money out of a recently-depreciated portfolio, whenever the stock market is falling.

Can't We All Just Get Along?

Our hope is that our efforts will return the active-passive management issue to a healthy discussion and debate, which it used to be before it became a Yankees-Redsox-style ranting, mock-fest. More importantly, we hope the individual investor who questions the prevailing wisdom in this area, but cannot find the evidence to support their concerns, will have something to point to as they attempt to make the most informed decisions they can.

When we discuss the conclusions of this study with investors who are die-hard indexers, the most common response is that while active managers may outperform the index in certain periods, finding a manager who outperforms over a long period of time is a losing effort. To be clear, ***this research paper is NOT about whether one can choose active managers well. It is about showing that indexed investing is often a middle-of-the-pack performer and thus should be considered alongside a variety of active strategies in determining which path suits you best.***

This study also strengthens our already strong belief that investment **process is a key part of evaluating any investment strategy or manager**. Indexing is one process, and there are seemingly an infinite number of active management processes available. **Finding a philosophical match is what investing is all about for the investor. Identifying investors that philosophically match one's style and process is what investing is all about for the money manager.**

Adding Bonds No Longer a Remedy

The extension of the active-passive donnybrook is that by diversifying your portfolio with bonds (passively-managed of course), you can create something of an "all-weather" portfolio. Back in January of this year, we produced a 20-year study of such a concept. The Sungarden Study, as it is called, is also available at www.hedgedinvesting.com.

We looked pretty hard to find the conditions that make the index fund a superior performer to its peers. We tried four peer groups, looking for the investment equivalent of a fancy ice cream sundae, a banana split, or even chocolate fudge brownie. Instead, we found mostly vanilla.

We welcome your comments, feedback and suggestions at info@sungardeninvestment.com , calling 954-315-4680 or by contacting Rob Isbitts via LinkedIn.

Important Information about Study

This commentary is provided for informational and educational purposes only. The information, analysis and opinions expressed herein reflect our judgment as of the date of writing and are subject to change at any time without notice. They are not intended to constitute legal, tax, securities or investment advice or a recommended course of action in any given situation. All investments carry a certain risk and there is no assurance that an investment will provide positive performance over any period of time. Information obtained from third party resources are believed to be reliable but not guaranteed. Sungarden Investment Research offers investment advisory services through Dynamic Wealth Advisors.

Using only Morningstar data, the Study compared the performance of Vanguard 500 Index Fund Investor Shares (VFINX) to the performance of the following groups of mutual funds:

- All mutual funds traded in U.S. (all funds, regardless of style, which existed for part or all of the period studied were included. No such funds were excluded from the analysis).
- All mutual funds traded in the U.S. and classified by Morningstar as All Equity
- All mutual funds traded in the U.S. and classified by Morningstar as Large Cap Growth
- All mutual funds traded in the U.S. and classified by Morningstar as Large Cap Value

In cases in which more than one share class existed for a fund, we used the oldest share class as identified by Morningstar. The table on page 10 displays the number of funds analyzed for each time period and peer group:

Vanguard 500 Index Fund Investor Shares (symbol: VFINX) is a large cap mutual fund which seeks to track the performance of the S&P 500 Index. It remains fully invested in large capitalization growth and value stocks. VFINX is used in the Study as a representation of the S&P 500 Index. The performance of VFINX does not always track the performance of S&P 500 Index. See Vanguard.com for more information on VFINX.

The Standard & Poor's 500 (S&P 500) is an unmanaged group of securities considered to be representative of the stock market in general. S&P 500 is widely regarded as the best single gauge of the U.S. equities market and includes a representative sample of 500 leading companies in the foremost industries of the U.S. economy and provides over 80% coverage of U.S. equities. It is a market value weighted index with each stock's weight in the index proportionate to its market value. Indices are unmanaged and investors cannot invest directly in an index. The performance of indices do not account for any fees, commissions or other expenses that would be incurred. If fees and expenses were included, performance would be lower than represented. For more information on S&P Dow Jones Indices, please visit www.spdji.com

Mutual funds are sold by prospectus. Please consider the investment objectives, risks, charges, and expenses carefully before investing. The prospectus, which contains this and other information about the investment company, can be obtained directly from the Mutual Fund

Company or your financial professional. Be sure to read the prospectus carefully before deciding whether to invest.

Past performance is no assurance of future results; investing in equity markets involves risk, you could lose a significant portion or all of your original investment. Prices of mid- and small-cap stocks (and mutual funds that invest in them) often fluctuate more than those of large capitalization stocks.

Sample Sizes

Number of Funds Analyzed		All Managers	Equity Only	Large Cap Only	Large Cap Blend Only
15 Year Annualized	12/31/1998 - 12/31/2013	4075	2196	1026	380
10 Year Annualized	12/31/1998 - 12/31/2013	5085	2890	1392	505
Bear Period	03/24/2000 - 10/09/2002	4335	2419	1157	426
Bull Period	10/09/2002 - 10/09/2007	4987	2920	1401	510
Bear Period	10/09/2007 - 03/09/2009	5859	3244	1515	565
Bull Period	03/09/2009 - 12/31/2013	6092	3354	1528	566
Number of Funds that Shut Down or Merged					
15 Year Annualized	12/31/1998 - 12/31/2013	1410	760	382	151
10 Year Annualized	12/31/1998 - 12/31/2013	1485	896	479	181
Bear Period	03/24/2000 - 10/09/2002	1465	851	446	174
Bull Period	10/09/2002 - 10/09/2007	1611	1033	538	206
Bear Period	10/09/2007 - 03/09/2009	1256	1522	392	153
Bull Period	03/09/2009 - 12/31/2013	1091	660	326	119
Percentage of Funds that Shut Down or Merged					
15 Year Annualized	12/31/1998 - 12/31/2013	35%	35%	37%	40%
10 Year Annualized	12/31/1998 - 12/31/2013	29%	31%	34%	36%
Bear Period	03/24/2000 - 10/09/2002	34%	35%	39%	41%
Bull Period	10/09/2002 - 10/09/2007	32%	35%	38%	40%
Bear Period	10/09/2007 - 03/09/2009	21%	47%	26%	27%
Bull Period	03/09/2009 - 12/31/2013	18%	20%	21%	21%

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