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Active Management Under Siege

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As data continues to accumulate that reinforces the growing consensus of the superiority of passive indexing strategies over active management, the defenders of the old guard are fighting back. They are cutting fees, shuttering underperforming strategies, and merging businesses in order to reduce costs. The pressure is severe: according to Morningstar Inc., some $1.2 trillion has been withdrawn from actively managed U.S. stock funds since the start of 2007, while nearly the same amount has moved into passive U.S. stock funds over the same period.

Active managers have argued that performance needs to be measured over a long time frame in order to observe the value added by stock pickers. But a recent Wall Street Journal article[1] cited just-published research from S&P Global that showed that <u>82% of all U.S. funds trailed their respective benchmarks over the 15 years ended December 2016</u>. Among large-cap managers utilizing the S&P 500 as their benchmark, only 8% outperformed over the same time frame.

In the last few years, the financial gurus on Wall Street have introduced a number of new strategies designed to benefit from the trend toward passive strategies. Collectively known as smart beta strategies, these products combine the mechanical nature of passive exchange-traded funds (ETFs) with different "tilts" in order to beat the passive index. These tilts might include, for example, owning only stocks with more stable revenue growth, higher dividends, or a far more obscure combination of many factors that, through their analysis, have been shown to beat the market in the past. According to a recent Bloomberg article[2], more than $500 billion was invested in these smart beta equity ETFs at the end of February 2017.

The explosion in computing power has allowed financial analysts to test thousands of possible combinations of historical data in order to crack the code of beating the market. The results are less than convincing. According to the same Bloomberg article, Vanguard calculated in 2012 that these designer ETFs did great on their backtests, outperforming the market by 10 percentage points a year on average in the five years before they went live, but then underperformed the market by 1 percentage point a year in the five years afterward. The most complex strategies suffered the biggest drop-off from their backtests, according to an article in the Journal of Portfolio Management.

This analytical work can sometimes result in very strange outcomes. Besting the monkey throwing darts approach to active management, one of the conclusions from a study of United Nations data revealed that the **best predictor of S&P 500 performance was butter production in Bangladesh.**

Nothing lasts forever in financial markets, so it is reasonable to expect that active managers will one day again have their day in the sun. Is it possible that one day indexed assets will grow to such a level that active managers can exploit the pricing anomalies that arise from too much money in passive strategies? Yes, but it is hard to say when that tipping point may occur, and according to Horizon Kinetics, as of year-end 2015, indexed equity mutual funds and equity ETFs still only comprised about 35% of all actively managed equity mutual funds and ETFs.

So, for the time being, the lower cost and tax efficiency of passive strategies continue to make for a difficult hurdle to jump for active managers. We are sticking with the winner.

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Bruce is a Managing Director and Director of Portfolio Research at the firm. Bruce rejoined Ballentine Partners in June 2016 after more than 5 years as Chief Investment Officer of City National Rochdale, LLC, in Los Angeles. City National Rochdale, a wholly owned subsidiary of City National Bank, serves family clients across the United States with a staff of nearly 100 investment professionals. Before moving to Los Angeles, Bruce served as Chief Investment Officer of Ballentine in our Waltham office for three years. Prior to that, Bruce spent four years with Morgan Stanley Private Wealth Management in New York and eight years with Glenmede in Philadelphia as Chief Investment Officer and Portfolio Manager. n addition to working directly with a number of family clients, Bruce serves on Ballentine's Investment Management Committee, which is responsible for the oversight of all of the investment activities for the firm. Bruce received an MBA with a concentration in Applied Economics from George Washington University and a BS degree in Business Administration from Penn State University. Bruce holds the Chartered Financial Analyst (CFA) and the Certified Private Wealth Advisor (CPWA®) designations. He lives with his wife in Palm Beach Gardens, Florida.

[1] "Indexes Beat Stock Pickers Even Over 15 Years", *The Wall Street Journal,* April 13, 2017, https://www.wsj.com/articles/indexes-beat-stock-pickers-even-over-15-years-1492039859

[2] "Lies, Damn Lies, and Financial Statistics, *Bloomberg,* April 6, 2017, https://www.bloomberg.com/news/articles/2017-04-06/lies-damn-lies-and-financial-statistics