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The Active versus Passive Investing Debate

There are many hotly debated issues today. Nationalism versus globalization. Internet privacy versus national security. School choice versus public schools. Medical marijuana versus recreational marijuana. Active investing versus passive investing.

Active versus passive investing—what's that all about? Active investment managers, like our firm, put a lot effort into analyzing financial markets, global economic activity and specific securities. The end result is focused portfolios that we like all active managers expect to appreciate over time. Passive investors say research is not worth the time and money. Passive managers simply create widely diversified portfolios to replicate a popular index like the S&P 500. Without spending on research, passive managers charge less. Over the last several years, passive indices have produced better returns than most active managers. As a result billions of dollars have been moving from active managers to passive index funds.

Passive Investing works especially well for Institutions

We think passive indexing is better suited for institutional investors than for most individuals who, at certain key times, need professional guidance. Although not a new phenomenon, Indexing is currently included in the asset allocation of most endowment and foundations, pension funds boards and other large institutional pools of money for the following reasons:

- These institutions have perpetual time horizons and reasonably predictable cash outflows.
- They are overseen by sophisticated investment committees and boards that have enough knowledge, information, and gumption to remain invested during market declines.
- Most individuals, in contrast, have shorter time horizons, unpredictable cash needs, limited financial market experience, and most importantly intense emotional reactions to the ups and downs of their investments.
    - Individuals have notoriously committed the cardinal sin of investing—selling out during market declines. Some well-known institutions have done the same.

In his latest shareholder letter, Warren Buffett, Chairman of Berkshire Hathaway, castigated institutional investors for investing with high cost "active" managers instead of allocating more money to low cost passive index funds. He specifically took aim at high cost hedge funds and their parasitic enablers, fund of funds hedge funds. His fiery attack on the exorbitant fees and poor performance of hedge fund managers is another wake-up call to institutional boards and their constituencies to employ passive indices more broadly.

Bull markets, like the stock market in the 1990s, have a way of casting a glow on passive indexing. The most recent push towards passive investing comes after eight consecutive years of stock market gains and several decades of higher bond prices. The last eight years have been a perfect backdrop for indexing. In this long running bull market, money chases the better performing passive index managers regardless of the differences in objectives and portfolio construction:

- Bond and stock active managers generally hold cash to meet redemptions, which is a drag on performance when markets are booming and cash returns are zero.
- Many active managers are not paid to beat some broad based market index. They target other benchmarks.
    - Most of Mr. Buffett's vilified hedge funds, for example, invest with the goal of producing absolute, positive returns in all market environments. Hedge funds MAY be less volatile and not correlated with market moves. Hedge funds defend their higher fees by arguing that on a risk adjusted basis their returns are meeting the objectives of the institutional investors and their constituencies.
    - Most active mutual funds have different objectives as well. Many actively managed mutual funds have income as a primary objective and capital appreciation as a secondary goal. In most cases, their compensation is based on beating their peer groups, not a broad based index.
- Most active managers create portfolios that are more concentrated and less diversified than widely diversified passive indices.
    - Poor security selection of even a few positions has a greater negative impact on performance in less diversified portfolios.

Industry trends and technology further promote passive investing

There are several trends in the individual money management industry that are accelerating the move to passive indexing.

- Changing business models at brokerage firms has led to more indexing.
    - The decline in commission rates generated by trading individual securities was a factor in moving to a fee based model of charging on asset levels. Without the incentive to trade individual securities, brokers have found it easier to use passive index products.
    - After being criticized and fined for putting clients into their own, higher cost actively managed mutual funds, brokers have also been forced to embrace better performing, lower cost passive index funds.
- Brokers are leaving large national firms in groups to become independent Registered Investment Advisors.
    - These new teams become fiduciaries as Registered Investment Advisors, which requires them for the first time to put clients' interests first.

    - There is no longer any monetary incentive to invest client money into in-house mutual funds enabling them to act as "conflict free" advisors to their clients. Indexing fits the bill as a way to offer a diversified, low cost portfolio to clients.
- Online "wealth management" shops are targeting and attracting small investors with low cost investment options. This trend holds the promise of providing diversified, low cost index funds to individual investors, particularly investors who prefer to connect with a computer than a human advisor.

What these new business models share in common, other than a greater use of passive vehicles, is that they are designed to accomplish two objectives:

- Improve revenue growth by allowing brokers/advisors to focus primarily on asset gathering not spending time evaluating the complexity of financial markets.
- Insulate the brokers/advisors from client criticism and accountability for investment decisions by creating widely-- some say wildly-- diversified portfolios across global stock and bond markets.

Do-it-Yourself Passive Investing is a riskier choice for individuals

Mr. Buffett concludes his recent shareholder epistle by saying that "both large and small investors should stick with low-cost index funds". This is where we part company with the billionaire, who ironically made a fortune for himself and shareholders as an active investor. As Mr. Buffett states in his letter "human behavior won't change" and that is the reason that do-it-yourself indexing, or investing without professional guidance, is a risky endeavor for individuals.

- Large institutional boards are comprised of individuals with a wealth of investment information and experience--individuals are left with CNBC.
- Behavioral economists have proven that individuals are ill suited for calmly watching the value of their investments decline. Individuals are creatures of "loss aversion", which means they hate losing money more than they like making money.
    - **When individual investors start losing more money than they can afford to lose, they cash in their chips and sell--usually at the worst possible time.** Hence, the untimely capitulation that marks the bottom of bear markets and the confirmation of the great cardinal sin of investing.

The evidence of self-defeating actions is not a myth, it is in the numbers—individuals do not actual earn index returns. In a 2015 report, Morningstar, the independent expert on fund investing, calls this divergence in returns the "behavioral gap". This gap is measured by comparing *time weighted index returns* to the *dollar investor weighted returns* that investors actually earn. Individual investors evidently put more money into passive indices when markets are bubbly and withdraw money under pressure when markets are weak. Unfortunately, dollar weighted returns are less than time weighted returns, which are the returns promoted by passive marketers. For the 10 year period ending in 2015 referenced in the Morningstar report, the gap was 74 basis points (or ¾ of 1 percent) per year on the U.S.

diversified funds analyzed. Their data on international funds is even worse for dollar weighted returns. Mr. Buffett is most likely correct that the do-it-yourself indexer will do better than active funds as long as he just "sits still". Unfortunately, angst ridden investors do not just sit still in bear markets—they squirm and eventually sell. His advice to stand pat is solid, but naïve and unrealistic, much like eating in moderation and exercising 30 minutes per day.

The Key for most individuals is not passive or active, but staying the course

The key to long term investment success is not whether you are invested with active managers or passive indices, the key is not selling under pressure. A distinct minority may handle the pressure alone, but many individuals require an experienced advisor with strong convictions to stay the course. Certainly, the ultra-wealthy have enough capital to ride out market declines. Less wealthy individuals with shorter time horizons feel the pressure more acutely as they did most recently in 2008 and early 2009. **It is in bear markets that an investment advisor must earn their fees by convincing these individuals to as Mr. Buffett says "sit still".**

Active investing will keep its appeal with individual investors

The trend towards passive investing in the 1990s ended abruptly with the bear market in 2000. Indexing can lose it allure again for the same reason and many others:

- Indexing obviously does not prevent investors from losing money—the outcome all investors fear.
- Diversification is not effective when markets move in the same direction.
- Risk controls within the indexes are unclear.
  - How exactly do the index compilers that passive investors rely on control sector risk? Remember the 30% energy weightings in the S&P 500 in the 1980s, or the outsized technology "passive" weightings in the late 1990s?
- Some active managers are offering passive funds with an active overlay that may produce better results and with clear risk controls.
- Low fees may not last forever as the two winners in the passive game, Vanguard and Blackrock, become virtual monopolies.

Despite the current flow of money from active to passive, active managers continue to manage the majority of stock and bond assets. We think there are several reasons for this:

- Active management allows the investment manager to customize the portfolio for each client.
  - This customization can be based on risk tolerance, cash needs, tax planning, and diversification relative to the clients other assets.
    - Many individual investors might want a portfolio geared towards less risk than indices provide. Clients often want to have a level of cash for emergencies. Other individuals might actually be looking for higher returns than the market averages may provide. Active managers can target those objectives.
    - Managing capital gains and losses is easier with active management than passive management.

- Active investors have deep investment talent and experience that gives them more investment credibility with clients versus passive managers who have focused their resources on selling and gathering assets. This is especially true during periods of unsettling market turmoil.

The active versus passive debate is lively but to some extent it is a secondary issue, particularly with respect to individual financial management. The central issue for investment success is what does the individual do under intense pressure. If a thoughtful, active advisor for individuals can calm investors during periods of market upheaval then they have earned their fees and the allegiance of their clients.

Robert J. Milnamow
Chief Investment Officer

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