Brinker Capital

Innovative Solutions Series

active vs. passive investing

An in-depth look at each approach and why a portfolio’s success may lie within the compromise.

In this paper, we will discuss

- Which market environments, including that of 2014, may highlight the benefits of **passive investing**
- How **active investing** and educated manager selection can shine during declining markets
- Why Brinker Capital believes in a **careful combination** of both active and passive investing

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Choosing Sides

The active versus passive investing debate has been going strong since 1973, when Burton Malkiel published his book, *A Random Walk Down Wall Street*, which challenged active managers' ability to outperform their indexes over time.

Performance results from 2014 certainly support the argument for passive management; not one broad domestic Lipper universe finished the year with more than half of its managers outperforming their benchmark.

The new year gives investors a convenient anniversary to revisit their active versus passive portfolio allocation decision. Brinker Capital does not see this allocation as an "either/or" decision.

Jack Bogle and Vanguard have built a large enterprise on passively managed index mutual funds and ETFs, but Vanguard also offers a large spectrum of active mutual funds. On the other hand, David Swensen at Yale University successfully runs the university's endowment using significant active management. Yet, he highlighted the benefits of passive investing in his two books – *Pioneering Portfolio Management* and *Unconventional Success: A Fundamental Approach to Personal Investment*. Additionally, the line between active and passive management is blurred with smart beta strategies as quasi-active and index funds are used to make active weighted bets within broad asset classes. The result is that, together, these strategies make up a broad opportunity set from which to construct diversified portfolios.

Given that asset allocation has been found to be the driver of over 90% of the variability of a portfolio's returns, most notably discussed in the paper "Determinants of Portfolio Performance" (Brinson, Hood, Beebower 1985), any discussion of active management without a discussion of asset allocation is woefully inadequate. In the portfolio construction and asset allocation process, Brinker Capital considers the full opportunity set available and utilizes both active and passive investments in client portfolios. We see obvious benefits of both.

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The Case for a Passive Investment Approach

Supporters of passive investing cite several noteworthy advantages

Cost
Perhaps the most solid argument for passive investing is the advantage of lower costs. As noted in the paper "Vanguard's Principles for Investing Success"[1] and Chart 1, lower cost funds tend to outperform their higher cost peers.

If cheaper is better then cheapest would seem best. That most often means passive index funds, with their low expense ratios, and acting as the quintessential diversified buy and hold investment, the lowest transaction costs. Table 1 shows that index funds are, in fact cheaper. In addition, less than 50% of active funds beat their index fund peers over the 10-year period ending 12/31/13.

Chart 1: Average Annual Returns Over The Ten Years Through 2013

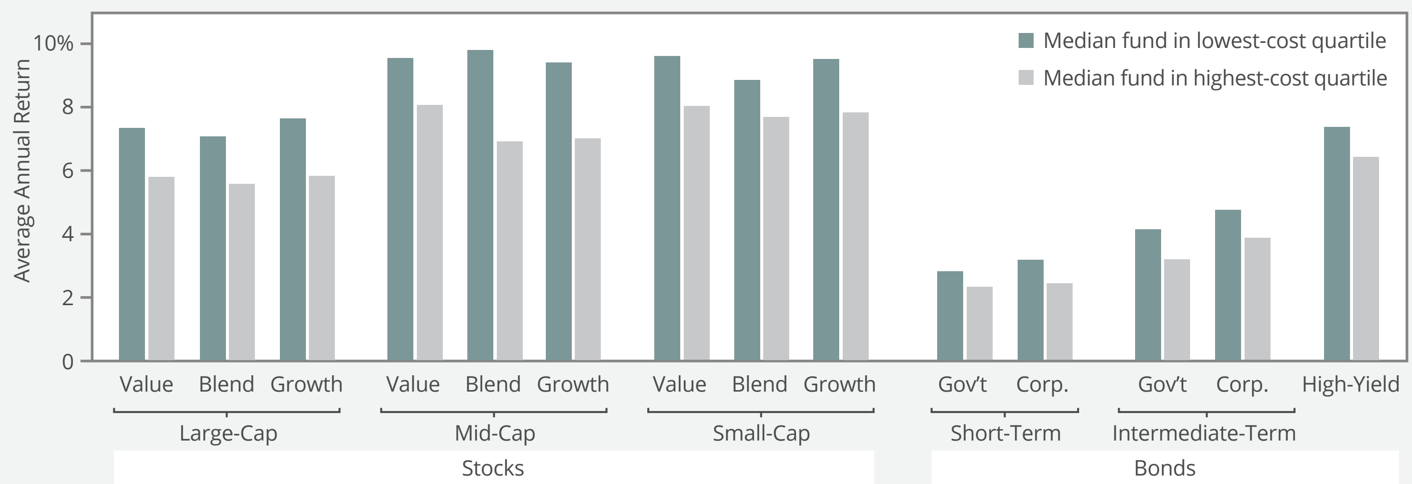


Table 1: Average Expense Ratio as of December 31, 2013

	Investment Type	Actively Managed Funds	Index Funds	ETFs
U.S. Stocks	Large-Cap	0.80%	0.11%	0.14%
	Mid-Cap	0.97	0.18	0.25
	Small-Cap	1.04	0.19	0.23
U.S. Sectors	Industry Sectors	0.94	0.44	0.37
	Real Estate	0.92	0.13	0.20
International Stocks	Developed Market	0.91	0.17	0.29
	Emerging Market	1.16	0.21	0.42
U.S. Bonds	Corporate	0.58	0.11	0.13
	Government	0.47	0.12	0.15

Chart 1: Source: Morningstar and Vanguard, 12/31/13. Vanguard calculations, using data from Morningstar. All Mutual funds in each Morningstar category were ranked by their expense ratios as of 12/31/13. They were then divided into four equal groups, from the lowest-cost to the highest-cost. The chart shows the ten-year annualized returns for the median funds in the lowest-cost and highest-cost quartiles. Returns are net of expenses, excluding loads and taxes. Both actively managed and indexed funds are included, as are all share classes with at least ten years of returns.

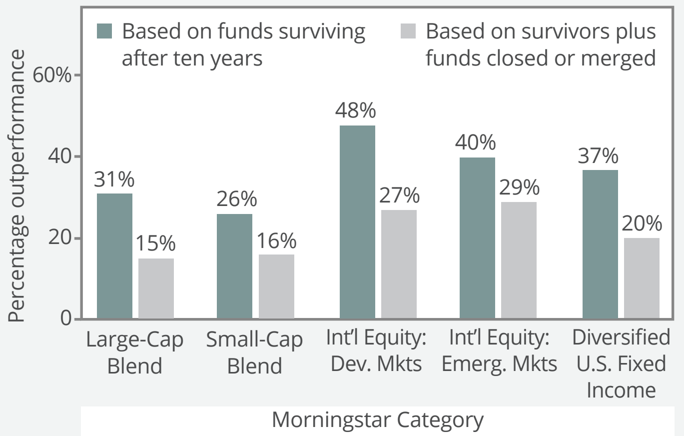
Table 1: Source: Morningstar and Vanguard, 12/31/13. Vanguard calculations, using data from Morningstar. "Asset-weighted" means that the averages are based on the expenses incurred by each invested dollar. Thus, a fund with sizable assets will have a greater impact on the average than a smaller fund. ETF expenses reflect indexed ETFs only. "Active ETFs" were excluded because they have a different investment objective from indexed ETFs.

[1] Vanguard's Principles for Investing Success, 2014.

Tax efficiency

The gross return on an investment is not the number that represents how much money an investor has earned. Taxes must also be considered and can have a significant impact. Given that passively managed investments are often used as buy-and-hold strategies, the amount of executed trades within those investments tend to be significantly lower, yielding lower portfolio turnover and less realized gains and losses to be taxed. Chart 2 calculates the total tax costs of 823 active funds and 52 index funds and illustrates that 75% of the index funds have lower tax costs than actively managed funds.

Chart 2: Index Funds Have Lower Tax Costs Than Actively Managed Funds



Sources: Morningstar and Vanguard. Data cover the ten years ended 12/31/13. The actively managed funds are those listed in the respective Morningstar categories. index funds are represented by those funds with expense ratios of 20 basis points or less as of 12/31/13. All returns used were for the Investor share class.

Cash drag

Active managers tend to hold more cash within the investment when compared to their passive counterparts. Active managers are continually striving to uncover the next opportunity while index funds are mandated to stay fully invested in their stated index. This gives active management the ability to act quickly when the next opportunity presents itself as well as providing a tailwind during a down market environment. However, given that the S&P 500 Index has been positive for 20 of the last 25 years (1/1/90 – 12/31/14), cash often represents a performance drag on active manager performance. It should be noted though, that for the five years that the S&P 500 Index was down, the cash holdings helped boost the performance for active managers.

The zero sum or the total-equals-the-sum-of-the-parts argument

Moving beyond the costs, tax efficiencies and cash drag advantages of passive investing, there exists a hypothetical mathematical argument that also speaks to its continued relative success. This argument, paraphrased from William F. Sharpe's paper, *The Arithmetic of Active Management*[2] and John Bogle's book, *The Little Book of Common Sense Investing*,[3] is represented in Chart 3.

Chart 3: Zero Sum Game

1 The market (M) is collectively invested in (P) passive market-weight indexes and (A) everything else. Mathematically, this is expressed as M = P+A.

2 Each security in the market represents a specific X% of the market. Therefore it must also represent X% of the sum of (P) passive and (A) active assets in the market. Mathematically, this is expressed as X (M) = X (P +A).

3 The market weight index also holds each security with an X%. As a result, the active proportion of the market must also in aggregate hold each security at an X%. Mathematically, this is expressed as X(M) = X(P)+X(A).

4 If, in aggregate, the passive and the active proportions of the market hold each security at the same X%, then the return of each proportion of the market is the return of the market less costs.

5 If active investing is more expensive than passive investing, then passive investing will win in aggregate.

The biggest assumption supporting this argument is that everything is measured in aggregate. Since no one investor owns all of the active managers in aggregate, the active management experience solved for the above doesn't represent any one investor's experience. Many active managers can and do outperform. Similar to very skilled poker players who consistently walk away from the table ahead, they maintain a win even if the overall table experiences a zero sum game.

The conclusion is that selecting an active manager without doing the proper due diligence is not the best way to invest.

2014 was a good year for passive

It has been a challenging year for active funds versus their broad Russell Market Cap benchmarks as shown in Table 2. Among domestic equities, only small cap core and small cap value managers kept up with their stated benchmarks.

Table 2: Percent of Managers in Lipper Universes Outperforming their Index in 2014

	Value	Core	Growth
Large Cap	11%	20%	28%
Mid Cap	9%	13%	10%
Small Cap	46%	46%	23%

Source: FactSet

[2] Sharpe, William. ***The Arithmetic of Active Management***. The Financial Analysts' Journal. Vol. 47. No. 1, January/February 1991. pp. 7-9. [3] Bogle, John C. *The Little Book of Common Sense Investing*. Hoboken: John Wiley & Sons, 2007.

The Case for an Active Investment Approach

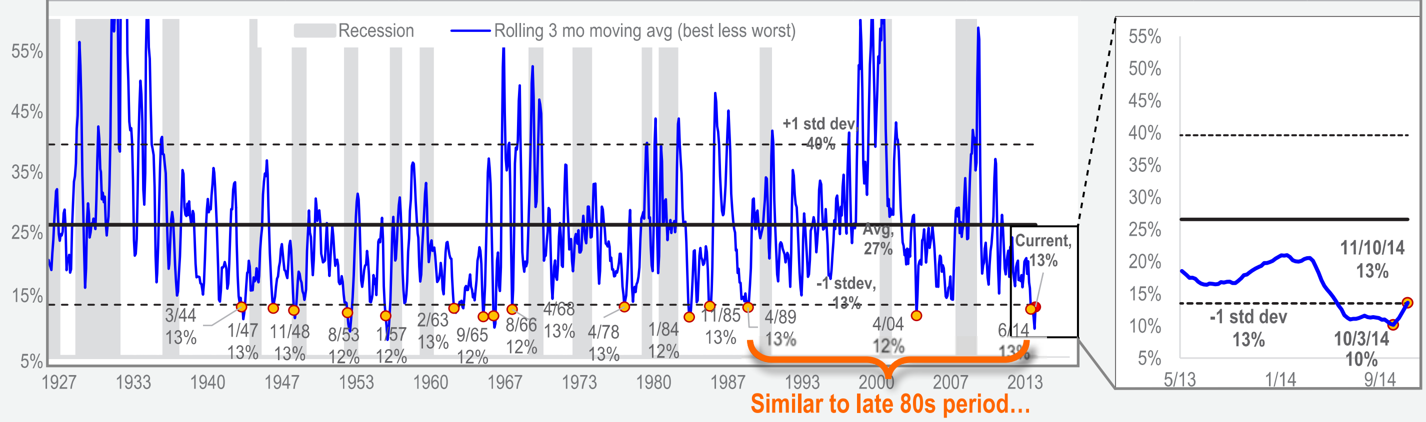
So is that it? Has active management lost the battle to the index advocates? Should we all stop betting on the talents of stock pickers? Well, not so fast.

In 2014, one of the major detractors to the active manager's ability to outperform has been historically low sector dispersions. In other words, when all sectors are performing at about the same level, it is difficult to add value by picking sectors that are meaningfully better than the rest. In fact, Chart 4 illustrates October 2014's three month average dispersion of 9.6% as the third lowest recorded and the lowest since 1953. In order for active managers to surpass a passive index, active managers need to pick stocks that will differ from the average and perform positively.

Thankfully for active management, as shown in Table 3, there has been a very strong tendency for sector dispersion to revert to the mean. During the six months following each period, dispersion has moved more than one standard deviation from the long-term average. Because there has been correlation between sector dispersion and the percentage of active funds that outperform, history suggests that sector dispersion should increase and active managers should see a significantly improved opportunity to shine in 2015.[4]

Chart 4: Top 10 Narrowest Dispersions. Rolling 3-Month Moving Average Dispersion (Best Sector Less Worst Sector)

	1	2	3	4	5	6	7	8	9	10
Date	3/57	11/53	10/14	9/66	5/44	12/48	1/84	9/65	4/04	4/63
Dispersion (3 mo avg.)	7.8%	9.2%	9.6%	9.8%	11.1%	11.3%	11.5%	11.5%	11.7%	12.2%



Source: Fundstrat Global Advisors, Bloomberg, Fama/French

Table 3: Dispersion Historically Widens to 25% in the Next 6 Months Following a -1.0 Standard Deviation Move

		1	2	3	4	5	6	7	8	9	10	11	12	13	14	Avg.
Dispersion: Rolling 3 months moving average (best less worst)	Date	3/44	1/47	11/48	8/53	1/57	2/63	9/65	8/66	4/68	4/78	1/84	11/85	4/89	4/04	
	Low/Starting Value	13%	13%	13%	12%	12%	13%	12%	12%	13%	13%	12%	13%	13%	12%	**12%**
	3mo fwd	12%	16%	15%	9%	9%	13%	22%	18%	36%	18%	15%	20%	19%	21%	**17%**
	6mo fwd	19%	20%	19%	16%	20%	14%	37%	17%	40%	29%	22%	48%	31%	24%	**25%**
	Change: 6mo fwd vs. Low/ Starting Value	554bp	674bp	595bp	381bp	805bp	106bp	2575bp	492bp	2743bp	1579bp	1085bp	3472bp	1772bp	1223bp	**1290bp**

Source: Fundstrat Global Advisors, Bloomberg, Fama/French

100% of the time, dispersion has risen after reaching 1-std deviation lows...by an average of 1,290bp...

Returns to long-term average of 25% or so...

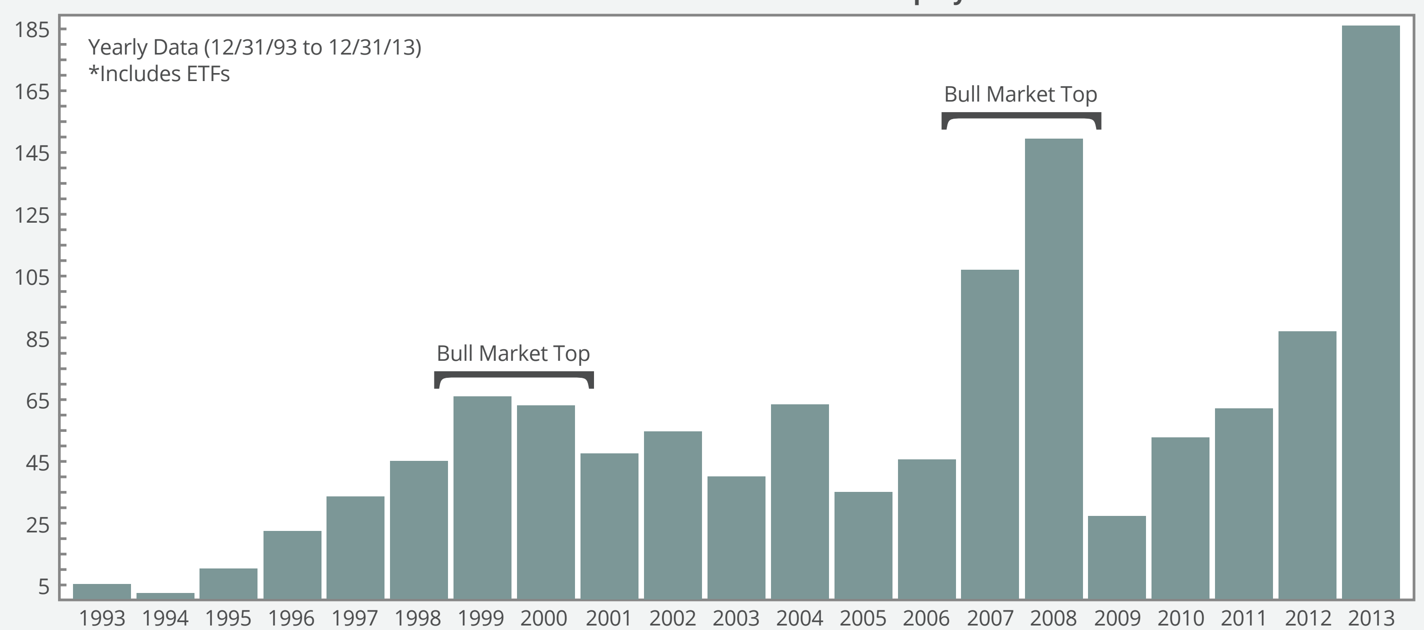
[4] Fundstrat Global Advisors. FLASH: The Case for active manager performance to improve in 2015, 11/14/14.

Additional reasons to consider active managers as a part of a long-term portfolio was noted by Ned Davis, a prominent research provider, "I am not down on passive index investing for some people. And in fact, just during bull markets, it is almost impossible to beat passive investing because hedging usually hurts performance in bull markets, as do transaction fees on switching stocks. But during bear markets, active managers and hedgers nearly always beat passive investing. Investors really need to look at their own psyches and a full cycle to see which investment style suits them best."[5]

In other words, active management tends to earn their place in portfolios during down markets more than up markets. With this thought in mind, Ned Davis in Chart 5 points out that large flows to index funds correlate with past market tops. Record inflows to domestic equity index funds in 2013 and 2014 further advance the case for active management in 2015 and suggest the potential for a market correction.[6]

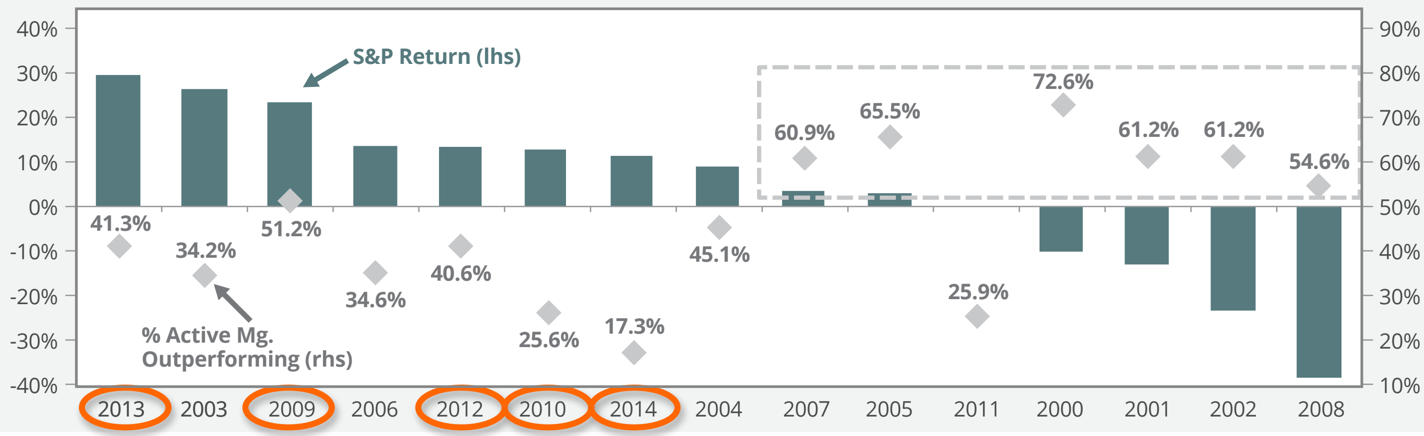
Research provider, Strategas, has also independently made this down market/active management correlation observation. In Chart 6, the highlighted box shows strong active management years during recent negative performing years for the S&P 500 Index. Further it is noted that five of the last six years have seen high single or double digit returns in the market, the most difficult environment for active management to distinguish themselves.[7]

Chart 5: Net New Cash Flow into Domestic Equity Index Funds



Source: Investment Company Institute, www.ici.org

Chart 6: Annual S&P 500 Index Performance vs. Percent of Active Managers Outperforming
(Sorted by Annual S&P Performance High to Low)



Source: Strategas Research Partners

[5] Ned Davis Research Group. "Can Passive Investing Be a Sentiment Indicator" (11/26/2014). [6]"Ned Davis Research Group. "Active versus Passive" (11/24/2014).
[7] Strategas. "Factor Analysis in the Aid of Active Management A Focus on Consumer Sectors" (1/15/2015).

Markets are extremely hard to forecast but what is clear is that the past five years have been extraordinary in their headwinds for active managers to outperform. Will these conditions continue in 2015? While possible, it seems more likely to expect a reversion to the mean across these many factors resulting in some above-average opportunities for active management.

The case for due diligence in active management

Even if, over the long run, the aggregate active management space loses to passive investing due to cost, the thoughtful investor need not select an active manager at random, hold forever and hope for the best. Rather investors can look for specific active managers on a case by case basis to determine which have the best opportunity for success. One of the best counters to the passive index argument is the success of those professional investors, such as Warren Buffet, who seem to continually beat the market. If an investor can identify the good active management from the active management herd, the equation changes. It now becomes a comparison of the good active management versus the benchmark rather than all active management versus the benchmark.

Additionally, David Swensen, CIO of Yale's endowment, notes that while passive investing may make the most sense in efficient markets, like larger cap domestic equity, active management has a stronger case in less efficient spaces. Swensen notes, "Active management strategies fit inefficient markets, such as venture capital, where market returns contribute very little to ultimate results and investment selection provides the fundamental source of returns."[8] The more efficient a market is, the less important active management becomes. However, as a market becomes less efficient, active management finds its place. Two more examples are emerging markets and frontier markets.

The asset allocation return driver

Thus far, discussion of active management has focused on comparing an actively managed fund versus the appropriate style box benchmark. However, as Swensen made note of choosing carefully which sectors of the market to use active management, the logical extension is to also be mindful of which sectors of the market to allocate.

There is strong evidence that the most meaningful investment decision in performance differential among portfolios over time is the asset class and sub-asset class decision. The widely cited study "Determinants of Portfolio Performance," Brinson, Hood, and Beebower, noted that the asset allocation of portfolios explained 93.6% of portfolio return difference.[9] This is to say that the decision to be allocated to stocks over bonds, domestic equity over international equity or large cap over small cap trumps the individual fund decision within a market segment. As an example, in 2014 within domestic equity, the Russell 1000 Index returned 13.24% while the Russell 2000 Index returned 4.89%. In International Equity, the MSCI EAFE returned -4.48% as compared to the MSCI Emerging Markets -1.82%. In 2014, while there was no doubt that a few developed international funds that beat a few domestic large cap funds, in most cases, the primary driver of a portfolio's absolute return was the allocation of assets across market segments.[10]

This asset allocation discussion also helps to partially explain active manager underperformance within the large cap equity space. As noted by Michael Goldstein, Managing Partner of Empirical Research Partners, "Non-U.S. stocks comprise a little less than a tenth of domestic funds' portfolio holdings and in the last six years they've created a performance drag of around 50 basis points per annum. In the prior six years, they had added that much to returns." Additionally, these managers tend to hold some small cap stocks. Given that large-cap domestic equity outperformed small-cap domestic equity, international developed equity and international emerging market equity, managers' decision to diversify away from the large-cap domestic equity asset class represented a headwind to 2014 performance. However, over time, these asset class decisions can also be additive to relative performance. As previously discussed, even the most bullish of fund managers always hold some percent of the portfolio in cash to allow for new stock purchases and to make fund redemption requests without forcing liquidation of holding prematurely. In strong equity markets, as was present in domestic large-cap equity, this represents an additional performance headwind. It should be noted that during periods when equity markets struggle, cash is additive to relative performance.

As a result of this broader view of active management, the active versus passive discussion fundamentally changes. The use of any market-weighted index fund may be a passive investment vehicle, but the weight one assigns to it as a part of a portfolio is an active decision of picking one market exposure over another. Putting the attention back on the asset/market segment allocation decision as the largest driver of returns, leads to potentially better and more reliable investor outcomes.

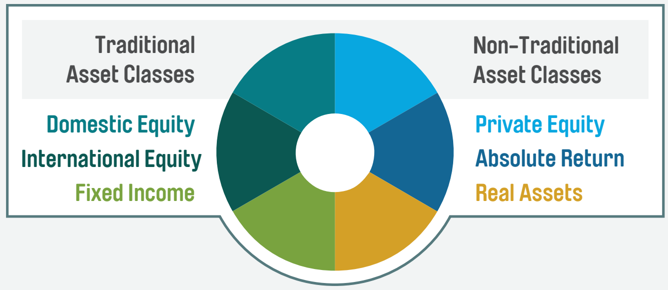
[8] Swensen, David F. ***Pioneering Portfolio Management: An Unconventional Approach to Institutional Investment.*** New York: Free Press, 2009. [9] Brinson, Gary P., L. Randolph Hood and Gilbert L. Beebower. "Determinants of Portfolio Performance." (1985). ***Financial Analysts Journal,*** 39-44. [10] FactSet, 2015.

The Brinker Capital Approach

Brinker Capital is anchored by our multi-asset class approach to investing, adapted from the Yale endowment model.

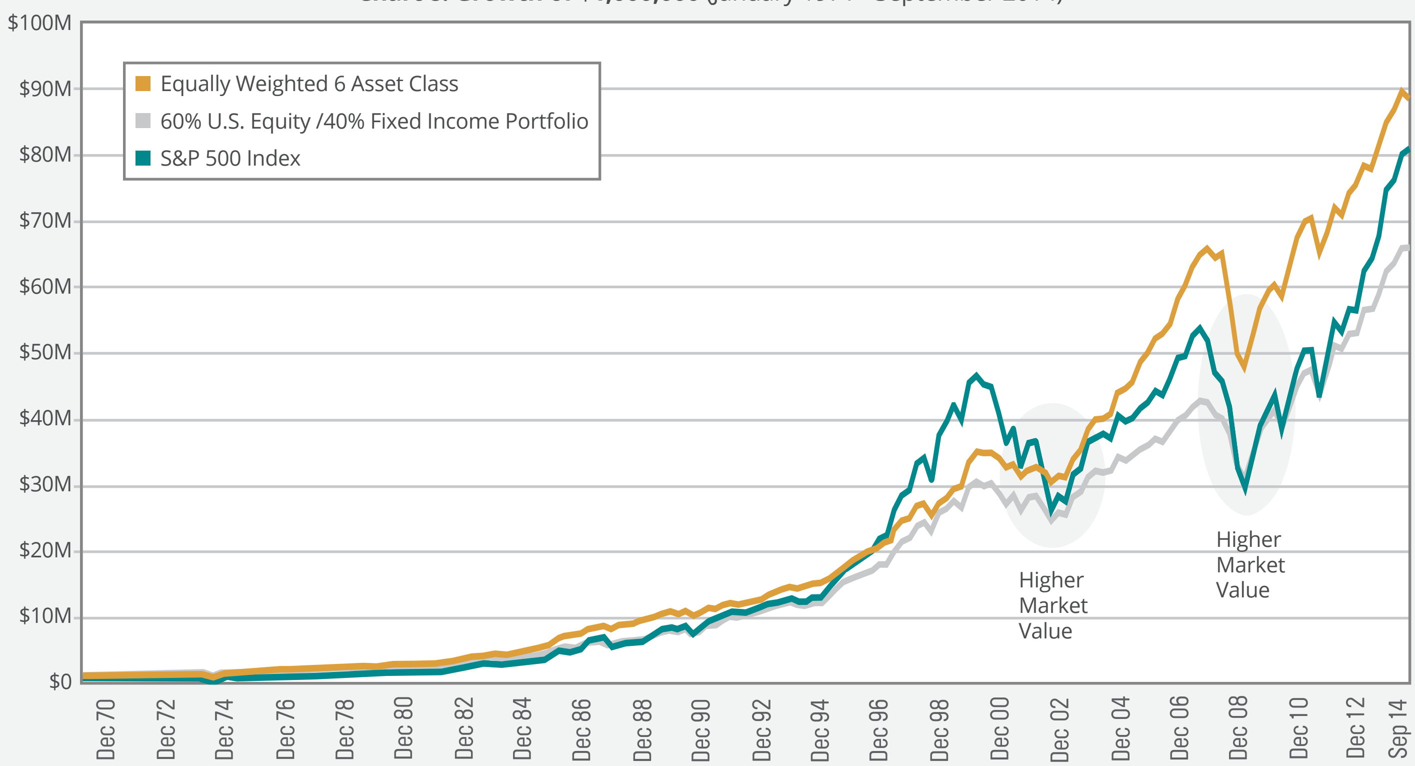
Consistent with Brinker Capital's six asset class methodology, one can also view market exposures as beyond just domestic equity, international, and fixed income, but to also include real assets, absolute returns and private equity as illustrated in Chart 7. This diversification is time-tested and proven to help protect and build wealth to achieve better outcomes for investors as evidenced by Chart 8.

Chart 7: Brinker Capital's Six Asset Class Methodology



Source: Brinker Capital

Chart 8: Growth of $1,000,000 (January 1971 - September 2014)



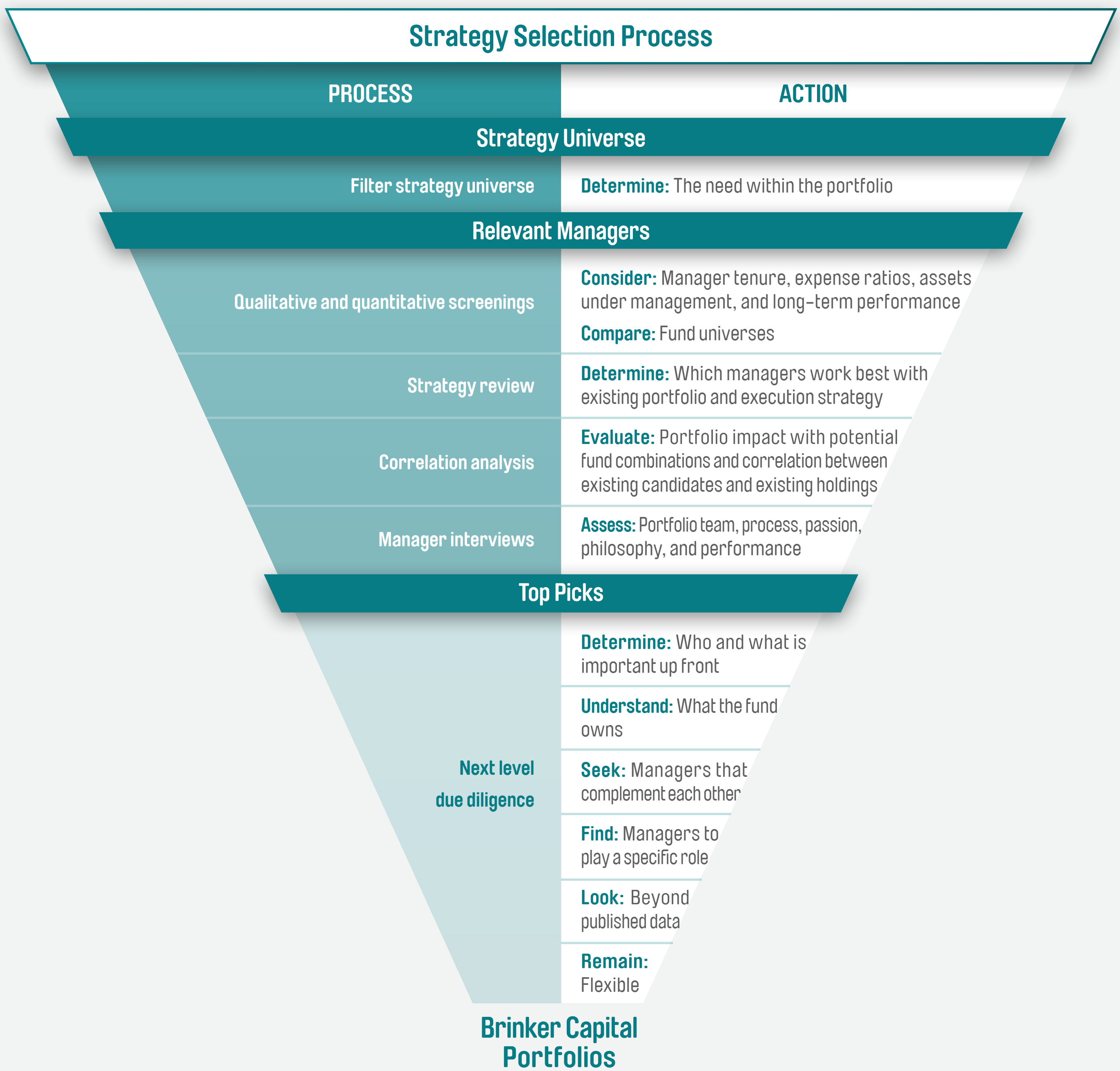
Source: Brinker Capital, Inc., Fact Set, Cambridge Associates, NCREIF. Data from 1/1/71 through 9/30/14. This Growth of $1M chart is for illustrative purposes only. No representation that the results represent performance of actual client accounts is intended. The chart is intended to demonstrate the impact on a traditional portfolio of diversification through the inclusion of additional asset classes over a long-term investment horizon. An investor cannot invest directly in an index. Past performance is no guarantee of future results.

Additionally, alternative factor index funds that previously lived in the limbo between the passive market-weight indexes and the active portfolio manager-run strategies, no longer need to struggle with labeling but rather focus on their risk and return profile. Many alternative market exposures/factors such as spin-offs, momentum, low-volatility/beta and insider buying, have shown to add value over time and warrant portfolio consideration.

At Brinker Capital, we continually look for ways to innovate, searching beyond typical style boxes, common investment classes and popular fund managers to better enhance our strategies. That's why we take an active approach to investing. That may mean capitalizing on inefficiencies, adapting investing styles or implementing strategies to take advantage of new market opportunities. By staying active and diligent, we can help investors pursue their goals without missing potential opportunities.

A rigorous due diligence process helps ensure that every investment decision is made in the best interest of the portfolio as illustrated in Chart 9.

Chart 9: Brinker Capital's Due Diligence Process



Source: Brinker Capital

Holistic portfolio management is a multi-step, top-down decision starting with the asset/market segment allocation decision. This makes sense from a strategic risk tolerance prospective as well as a tactical return enhancing approach. It follows, then, to determine within each market opportunity set, the best way to position this portion of the portfolio. At times, this can be accomplished through the use of an index fund, other times it can be achieved through the use of active fund. As an example, of Brinker Capital's assets under management, currently 16% is in passive index vehicles (as of December 31, 2014). Finally, risk management decisions are made at the portfolio level, rather than insolation of asset classes, as decisions to increase risk taken within fixed income strategies could be balanced by decreasing the risk of strategies held with equity positions.

The bottom line

Active management, especially as an effective asset allocator with due diligence to select those funds with the best opportunity for success within each market opportunity set, makes a strong case for success in 2015 and to remain a positive contributor to long-term investment portfolio success.

Learn more about Brinker Capital's investment approach

- Visit www.BrinkerCapital.com
- Call 800-333-4573 and ask to speak with an Investment Consultant
- Connect with us at blog.brinkercapital.com

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Who we are

At Brinker Capital we implement great ideas with a disciplined investment approach to consistently offer financial advisors forward-thinking solutions intended to achieve better outcomes based on their clients' personal goals.

great **ideas** + strong **discipline** = better **outcomes**

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