BLENDING ACTIVE WITH PASSIVE MANAGEMENT IN STRESSED MARKETS

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Shortly after its onset, COVID-19 managed to push the global economy into a deep, sharp recession and interrupt what had otherwise been a strong start to 2020 for equity markets. In the midst of this upheaval, many organizations are facing financial pressures on multiple fronts. In addition to the challenges of funding and operating their organization in a pandemic, they must also deal with the volatility in financial markets and the prospects of lower returns from their investment portfolios. How do organizations manage to navigate these uncertain times in the financial markets?

One answer may lie in the ongoing debate around active versus passive management: Does it pay to invest in active managers for the chance to outperform the index over time, or is an investor better off keeping costs low and performing in line with an index? We believe the sweet spot is a blend of the two investing styles: active and passive management combined.

INVESTED ASSETS FOR BOTH MANAGEMENT STYLES

Today, about $13.3 trillion in assets are invested in active mutual funds and many trillions more in individual stocks and bonds. Additional assets are invested in derivatives (such as futures) on indices.

This compares to around $8.5 trillion in assets invested in index funds (mutual funds and ETFs), with the vast majority of indexed assets in equities.[1]

WHY A COMPLEMENTARY APPROACH MAKES SENSE

Passive management refers to mutual funds or exchange-traded funds (ETFs) that are built to replicate the returns of a specific market benchmark. A common example would be a mutual fund built to replicate the returns of the S&P 500 Index. Our research shows that active managers in certain asset classes (e.g., mid-cap and small-cap growth) have been able to outperform passive options on average when measured over the long run. It is also commonly accepted that active managers have an opportunity to add alpha (e.g., performance above a benchmark or index) and outperform during periods of market volatility when stock selection matters more.

On the flip side, our research shows that active managers on average struggle in certain categories (e.g., large-cap value) over the long run, and in those categories passive investing makes sense.

While periods of market stress should present an opportunity to investors, we've observed that some institutional investors shy away from active management in favor of the trend towards passive management as they don't feel comfortable with the risk of underperforming the market. Often the assumption is to invest in the index because it's more predictable —by that we mean there's a higher bar if you employ an active manager that must exceed the performance of the index enough to cover the fees they charge.

It is true to say that even the best active manager will experience periods of underperformance from time to time. Combining complementary managers or styles can smooth the rollercoaster ride for investors—such as potentially including an index fund with a more aggressive active manager, for example.

Diversification also plays an important role by bringing complementary managers together that can add value and diversification of investment style to a portfolio (for example, using an aggressive growth manager combined with a growth at a reasonable price or GARP manager) and provide an opportunity to outperform the benchmark.

One common problem active managers face is investors giving up on them too quickly. If you hire a manager that goes through periods of underperformance, stick with them. Don't give up too soon, even if their style is out of favor. Not every manager is going to win every year. Judge their performance over a full market cycle—often thought of as a peak-to-peak period in the market with at least a 15% decline in the middle—based on a five- to ten-year track record.

Institutional investors have the ability to think and act with long-term results in mind, which is the proper way to look at active managers. Often that patience can be rewarded by sticking with a manager through a full market cycle to realize their potential.


RESEARCH REPORT

The Active vs. Passive Management Debate

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It's also important to understand that at market extremes (up or down) is often when the correlations of all stocks converge and diminish the value of stock selection—stock picking doesn't matter that much.

As we saw this past March, investors can panic—they sell everything, and all stocks behave the same. In that environment, all stocks decline together. But in the ensuing recovery, the markets and investors decide which companies will be the winners. This is where the differentiation and benefit of stock selection is seen.

WHY TODAY'S BIGGEST MARKET WINNERS MAY BE RISKY FOR INDEX FUNDS

Many institutional investors are unaware of the significant exposure their index funds may have to some of today's biggest stocks and market winners—thus increasing the risk beyond what many would expect from their index funds.

As we covered in our recent report, "Pandemic Forces New Realities on S&P and Dow Indexes," a very small pool of names is driving the concentration that now exists in the S&P 500 Index®: Facebook, Apple, Amazon, Netflix, Google, and Microsoft (a.k.a. the FAANGM stocks). Consider this:

- These six companies represent roughly 25% of the S&P 500 market capitalization and approximately 20% of the earnings (as of September 30).
- They represent over $7 trillion of market capitalization, up from roughly $4 trillion in April 2020.
- Collectively, these six companies have a larger market capitalization than the combined market cap of the energy, materials, industrial and financial sectors of the S&P 500.[2]

It's important for investors to understand the great impact these largest companies can have on market returns. Evidence of this is clear in year-to-date returns through September 30, with the index returning 5.6% compared with the return of the six FAANGM stocks of 42.6% (and a decline of -2.2% for the other 494 companies in the index). Longer term, a similar pattern exists over the past five years in which these companies have outperformed the S&P 500 Index by 18.5% per year.

While this overwhelming influence feels like a good thing as these six stocks continue to lift market indexes to new record highs, it can be just as scary when those same market indexes drop lower as investors decide it's time to sell. As a result, institutional investors should carefully consider their ability to weather this risk during these volatile times.[2]

FIND THE SWEET SPOT ALONG THE PATH TO SUCCESS

Institutional investors are facing some big challenges over the next five to ten years. Endowments and nonprofits will continue to face fixed income returns below long-term averages, the potential for lower equity market returns due to high current valuations, and a continuing need for funds to spend on their organizational mission.

Organizations will have to come to terms with how their business models are changing and their ability to maintain asset values are changing and focus on ways to earn more on their assets in order to meet spending rates. We believe the key indicators of success for institutional investors will be to:

- Find that sweet spot of blending active and passive management styles.
- Keep a long-term and multi-generational focus, including sticking with an active manager through a full market cycle (peak to peak, for at least a five- to ten-year window).

For more detailed information on the active versus passive management debate, click here to access our special white paper. And contact your Commerce Trust Company Institutional Advisor—or complete the form to find an experienced advisor—to learn more on how to integrate active management with index investing for your organization's specific needs.

[1] Source: Commerce Trust Company Research Group, Commerce Trust Company Research Report, "The Active vs. Passive Management Debate," 2020.

[2] Source: Commerce Trust Company, Matt Schmitt, CFA®, "Pandemic Forces New Realities on S&P 500 and Dow Indexes," September 17, 2020.

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