Fiduciary Focus: Active vs. Passive Investing (Part 5)

W. Scott Simon | 06-30-05 |

Given my suggestion in last month's column that passive investing is the "default" standard for modern prudent fiduciary investing, I though it might be worthwhile to dispel some widely accepted myths of passive investing to help fiduciaries in their understanding.

Myth: *Passive investing is risk-free.*

Reality: Nobel Laureate Harry Markowitz observes: "Risk is risk." Since there's no guaranteed safe way to reap the rewards of investing in financial markets, passive investing is no panacea for escaping investment risk. Passive investing is, however, the best way to rid a portfolio of as much uncompensated risk as possible (and the only way of eliminating the risk of underperforming a given financial market).

But investing passively cannot eliminate the risk of losing money. No amount of diversification--whether done on an active basis or a passive basis--can reduce the compensated risk that's present in all investment portfolios. That's because such risk is inherent in all financial markets. The only way to avoid that kind of risk is to avoid investing.

Myth: *Passive investing is investing just in S&P 500 index funds.*

Reality: Many investors equate passive investing with investing just in S&P 500 index funds. When the stocks of the S&P 500 outperform some other well-known asset class such as small-company stocks, they seem to think that passive investing works. When those stocks underperform, many investors seem to think that passive investing doesn't work. The fact that the large-company stocks composing the S&P 500 underperform some other asset class, though, has nothing to do with the validity of passive investing. It just means that the stocks of that asset class failed to outperform those of the other asset class for the period in question.

Passive investing, then, means more than investing just in S&P 500 index funds. For example, passive investors can invest in funds tracking the entire U.S. stock market. Passive funds are also invested in small-company, midsize-company stocks, and emerging-markets stocks that represent discrete asset classes. Other passive funds provide the performance of asset classes reflecting specific investment styles such as "value" and "growth" stocks. Nor is passive investing limited to stocks. There are passive fixed-income funds that hold corporate bonds, Treasury bonds, or combinations of them with clearly defined standards of quality and maturity.

One of the reasons why passive investing is associated with the S&P 500 is that this benchmark is the most widely used to designate the U.S. stock market. In addition, the first index fund opened to individual investors tracked the S&P 500. At that time in 1976, the S&P 500 was the only part of the U.S. stock market that was sufficiently liquid to index. Since then, the U.S. stock market (as well as other non-U.S. financial markets) has become much more liquid.

Myth: *Passive funds lose more money in market downturns than active funds.*

Reality: Evidence indicates that active funds do not avoid losses in market downturns any better than passive funds. In fact, many active funds experience losses larger than those of passive funds.

An active manager seeks to hold a greater percentage of cash reserves at market highs, thereby exposing a smaller portion of its portfolio to declining values in subsequent market downturns. (Passive funds, in comparison, are required to remain fully invested so they are fully exposed to market downturns.) Conversely, an active manager seeks to hold a smaller percentage of cash reserves at market lows, thereby exposing a larger portion of its portfolio to increasing values during subsequent market upturns.

There's little evidence, though, that active fund managers have the foresight to either a) hold more cash reserves before market downturns or b) hold less cash reserves before market upturns. On the contrary, the evidence is clear that active fund managers consistently hold smaller percentages of cash reserves at market highs (thus exposing a greater percentage of fund assets to market declines) and larger percentages of cash reserves at market lows (thus exposing a smaller percentage of fund assets to market advances).

An example of such behavior occurred before, and subsequent to, the market downturn of 1973-74. Just before that downturn, cash reserves of the average active stock fund constituted just 4% of its assets. This illustrates the failure of active fund managers to maximize cash reserves at market highs to minimize losses when the market subsequently plunges in value.

Just when the market began to recover in 1975, cash reserves of the average active stock fund stood at about 12% of its assets. This illustrates the failure of active fund managers to minimize cash reserves at market lows to maximize gains when the market subsequently soars in value. Note that the market gained over 37% in the first year of the subsequent recovery in 1975.

The fact that managers of active funds typically lower their cash positions during market highs and increase them at market lows seems like just another form of "buying high and selling low." For example, in the summer of 1998 (just before the largest stock market decline since 1987 up to that time), the average active stock fund held cash reserves of less than 5%. These cash holdings were near all-time lows, compared to cash reserves of 13%, close to all-time highs, at the market low in 1990. Similarly, the average active stock fund held cash reserves of 12% of assets in 1982, just prior to the beginning of the extended bull market of the 1980s and 1990s.

The belief that passive funds lose more money in market downturns than active funds, then, does not square with the facts. To the extent that passive funds do

underperform equivalent active funds in market downturns, such margins are relatively insignificant (and transitory) when weighed against the substantial (and ongoing) cost and tax advantages of passive funds in both soaring and falling markets.

An active investor that holds, for example, cash reserves of 10% in a 20% market downturn avoids two percentage points of loss. While this is advantageous, a passive investor can save about the same amount every year (in both down and up markets) because its portfolio costs and expenses are about two percentage points less than the typical actively managed portfolio.

Myth: *Financial markets would become inefficient if all investors became passive.*

Reality: There are a number of reasons why it's highly unlikely that this would happen--at least within the next 1,000 years.

First, human nature ensures that many investors will continue to believe that they (or someone they hire) can beat the market. The investment information system has an enormous financial self interest in feeding and sustaining this belief. This isn't going to change.

Second, most money continues to be actively managed, despite the increased popularity of passive investing in the 1990s. The amount of money held by passive stock funds in that period inched up from only 6% to 8% of the money held by all stock funds. If, after such a favorable period, passive investing couldn't make any greater inroads, then it's difficult to understand how passive investing is going to dominate financial markets.

Suppose, however, that reality was suspended and all investors suddenly became passive investors. Once that happened, stock, and bond prices would begin to diverge from their "true" underlying values. Note, however, what Nobel Laureate Merton Miller says: "I know people will say, yeah, but if everybody invested passively, who would discipline the corporations [i.e., ensure that corporate stock prices are close to their underlying values]? Well, as I explained earlier, the few people who are willing to spend the money to do it. And they will get enough extra returns to compensate for their costs. But that's about it."

Who are those "few people" Miller is talking about? One group of people would be managers of the companies that issue such stocks. Another group would be managers of competing companies who are always faced with the question of whether they should invest in more real resources (e.g., factories, machines, and distribution networks) or just buy all the stock of the competition and take over its real resources. A third group of people would be market makers who want to ensure that stocks are priced efficiently. In a world where all investors are passive investors, then, there would still be plenty of groups of people interested in making sure that the market prices of stocks reflect their underlying values efficiently.

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He is a member of the State Bar of California, a Certified Financial Planner® and an Accredited Investment Fiduciary Auditor™. Simon's certification as an AIFA™ qualifies him to conduct independent fiduciary reviews for those concerned about their responsibilities investing the assets of endowments and foundations, ERISA retirement plans, private family trusts, public employee retirement plans as well as high net worth individuals.

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