

# Active vs. Passive? It Doesn't Matter.

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How the Debate Misses the Point



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The debate between stock-picking active and index-based passive management has been raging for years. So far, the momentum is all on the side of passive managers. BlackRock, Vanguard, and State Street occupy the top spots on the AUM tables, each passively managing trillions of dollars. Meanwhile, traditional stock-picking active managers<sup>1</sup> have been hemorrhaging assets. According to Morningstar research<sup>2</sup>, U.S. passive mutual funds added \$492bn in 2016, whereas active managers have shed \$204bn. These numbers are for open-ended mutual funds and don't include ETFs or the shift in institutional assets, where the same trends are underway.

Each side makes valid points:

<b>Active Management argues...</b>	<b>Passive Management argues...</b>
Passive investing doesn't allow for the efficient allocation of capital	Active management has very high fees
There is no attention paid to valuations, fundamentals, etc.	Few active managers outperform their benchmarks after fees
Passive has no chance of outperforming the benchmark	Identifying active managers likely to outperform is difficult

In the end, however, it doesn't matter.

**Active or passive: *It doesn't matter.***

The argument is largely futile because it misses the point for two reasons.

## **Relative vs. Absolute Performance**

First, the active vs. passive argument is about relative performance, not absolute performance. There will be differences between the relative performance of active and passive managers, but absolute performance reveals the gains and losses experienced. Out of these two measurements, which one would an investor prefer?

By focusing on differences measured in basis points, the investor risks losing the forest for the trees.

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<sup>1</sup> For the purposes of this discussion, "active management" refers to stock-picking strategies that seek to outperform a given benchmark through superior stock selection, rather than any type of top-down sector rotation or tactical asset allocation strategy.

<sup>2</sup> Morningstar Asset Management Quarterly, 1Q 2017

## **Systematic Risk: the 800-pound Gorilla**

Second, the active vs. passive argument mainly focuses on fees, asset allocation, and outperforming the benchmark. But what do they offer for mitigating market risk? How does an active management approach or a passive management approach help reduce risk exposure?

The choice between active and passive managers becomes irrelevant because both active and passive managers are heavily exposed to systematic risk. This is the biggest risk an investor faces, yet neither side really addresses it.

## **What Does Risk Look Like?**

While many investment professionals define risk in terms of volatility or relative performance, the perspective of most investors is different. Most investors define risk in terms of simple capital preservation. Market risk represents absolute risk: the risk of catastrophic loss or the risk of running out of money.

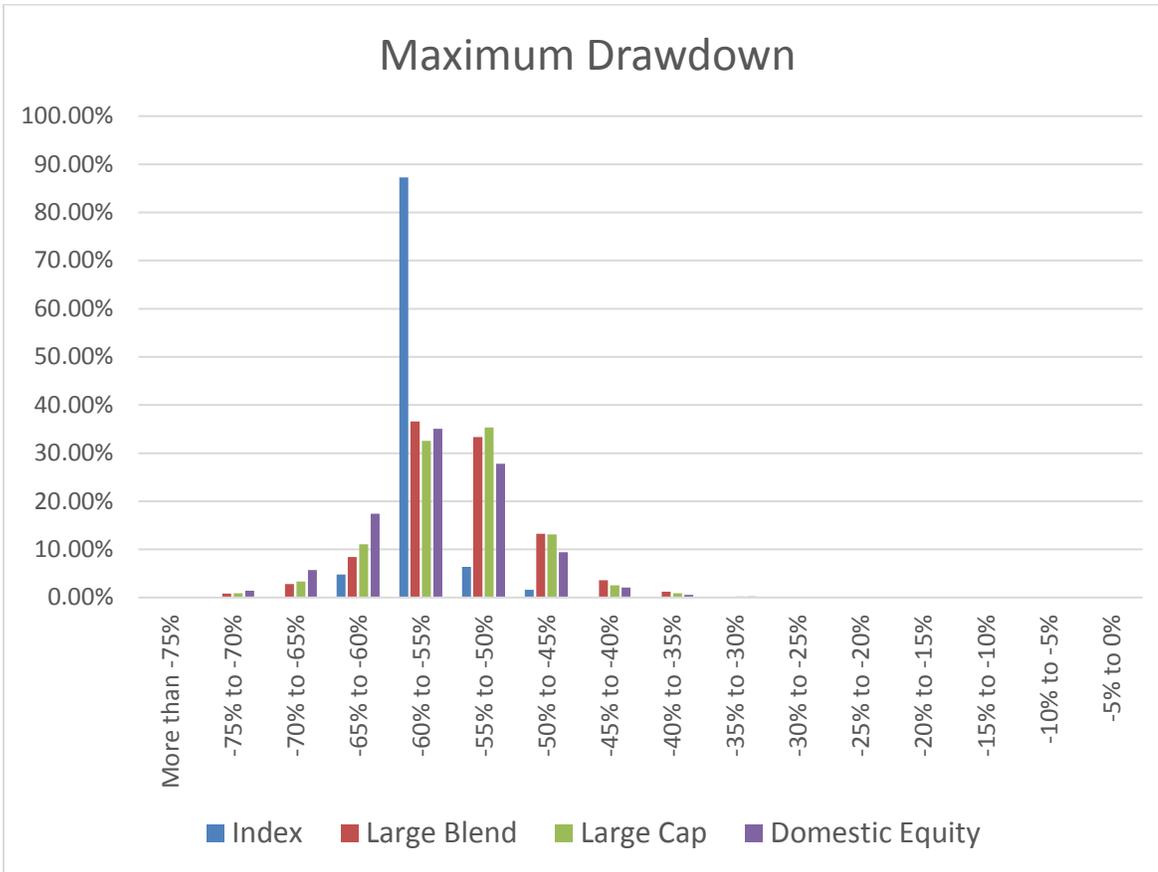
In the graph below, we examine how systematic risk impacts the following classifications of managers<sup>3</sup>:

1. Index funds within the large cap blend space
2. Active managers classified as Large Blend by Morningstar
3. Active managers classified as Large Value, Large Growth or Large Blend by Morningstar
4. Active managers across all nine Morningstar style boxes - Large, Mid, and Small and Value Blend and Growth

From peak-to-trough, how much did these managers lose? When the markets collapsed between mid-2007 and early-2009, were any of the funds in this study successful at mitigating the losses?

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<sup>3</sup> The field of managers was scrubbed to include only those funds with an inception date prior to January 1st, 2007. Also, duplicate share classes were removed, leaving only the primary share class.



Source: Morningstar Direct, Swan Global Investments

During the Financial Crisis of 2007 to 2009, the vast majority of passive and active funds lost over half their value in a very short time span. Only one fund out of 1,451 was able to lose less than 25%. This is the impact of systematic, market risk: losing big.

When things go wrong, the relative advantages or disadvantages in the active vs. passive debate are rendered irrelevant.

## **The Best Way to Address Risk Directly**

The bottom line is that traditional, stock-picking active managers will not be able to stock-pick or market time their way out of systematic risk during a full-blown bear market.

Moreover, a passive manager is systematic risk by definition. If the market sells off by 30%, 40%, 50% or more, an index manager is designed to go down with the ship because a passive manager is entirely 100% systematic risk.

If systematic risk cannot be diversified away, it must be hedged away. An investment approach that does not address risk directly is an incomplete one. By not losing big, investors may better situate themselves for long-term gains; therefore, investors should worry less about fees and outperformance and instead focus more on risk defense. Until that happens, the active vs. passive debate is inconsequential.

Our stance and an analysis on the impact of systematic risk on four types of strategies are explored in depth in our white paper "[Losing the Forest for the Trees: How the Active vs. Passive Debate Misses the Point.](#)"

#### About the Author:



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