



## Letter to the Editor re Passive versus Active Management

April 8, 2008

The following letter is in response to our article last week: [Collective Wisdom, Financial Markets, and Investment Lessons from Google](#)

Dear Editor:

By the author's own admission - even if the peers used have defects - it's not significant that the Vanguard S&P index fund outperformed 78% of all diversified large stock funds. The real story is in the 22% it didn't outperform. And this issue is obviously related to return as it gives no reference to MPT statistics. It is time for a reality check based on what we have found to be consistent with the statistics cited in the article.

Using index funds is certainly an easy way for advisors to get out from under the investment manager selection conundrum. An advisor can never be wrong with an index fund. The advisor provided a "market" return minus costs and expenses - which costs frequently include a low fund expense ratio but a high advisory fee, 1%, 1.5%, even more. It is unlikely that any advisor can make up this value drain by the asset allocation policy alone. After all, good asset allocation practice really results in lower risk (standard deviation), which can be measured and controlled, but also results in whatever return the "market" gives in any period, which is not controllable.

Identification of asset managers that exhibit certain traits can lead to identifying those managers that occupy the 22% (or, in our experience, about 20%) of active managers who regularly beat their index and peers if the appropriate index is selected and the peer group is truly rational and representative of the asset class in question.

In response to this article we ran a short [report](#) in the large US blend asset group, in which the Vanguard index fund resides. We compared and measured the results against the Federated Capital Appreciation fund ("A" share). The index used was the S&P 500 index. The peer group was the InterServ® Large Blend peer group. The period was 03/01/1998 through 02/29/2008. The results demonstrate that advisors can identify funds that beat their peer groups and deliver positive alpha.

We selected this particular fund because it has a *significantly* higher expense ratio than the index fund, 1.3% compared to .18%, so it obviously can't be expected to outperform the index or the index fund. In the 3-year trailing rolling period the S&P 500 index was at the 36th percentile of the peer group and the Vanguard index fund was at the 39th percentile. The Federated fund was at the 15th percentile of peer group. In the 5-year trailing rolling period the index was at the 24th percentile of peers, the Vanguard fund at the 30th percentile of peers and the Federated fund at the 42nd percentile. Interestingly enough, in 10 years the Federated fund was at the 2nd percentile of peers, dwarfing the



index and the Vanguard fund. In the trailing 1-year period the fund also blew away the index and the index fund at the 7th percentile of peers.

Now that is only *one* part of the story. The other side is the "value added" side or "alpha". Both funds had virtually identical betas, rounded at 1.0, to the index. However, the Federated fund posted significantly lower semi-variant deviations in the 2, 3, and 5 and year trailing periods. The Federated fund also posted a positive alpha of 1.3% in the 3-year trailing period and 3.6% in the 2-year trailing period while the Vanguard fund posted a consistent -.1. This means that a 3-year ride in the actively managed fund not only produced a 1.42% higher return than in the index fund, but compounded the investment dollar over that period at a 1.4% higher rate for 3 years and 3.7% over the last 2 years. And this takes place in an "efficient" segment of the market, large cap US stocks. Consider the value added opportunities that exist in less efficient market segments - mid caps, small caps, and foreign equities - just to name a few.

Examining the behaviors of asset managers that have delivered excess returns and positive alphas is the key to selecting managers who are more likely than not - if those behaviors are maintained and repeated - to continue to outperform their correct indexes and peers. Maybe it's time for advisors to add value both by creating appropriate asset allocation strategies to solve for their client needs, and by identifying asset managers who are more likely to add value through their management process (positive alpha). Success with both endeavors will offset advisory fees and expenses and will result in meeting forecasts and objectives net of fees. Identification of managers that add value through their process can create significantly more wealth for the investor. See the last slide in the report attached. After all, using an index fund unalterably dooms the investor to always underperform the index by the sum total of all expenses and costs.

Finally, if the manager selection process is sound, the monitoring process must be equally sound. Managers do "revert to and through the mean". The sooner this observation is made the sooner active and ardent monitoring will allow a timely replacement decision to be made.

Respectfully submitted,  
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