One of the most common questions that we’ve heard/received from clients over the past year has been our view on active versus passive management. Active management has come under significant pressure due to its underperformance relative to passive over the past few years, particularly in the very competitive US large cap space, as well as the broader theme of fee compression in the industry. This theme is well illustrated by mutual fund flows over the past couple of years. According to Morningstar, passive fund strategies in the U.S. experienced inflows of $505 billion in 2016, while active funds saw outflows of $340 billion. Will this trend continue, or will active management again have its day in the sun? (As we are an active manager ourselves, we have referenced third party consultant research for this piece).

Factors Benefitting Active for Six Strongest Signals
What Matters in Assessment of Active vs. Passive?

There are a number of factors which tend to influence the relative performance of active vs. passive management. These factors include metrics such as the performance of U.S. small caps minus U.S. large caps (positive number typically favors active management) and the relative performance of positive earning companies minus negative earners (again, a positive number typically favors active management). The above chart from Leuthold Weeden highlights some of these factors. It is somewhat remarkable how quickly these factors have changed in favor of active management after appearing to bottom out in late 2015/early 2016. One can see from the chart that active vs. passive performance tends to be cyclical and that these cycles tend to last at least a couple of years.

Callan Associates, a consultant, has calculated where the S&P 500 Index ranks relative to its peer group of active managers in the large cap universe on a one-year rolling basis (to illustrate, a ranking of 50 means that the S&P 500 index is right in the middle of peer returns and a ranking of 20 means the S&P 500 ranked higher than 80% of fund managers). This chart illustrates the extent to which passive management has outperformed active management over the past five years. It again shows the cyclicality of active and passive relative performance.

Percentile Ranking of the S&P 500 Index in an Active US Large Cap Universe - One-Year Rolling Periods

Source: Callan Associates

In light of all this, we advocate a thoughtful portfolio construction approach which uses a combination of active and passive. Too often, the discussion seems to be an all or nothing proposition. Active managers differ substantially in the amount of risk (tracking error) they take, turnover, cost etc. Passive funds can differ widely on cost, the index that they track, and implementation process (i.e. index replication vs. sampling). Additionally there are parts of the market where active management
has proven to be able to add value and/or lower risk and different types of market environments which favor active vs. passive management.

In our multi-asset funds, we utilize a combination of active and passive management. In areas that we believe to be more efficient, such as U.S. Large Cap equities and U.S. Mid Cap equities, we tend to employ more passive exposure. While we are not confident in our ability to predict the precise timing of a “sea change” in performance between active and passive, it appears to us that many factors are lining up in favor of active management.

BMO Global Asset Management - Multi-Asset Solutions Team

Contributors:

Jon Adams, CFA, Chicago

Michael Dowdall, CFA, Chicago

Steve Bell, London

Paul Taylor, CFA, Toronto

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