Active versus Passive: A Flawed and Misleading Study

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The just-released Standard & Poor's Indices Versus Passive (SPIVA) study contains heartening news for advocates of passive management. Among its claims are that the S&P 500 outperformed 68.6% of actively managed large-cap funds over the last five years. Similar results were reported for other style boxes, for other time periods, and for non-US funds. In summarizing the results of the study for US funds, S&P states, "Over longer time horizons, indices continue to outperform active managers."

Reading the headlines from the report, one would conclude that the active-versus-passive debate is over, and the active camp should surrender.

But active management proponents take heart — the SPIVA study is no reason for anyone to get out the white flag. Its methodology is superficial and seriously flawed, and it offers very few meaningful insights into the active versus passive debate.

The SPIVA Study

S&P analyzed the returns for a broad universe of US and non-US actively managed equity funds using data from the Center for Research in Securities Prices (CRSP) database. This is the first SPIVA study to use the CRSP database, which is free of survivorship bias and is frequently used in academic studies. Results are reported as of June 30, 2008.

For US funds, the SPIVA study does a "headcount" analysis, showing the percentage of funds that outperform the corresponding S&P index over 1-, 3-, and 5-year periods. As would be expected, the number of funds beating their benchmark declines as the measurement period increases from one to three to five years. Curiously, a relatively high percentage of all funds beat S&P's broad market index, the S&P Composite 1500. In fact, more than half of active funds outperformed the index over the last year, with slightly less than half outperforming the index over the 3- and 5-year periods.

S&P also performed an asset-weighted analysis across funds, and the results are strikingly different from their headcount analysis. On an asset-weighted basis, actively managed US funds outperformed the S&P Composite 1500 over 1-, 3- and 5-year periods. Actively managed funds consistently outperformed indices at the more granular style-box level over all three time periods. S&P's failure to highlight these results is perplexing.

For non-US funds, S&P makes the identical claim, supported by headcount data they provide, that indices outperformed active funds. Non-US funds are grouped into four categories (global, international, international small cap, and emerging market) and an S&P index is used for benchmarking each category.

As with US funds, the asset-weighted results tell a different story, with active global funds outperforming the S&P Global 1200 index over 1-, 3- and 5-year periods.

S&P also evaluates 13 categories of fixed-income funds, using either Lehman or S&P benchmarks for comparative purposes. S&P notes that, on a headcount basis, indices outperform actively managed fixed-income funds by a greater percentage than either they do either US or non-US equity funds. They offer two hypotheses for this phenomenon: First, that lower liquidity and higher transaction costs affect actively managed fixed-income funds more than equity funds, and second that distributions of bond portfolio returns are much narrower than those for stocks, so a little performance difference can cause a big ranking difference. In particular, it may be that many of the underperforming bond funds missed the index by just a few basis points.

What's Wrong with This Picture?

Academic papers have compared active and passive strategies extensively, so the potential biases and pitfalls in these studies are well-known and have been carefully documented. An article, *Active versus Passive: The Great Debate Continues*, by Dave Blanchett and Craig Israelsen in the November 2007 issue of the *Journal of Financial Planning* specifically identifies the proper methodological framework for an active-versus-passive study.

Unfortunately, S&P chose to ignore this literature, and presented a narrowly focused and highly imperfect analysis.

Here are the problems with S&P's approach:

- S&P chose to highlight its "headcount" results and downplay its asset-based results. Headcount results apply an equal weight to all funds. A fund with $10 million in assets carries as much weight as a fund with $10 billion in assets, and the analysis "ignores the actual assets invested in each fund and consequently the net return to investors," according to Blanchett and Israelsen. S&P performed an asset-weighted analysis, which produced a different result than their equal-weighted analysis, yet they offered no explanation for this inconsistency. At best, we can question the thoroughness of their analysis. At worst, their choice to highlight their headcount results may reveal a hidden agenda favoring the passive side of the debate.

- S&P chose to compare their results to only one set of indices, those maintained by S&P. While S&P's indices are widely used as benchmarks throughout the industry, they are not the only set of indices available. Four other vendors — Morningstar, Lipper, Dow Jones, and MCSI — also provide indices. As Blanchett and Israelsen demonstrate in their article, the choice of index can dramatically impact results. Blanchett and Israelsen also found that S&P's indices were the highest-performing index set over the time period they studied (1997-2006). Thus, by using their own indices, S&P further biased their results toward the passive side of the debate.

- Finally, S&P's analysis implicitly assumes each fund in a peer group can be accurately compared to the peer group benchmark, an assumption which exposes their analysis to classification bias. Peer group providers establish rules for classifying managers as large or small cap, value or growth, etc. and then populate their peer groups with managers meeting these criteria. The lack of similarity among the funds meeting these classification rules means that, when funds hold securities outside of the peer group definition or style drift occurs, classification bias can result. No amount of scrubbing can remove this bias; the only way to avoid this bias is to construct customized benchmarks.

Our purpose is not to take sides in the active-versus-passive debate. Active funds, on an asset-weighted basis, will underperform a properly constructed index by fees and costs. But S&P's approach does not add meaningful insights to this debate. A more thoughtful approach is required.