Morningstar Investment Management Insights

Active *and* Passive: Seeking to add value through investment selection

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For Financial Professionals Only

Key Takeaways

- Active and passive investments have unique benefits; using both takes advantage of the best of each.
- Passive funds can allow us to express investment ideas more nimbly and precisely.
- We believe there's no substitute for active management in certain asset classes, like high-yield debt.

Often investors and their advisors set up active and passive investing as a dichotomy—either seek outperformance from actively managed mutual funds or cut costs with passive investments. However, we find value in making the most of both approaches by choosing the right fit to best express each investment idea.

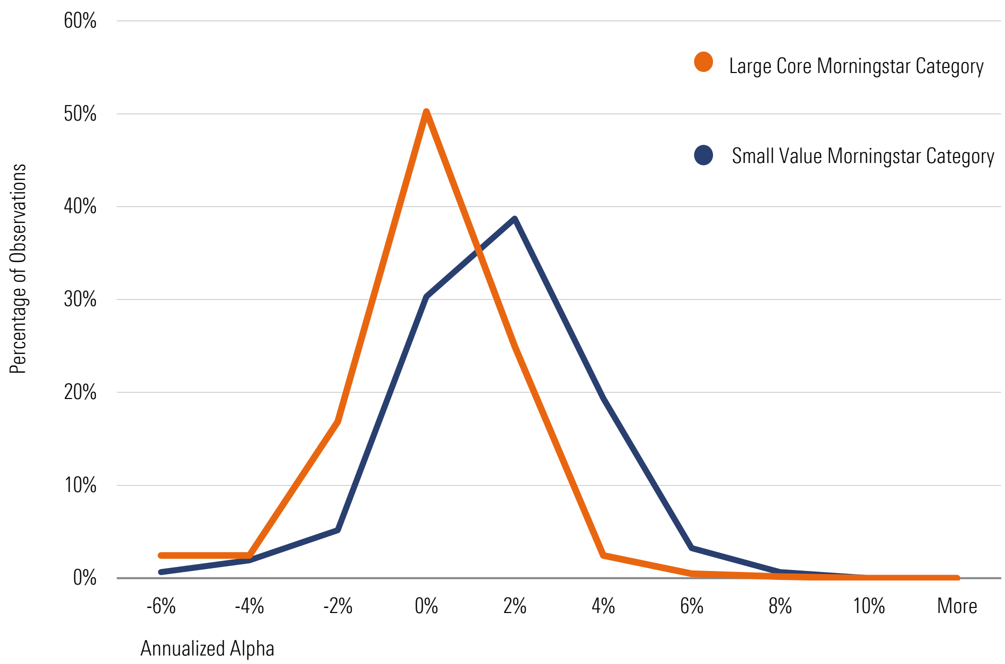
In exploring our philosophy, we use examples to illustrate how an active/passive approach gives us the flexibility to add value through not only the possibility of outperformance or lower costs but through precise implementation of our investment ideas.

The Efficiency Frontier

Early thinking on the active/passive decision was based primarily on the idea that active management has a greater chance to be effective in less-efficient markets. Within the literature, this found in part that the average small-cap manager was both more likely to top its benchmark than its large-cap counterpart, and that the size of the outperformance was also on average higher than that of large-cap managers. Similarly, emerging markets equity managers were more likely to outperform their respective benchmark than developed markets equity managers, and high-yield managers more often bested their benchmarks than did their counterparts.

Moreover, studies also showed that the dispersion among returns for large-cap blend managers was much less than that for other equity asset classes (see Exhibit 1). In fact, many of the asset classes in which the average manager topped the benchmark over the period also showed greater dispersion among managers. This suggested that skilled manager selectors might be able to more easily differentiate between future outperformers and underperformers in certain asset classes, making them better suited to active management than others.

Exhibit 1 Alpha and Dispersion Are Typically Greater for Less-Efficient Markets Like U.S. Small Caps



Source: Morningstar Direct. Morningstar Investment Management calculation from 1 January 1990 to 31 December 2016.

Taking Advantage of Inefficient Markets

We believe this insight needs to be married with the realization that valuations can play a large role in intermediate-term returns.

Over the long term, returns appear to be explained almost entirely by corporate fundamentals (for individual stocks) or the overall economy (for the entire stock market). This led most investors for many years to develop strategic asset allocations based on estimates of long-term returns for various capital markets. The result was asset allocations that made only minor adjustments to asset allocation after significant price increases or decreases. For example, the strategic asset allocation for a portfolio at the beginning of 2007 probably looked only marginally different from that of early 2009.

However, value-oriented investors have long known to “be greedy when others are fearful,” as Warren Buffett famously put it.[1] The upshot of this investment theme is that a security’s (or an asset class’) expected return and its drawdown risk vary with time. To potentially get higher risk-adjusted returns, then, investors should consider buying when risk is lower and expected returns are higher. Said differently, current valuations may help predict intermediate-term returns.

Nobel Laureate Robert Shiller, among the first to study the predictability of stock returns using valuation metrics, found early on that higher returns follow periods of low valuation, and vice versa. Research confirming this finding continued to mount, and the case became compelling that intermediate-term returns are much more affected by valuations than allowed for in a strategic asset allocation approach.

[1] Source: http://www.berkshirehathaway.com/letters/1986.html

New Opportunities in Active/Passive

With the implementation of valuation-based investment views comes the opportunity to improve how investors perceive active/passive investing. Moreover, the investment selection landscape has evolved, including the expansion of the exchange-traded fund market. The incredible growth in assets and continual launch of new ETFs has enhanced an investors ability to express investment views in ways that wouldn't have been possible just five years ago.

Exhibit 2 Combining Active and Passive Gives Us More Ways to Implement an Investment Idea

As investment ideas percolate from the valuation-driven asset allocation process, our first decision is whether we should express the idea via an active manager or through a passive or rules-based strategy. We've found that having the flexibility to implement investment ideas across the active, passive, and strategic beta spectrum can be a very effective way to invest. Because there's few actively managed strategies that focus on a particular region or sector, and even fewer that invest in a single country, the addition of passive or strategic beta products enables us to fine-tune our portfolios' effective exposure to ensure they are positioned to take advantage of our highest-conviction investment ideas.

Where Active Management Still Rules

We note that in some areas of the market, like high-yield bonds, active management still rules. The old efficiency argument still holds true in this regard, so until we see some price and benchmark tracking innovation, we believe the passive core options in high-yield bonds will continue to underperform.
But limited passive product advancement or fee reduction in the high-yield space, as well as liquidity issues, have led us to greater conviction on our active management preferences in this asset class.

How We Use Active and Passive Together

In our portfolios, we balance our use of active and passive to help:

- Reduce liquidity and trading risks;
- Nimbly implement an investment idea; and
- Reduce costs while striving for outperformance.

Again, by combining active and passive, we believe we can take the best of each approach.

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