ACTIVE VS. PASSIVE INVESTING

How the old debate is affecting today's investment strategies

BY JONATHAN BARNES

Equity market troubles have rattled active and passive investment makers alike. Indexed providers, having weathered the downturn, are looking to new indexing alternatives and markets. Active managers, outperforming today, must continue to add value if they hope to compete against the future growth of indexing.

Indexing: Slowed but not Stopped

While benchmarked portfolios have fallen as sure as their indexes, most clients haven't been so quick to abandon their positions.

"Plan sponsors and institutional investors are becoming much more aware of the need to strike the right balance between risk/return and cost," says Francis Enderle, CFA, CIO of the Global Index and Markets Group of Barclays Global Investors. "Even though we've been in a bear market for the past [few] years, indexing still continues to attract assets."

If anything, the market downturn has simply slowed the rush to indexing. The number of U.S. equity index funds increased only 0.4 percent from January to November 2002, compared to a 3.2 percent jump in the number of U.S. active funds, according to Morningstar. Prior to 2002, the growth of index fund numbers had easily outstripped that of active funds — 1,303 percent to 728 percent since 1992 (Table 1).

A market upturn could see a return to that trend. Some even envision a drop in the number of active managers, pushed out by the indexing boom. Not everyone thinks that's a good thing.

"I think it is a concern," says Richard Cripps, CFA, chief market strategist for Legg Mason Wood Walker, speaking about the reach of indexing. "I think it does commoditize what [managers] do. And if you're commoditized, you're going to have to compete on price, and as such, margins shrink. The investment business heretofore has been a very good business with very good margins."

Whether or not that scenario is fully realized, index funds must first face the tests of the current environment. "A lot of clients are asking questions nowadays," says Enderle. "The fall in the market is having an impact on the funding status for [benefit plans]. So plan sponsors are thinking about different ways to try to generate higher returns."

To accommodate those demands, plan sponsors are using alternative strategies such as indexed REITs, indexed high-yield bond funds, and enhanced index funds. Emerging markets, traditionally the domain of the active manager, could be ready for an increase in indexing as well.

Indexing in Emerging Markets

While the number of emerging market funds nearly doubled over the past five years — to 185, as tracked by Lipper — currently only five of those are indexed.

"When people want to invest in emerging markets, the question we often get asked is, 'Should we adopt an index manager or an active manager?'" says Enderle. "Indexing still makes sense even if the asset class is more risky, for a couple of reasons. One is that emerging markets are very costly to transact in, and so if you adopt an active strategy that has a lot of turnover, it can be very expensive."

Enderle says the second reason for indexing in emerging markets is manager selection. He sees a higher penalty for choosing underperforming managers than in developed-country funds.

"The client sponsor *has* to pick the right manager," says Enderle. "If he or she picks the wrong manager, the client sponsor is taking on a lot of risk — manager risk — in an already risky asset class.

"There's a perception out there that [in] emerging markets, there's lots of opportunity to outperform, and therefore, why index? That thought process is flawed given the cost issues or the risk of picking the wrong manager. There should be more assets that are indexed against emerging market indexes, but there's still a perception that indexing isn't the right approach for emerging markets."

Rick Boebel, Ph.D.,CFA, senior lecturer in finance at the University of Otago in Dunedin, New Zealand, doesn't see any single strategy as a clear winner. "I don't think it's easy

TABLE 1

U.S. Equity Funds: Growth of Index Funds vs. Growth of Actively Managed Funds

(LOAD ADJUSTED)

	YEARS PRIOR					
	10YR	5YR	3YR	1YR	Jan.02	Nov.02
Number of Index Funds	36	118	230	464	469	471
Growth from previous period	–	328%	195%	202%	1.1%	0.4%
Number of Actively Managed Funds	994	3527	5086	7087	7235	7467
Growth from previous period	–	355%	144%	139%	2.1%	3.2%

Source: Morningstar, Inc. 30-Nov.-02

to wave your hand and say, 'Active is good for this, and passive is good for that.' There are distinct advantages for each."

With markets such as Korea, Singapore, India, and Thailand in mind, Boebel adds, "When we think of emerging markets, we think that there probably should be some sort of informational inefficiencies there that would give active management an advantage. On the other hand, one of the problems with emerging markets is that typically the stocks are fairly thinly traded, so trading costs can matter a great deal. That gives a bonus for passive investing."

Other Indexed Alternatives

For clients discouraged by index returns, many managers still recommend enhanced index funds (also known as risk-controlled active funds), despite the criticism they've received.

These funds — designed to closely track benchmarks while beating them at the same time — have always had a difficult mandate.

In the 11 months ending November 2002, enhanced fund returns were almost even with their pure-index counterparts (net of fees) — down 16.43 percent vs. a loss of 16.29 percent, respectively — according to Thomson Financial. That isn't much to get excited about, but with a three-year Sharpe ratio of -0.42, compared to -0.85 for pure-index funds, investment planners see promise for enhanced funds.

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> Senior Lecturer, University of Otago
> Dunedin, New Zealand

Another avenue of potential is in hedge funds. While it is still too early to tell, the late September launch of Standard & Poor's Hedge Fund Index could fuel interest in indexed hedge fund products, much as Barclays' 2000 release of approximately 40 exchange traded funds helped propel the current ETF market.

Wherever indexing chooses to expand, active managers must meet the challenge by finding a way — whether innovative or traditional — to add value that is worth the price.

Active Management as Tax-Managed Investing

One area where active managers say they have the advantage — especially in tough markets — is tax-managed investing.

"This is the kind of environment we live for," says Duncan Richardson, CFA, manager of the Eaton Vance Tax-Managed Growth Portfolio, "in the sense that volatility is sort of the friend to the tax-managed manager. We find that volatile markets — ones that are emotional — are the ones where our strategy works best.

"The volatility and emotions often give you great purchase prices. When the short-term anxiety level is high and the fear is high, any little change in the fundamentals can dramatically change stock prices."

Tax considerations alone can boost a portfolio by an average of 2.5 percent in net annual return, according to Richardson. Long holding periods — Richardson looks for at least five years — reduce turnover and capital gains. Down-side volatility, abhorred by most, gives a tax-managed fund the chance to harvest losses and offset gains.

"The fatal flaw of passive investing from an investment professional's point of view is that there's no valuation discipline," says Richardson. "Anybody who is tempted to view indexing as a less risky strategy needs to appreciate that valuation is not a part of the judgment that goes into adding stocks to the index. No valuation discipline can be very dangerous in overpriced stocks.

"When Microsoft was 5 percent of the index, 5 cents out of every dollar of new assets was going into Microsoft, regardless of the price. Not owning Microsoft in the subsequent year allowed you to outperform the benchmark by 300 basis points. Three percent! It's huge."

With the recent U.S. SEC-mandated disclosure of post-tax returns in mutual fund prospectuses, more investors may soon be turning to tax-managed funds.

"About 1 percent of the mutual fund marketplace [is in tax-managed funds]," says Richardson. "The reality is that around 50 percent [of mutual fund assets] are held in taxable accounts. We have only 1 percent that's explicitly tax managed — with the opportunity for 50 percent of mutual fund assets that could benefit from a tax-managed account."

Index and Active Investing: Hand in Hand or Toe to Toe?

In many ways, however, benchmarking has already taken over, if not in actual asset size, at least in mindset. It's a rare active manager who doesn't occasionally look over his or her shoulder and see a benchmark staring back.

With modern portfolio theory driving the trend toward indexing, the importance of security and sector selection have been nearly lost in favor of equity allocation, says Cripps.

"Investors don't like volatility, managers don't like volatility, so they diversify and diversify and diversify their portfolio," he says. "However, by doing that, they're working against the opportunity that any individual sector, industry group, or stock can provide a better return than the market."

Indeed, sectors have been one place where active managers have been showing their skill lately, relative to indexers (Table 2).

Despite that outperformance, last October capped five straight months of net U.S. stock fund redemption by investors, with a US$7.7 billion net outflow according to the Investment Company Institute. Cripps interprets that outflow

as a lack of patience for managers who focus on returns relative to a benchmark, rather than on absolute returns.

"Investors are saying [to active managers], 'What are you doing other than what the market is doing? I see no protection of my capital. All I see is that you're just simply trying to put money in the market. You're not trying to add value by selling when the market is unfavorable and buying when the market is favorable.' As an active manager, at the very least, identify in the benchmark what you don't like, and get rid of those stocks."

With many active portfolios quietly resembling their benchmarks, investors may not be getting quite what they're paying for.

"What [clients] need to do," says Cripps, "is get away from managers who are pieced together from a style box, and go to what are known as holistic managers, who can go across sectors, across the growth/value divide, who can go where the opportunities lie.

"We have a lot of legacy thinking from the bull market that essentially says, 'The market is efficient, you can't beat the market, you shouldn't market time, volatility is bad.' Well, the fact of the matter is that volatility is a necessary component of success — you have to have something fluctuating to make money. There are as many inefficiencies as efficiencies in the market. Critical thinking people, using some discipline, are probably going to be better positioned — if they're thinking independently — to add value than they have been in a long time."

TABLE 2

U.S. Equity Funds: Active Management by Sector vs. Sector Index Funds (LOAD ADJUSTED)

SECTOR	YTD 30-Nov.-02
COMMUNICATIONS	
Index Funds	-67.68%
Active Funds	-42.01
FINANCIAL	
Index Funds	-15.61
Active Funds	-12.63
HEALTH	
Index Funds	-40.59
Active Funds	-29.58
NATURAL RESOURCES	
Index Funds	-29.52
Active Funds	-8.32
REAL ESTATE	
Index Funds	-7.23
Active Funds	-2.57
TECHNOLOGY	
Index Funds	-48.31
Active Funds	-44.72
UTILITIES	
Index Funds	-36.95
Active Funds	-28.70

Source: Morningstar, Inc. 30-Nov.-02

Optimal Portfolio Management

At Barclays, one focus is on the best way for clients to combine managers.

"Historically, there was a lot of debate saying that it was either or," says Enderle. "Should you index or should you [choose active strategies]? We think of all the strategies being along the risk spectrum, with the index strategy having zero risk, relative to an index...enhanced indexing with more risk, and higher risk active strategies as well. And all of them can coexist."

Clients are advised to consider an optimal portfolio of managers — including both index and active managers — that meets their current risk tolerances.

"It's applying the same concept [of asset allocation] in a different way that really helps [clients] answer the question of how they should allocate their money to different money managers," says Enderle.

Some institutions will doubtless take that advice, but others simply find indexing fees as low as 0.02 percent irresistible. "The United States is the most efficient market in the world," says Arndt Nicolaus, CFA, senior portfolio manager for Credit Suisse (Luxembourg). "If you look at the European market — although it's getting more and more efficient — it is very hard to beat a benchmark comprised of large cap U.S. stocks, so it's more attractive to index that part of your portfolio, and that's what many people do."

While global markets and trends certainly shape the direction of investment strategies, the final responsibility for the future may well rest with the individual manager.

"Portfolio managers are in the service industry," says Mark Riepe, CFA, head of the Schwab Center for Investment Research. "They're supposed to provide what their clients are looking for. If clients want to put managers into a box and give them a very narrow benchmark that they're supposed to follow, managers should adapt their portfolio approach in accordance with the mandate they're given.

"If managers think they're better with more free rein, it's up to them to convince their clients that, 'Hey, this is what I think is an appropriate benchmark, this is what I do, this is how I manage money, this is the correct way to evaluate me.'"

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U.S. Equity Funds: Average S&P 500 Index Fund Returns vs. Average Morningstar 5 Star – 2 Star Returns (LOAD ADJUSTED)

	YTD 29-Nov.-02	1YR	3YR	5YR	10YR
2 Star	-25.25%	-18.05	-11.37	-2.93	6.22
3 Star	-22.32	-15.17	-7.70	0.04	8.22
4 Star	-19.63	-12.22	-3.55	2.83	10.08
5 Star	-14.19	-7.15	3.04	7.13	12.07
S&P 500 Index Funds	-21.68	-15.65	-12.27	0.07	9.33

Source: Morningstar, Inc. 30-Nov.-02