April 26, 2017

The Incomplete Debate: Active vs. Passive

The debate around active versus passive management has intensified in recent years. The conversation isn't new, but it's more prevalent now than any time I can remember. Most investors are familiar with the terms active and passive management, but for those that aren't, here's a quick primer:

-Active Management is a portfolio management strategy where the manager makes specific investments with the goal of outperforming a stated benchmark index.

-Passive Management is the opposite of active management. The manager simply attempts to achieve the benchmark return

Prominent investors siding with passive include John Bogle, founder of The Vanguard Group and Warren Buffett, ironically considered by many (including me) as the best active manager ever. Bogle and Buffett have advocated most investors would be best served by owning a low-fee, tax-efficient, diversified index fund – not by attempting to beat the market. Bogle states the facts are on his side and passive will continue to take share from active (recommended reading: *Enough*, by Bogle). Buffett discussed the topic in his 2016 annual shareholder letter, see pages 21-25, although I would recommend reading the entire letter at: http://www.berkshirehathaway.com/letters/2016ltr.pdf. While Buffett extols the benefits of passive management, Berkshire continues to employ only active management in its equity portfolio. Most would say this is another "Buffett contradiction," but I would say Buffett has realized active management can be successfully deployed only under specific circumstances, of which Berkshire possesses (see list on page 2).

Bogle argues the stock market is a closed loop. Some investors achieve a higher return, but in aggregate, investors receive the total stock market return, less fees (advisor and asset management, including: mutual fund, hedge fund, index fund, ETF), taxes, inflation, and transactions costs (trading, bid/ask spread). Investors receive what's leftover – so clearly reducing fees, taxes, and transaction costs is a net win for investors in aggregate. The logic is perfectly straightforward and the math is irrefutable. See the hypothetical example in **Table 1** below.

Table 1

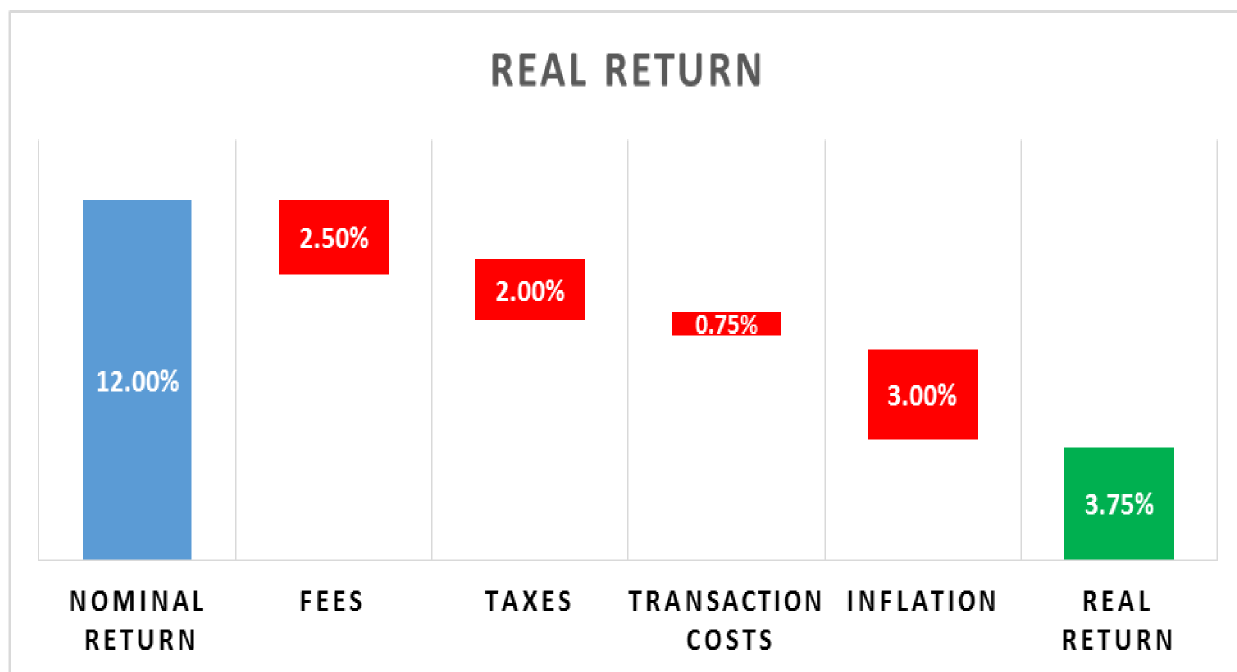

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Table 2 below shows the value of a $1,000 investment for 30 years earning the 12% return, and then subtracting fees, taxes, costs, and inflation, respectively.

Table 2

Rates of Return	12% nominal	9.50%	7.50%	6.75%	3.75%
Value of $1,000 after 30 years	$29,960	$15,220	$8,755	$7,096	$3,017

While it's impossible to completely avoid any of the costs above, mitigating them should be front of mind for everyone. My problem with the active vs. passive debate is it centers on what vehicle investors should employ to achieve investment success: should investors and advisors employ passively-managed index funds or ETFs OR should they employ mutual funds, individual stocks, individual bonds, hedge funds, real estate, private equity or cash? I have seen passive and active strategies poorly executed, and it generally had little to do with investment vehicle – it had everything to do with investment strategy. The vehicle doesn't determine investment success, the strategy does! I believe the appropriate way to frame the discussion is: "There is a right way to invest and a wrong way to invest." Following the list below will ensure investment success. Here is my advice:

1. **Create and Execute an Investment Strategy**: you cannot achieve investment success without a well-considered, patient, disciplined investment strategy. The strategy should consider asset allocation, taxes, distributions, fees, estate planning, illiquid and nonmarketable assets, investor psychology and risk tolerance. Generally speaking, the strategy becomes more complicated as the estate increases and should be reviewed/updated periodically.
2. **Proper Asset Allocation:** I believe asset allocation determines 75% of your investment return and disciplined adherence to asset allocation alone will result in above average results.
3. **Low fees**: fees are a direct subtraction to your investment performance and amount to a significant drag on your portfolio. Don't miss this. Understanding how much you're paying, why, and the corresponding value you're receiving is imperative.
4. **Defer Taxes, Forever**: taxes wreak havoc and should be avoided (legally of course) or deferred as long as practically possible. Most investors calculate gross returns, but forget the check written to the IRS. This is a mistake, investors should understand the tax impact of their portfolio and high-income earners should avoid taxable interest and short-term capital gains. In fact, short-term capital gains should be rare. A benefit to investing in equities is the ability to defer taxes, in many cases forever (as appreciated positions can be gifted or stepped-up at death), while losses can be used to offset gains.
5. **Long-term Mindset**: investors (individuals and institutions) don't take advantage of time. Time is the most important element in compounding. Investors focus too much on last year or the next quarter and not enough on the next decade. The entire investment community is fixated on "breaking news" and minute-by-minute updates and analysis – really? Did the U.S. economy or thousands of businesses operating in it change from yesterday? Did Johnson and Johnson's intrinsic value change overnight? I contest more money has been lost trying to avoid "the next correction" than all the recessions, wars, and bankruptcies put together. My advice: execute and stop thinking about things outside of your control. You cannot control geopolitics and interest rates and stop pretending Wall Street analysts can predict where the S&P 500 will end next year – they can't! And neither can anyone else. And frankly, it doesn't matter unless your time horizon is twelve months, in which case I recommend T-bills or cash.

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6. **Investment, Not Speculation:** transactions costs reduce your return, but more importantly, if you trade a lot, you're probably speculating, not investing. If you cannot quickly summarize the thesis and estimate the intrinsic value of an investment (future cash flows), you're speculating. I'm not saying don't speculate, just limit it and call it what it is. Investing is deploying capital with a long-term mindset of years or decades, not months. Turnover in the US stock market was 155% in 2016, up from 20% in 1975, and reached over 400% in 2008 (Source: Worldbank.org. US Equity Turnover Ratio %, 2016). An average holding period of eight months (155% turnover) would indicate most people are speculating, not investing.

If you follow the list above, you can achieve investment success employing an active or passive strategy or a combination of both.

Sincerely yours,

John

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