HAMMOND ILES
Investment Management

"The debate isn't active versus passive; it is what will benefit the investor within a given time frame."

Active Versus Passive Investing

Few investment topics are as hotly debated as the merits of active and passive investing.[1] The debate over active vs. passive investing has been raging for years and will continue to ebb and flow. In addition to money manager's skill, prevailing market conditions will raise or lower the odds of an active strategy beating indexing. Compelling arguments can be made for each side. It is more complicated than it may seem.

At Hammond Iles Investment Management, we believe we should examine the debate as part of our investment philosophy and for the benefit of our clients.

Market conditions, or internals, include the dispersion of returns within an index and the correlation of those returns. Simply put, when there is more differentiation between the stocks in an index, it creates a more favorable environment for stock pickers.

Then there is market breadth, which is simply the number of stocks that are advancing versus the number of decliners. The concept is straightforward: If a majority of stocks are outperforming their index, then statistically the odds of picking winning stocks are higher. Conversely, if only a few stocks are outperforming, then the active manager has to pick from just those few stocks to add alpha.

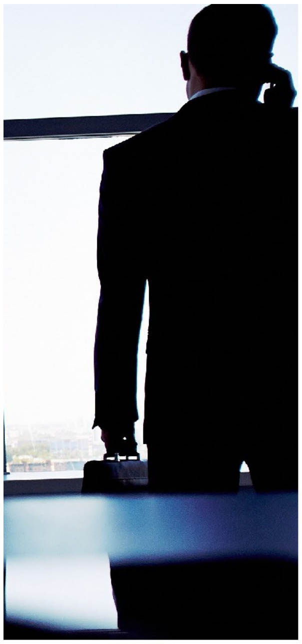
So, dispersion and breadth are important attributes of market regimes, which can enhance or detract from the success of an active or passive strategy. The questions then become: What creates these regimes in the first place? What causes breadth to broaden or narrow, or for correlations to spike higher or lower? We believe it is the business cycle, monetary policy, and systemic risk.

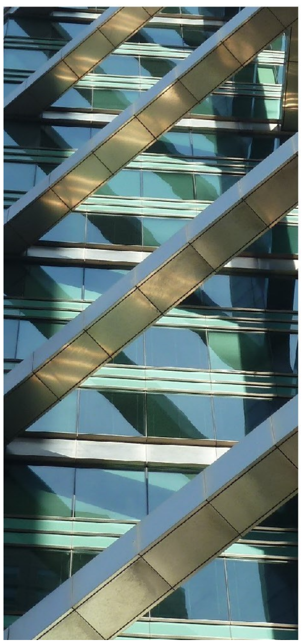
Let's Talk Monetary Policy

In a typical business cycle, when the economy overheats, the Fed will eventually tighten policy by raising short rates. Since short rates typically move faster than long rates, when the Fed tightens, the yield curve tends to steepen and eventually invert as a result.

Where we are in the business cycle, whether it be early, mid, late, or down cycle also helps determine market conditions. Typically, the early cycle lifts all boats, as the economy recovers from a recession and the stock market recovers from a bear market. When a new rally begins, breadth is often very strong. Then, when the bull market becomes more mature, the market's leadership and therefore, breadth tends to become narrower.

Then there are the structural forces, such as the degree of leverage and systemic risk. We only need to look back to the credit crisis and its aftermath to see what high degrees





of systemic risk do to correlations within and among asset classes.

At Hammond Iles Investment Management, we believe that active strategies tend to have a greater chance of outperforming indexing when breadth is high and correlations are low—conditions that are more likely to occur when the business cycle is fresh and when systemic risk is low or at least receding.

What Does This Suggest for the Future?

The Great Recession ended in 2009, so six years later the business cycle is more mature. On the surface, this might make managers less inclined to favor active strategies at this time. But this business cycle has been anything but normal, coming on the heels of a global systemic crisis, and a resulting lack of resource utilization and inflation. So chances are that this business cycle will last longer than average.

Clearly, advocates of passive management are supported by compelling evidence that markets cannot be beaten over the long haul, especially net of fees and taxes. However, there have been sustained periods of time when active managers have delivered superior relative returns and certain asset classes in which they have demonstrated the ability to add value.

What Does This Mean for Investors?

Given the cyclicality of market conditions, investors with only passive stock strategies in their portfolios may want to consider maintaining some exposure to active strategies to maximize their return potential.

Definitions

Both active and passive products are available, enabling investors to take either approach in order to gain exposure to a full range of stock and bond markets, investment styles, geographic regions and sectors.

Investors who practice active management select individual securities for purchase or sale usually based on fundamental research and/or by utilizing a broad array of quantitative methods. By contrast, the passive investor buys an entire index such as the Standard & Poor's 500 (S&P 500), simply to match its performance.

Passive investing can be accomplished by using index funds or exchange-traded funds (ETFs), both of which have been in existence for some time. Passive strategies among institutional investors have gained market share and now account for more than 40 percent of institutional assets.[3] They will likely continue to win over advocates, specifically during periods when active managers underperform.

Defining 'Active' Management is Essential

Properly assessing the value that active management adds requires clients to consider only the genuinely active managers. While broadly categorized as 'active', in truth, there are likely to be many 'closet index huggers' or enhanced index funds in any given peer group. These supposed 'active funds' will distort the active universe's overall performance. A truly active fund should exhibit high 'active share'. This measures the percentage of the portfolio that deviates from its benchmark, and a genuinely active fund would normally display active share in excess of 60%.

Time Horizon is Important

The importance of investment horizon should not be underestimated. Research indicates that the majority of active managers outperformed their benchmarks across all major equity markets, including the US, over periods of five years or longer.[4] Comparatively, passive funds have outperformed only over very short timeframes. Active managers take a long-term view on expected trading patterns and the management strategies of the companies in which they invest. Therefore, they typically select for longer holding periods in order to allow time for these fundamentals to be reflected in the share price. Clearly, based on these studies and reasonable time periods, true active management adds value.[2]

Advantages of Passive Management

By investing passively, the investor gains exposure to broadly diversified lists of stocks or bonds that target specific investment styles in the most tax-efficient manner. The performance advantages over long periods of time are in no small part the result of low fees and expenses, as well as limited portfolio turnover that mitigates trading costs and taxes. The passive investor also avoids the challenges and costs associated with selecting successful active managers.

Disadvantages of Passive Management

Perhaps the most significant drawback of passive management is that it requires the investor to accept the configuration of indexes, however constructed and regardless of the quality of their individual holdings and inherent risks. The S&P 500 is managed by a committee which considers, among many factors, market capitalizations, sector representation, liquidity and positive earnings; holdings are adjusted regularly. By contrast, the Russell indexes are reconstituted once a year “to ensure new and growing equities are reflected.” Companies operating at a loss are included, and in some cases, can be a material portion of a Russell index. In the case of bonds, some indexes do not account for defaults until they occur and occasionally contain illiquid securities.

The investor in passive products also assumes the weightings assigned to individual securities. On the equity side, by definition, the largest stocks become larger since money is allocated by market capitalization in most indexes. (An exception is the Dow Jones Industrial Average which is price-weighted.) This leads to an emphasis on companies or sectors that are trending, almost certainly because they are performing well, forcing one to assume material risks associated with concentration.

As for individual companies, passive management exposes investors to similar risks and must recognize that there are occasions when the diversification sought through an index is an illusion and that the accompanying risks can be formidable.

Advantages of Active Management

Along with the possibility of catching a sustained ride during a period when passive indexes underperform, there is solid evidence that actively-managed portfolios in inefficient markets have consistently beaten their indexed counterparts (and may continue to do so), is widely accepted. Additionally, many investors may not find it acceptable that ownership of stocks or bonds and all sectors in their portfolios must be entirely based on their size and consequent weighting in an index. They may take exception to investing in a portfolio that includes low quality companies, those losing money or are in bankruptcy, those in businesses that offend them, are in overly competitive businesses, are poorly managed, do not pay dividends, etc. They may prefer to adopt a strategy that reflects their own set of values, investment criteria and, importantly, unique tax circumstances.

An investor’s chances of successfully meeting his or her investment objectives through active portfolio management are increased by selecting managers with a solid investment philosophy that has been practiced successfully and consistently, and rigorous risk control.

Disadvantages of Active Management

Due to underperformance relative to passive alternatives, active managers have been, and continue to be, under enormous pressure to deliver results that justify their fees and other expenses. This has led to a radical change in the way money has been invested over the years. Managers, fearful of being out of top performing individual securities or sectors, frequently cling closely to their assigned benchmark, almost guaranteeing mediocre relative results at best. Many are justifiably labeled “closet indexers” as they invest defensively to avoid major errors.

Other managers sometimes choose a different tactic by straying from assigned benchmarks, sometimes markedly. For example, they may shift assets to a competing style (called style drift), or to larger or smaller stocks than authorized, violating their official mandate. They may even deviate from their own stated strategy, especially during times of meaningful and sustained underperformance.

Finally, there are risks related to the active management firm itself. It may encounter internal problems such as the loss of personnel or clients, lagging performance, a strategy or style that is out of favor, significant changes in ownership or a change in its investment philosophy.

Do Active Managers Outperform?

One claim frequently made by supporters of passive investing is that most developed stock markets are highly efficient and that share prices accurately reflect the vast majority of all publicly available information. Consequently, it is claimed that the opportunity for an active manager to add value through research is minimal and that the average active manager cannot consistently deliver better investment returns than the market after fees. However, this premise is flawed for the following reasons.

Efficient or Not?

The claim that developed markets are more efficient is a common one, and is often used to justify a passive approach. However, evidence suggests that this can be a potentially dangerous generalization. We find that active management performance is uncorrelated with market efficiency. Instead, market breadth and the availability of a large number of independent investment opportunities are the most important factors.

Unfair Comparisons?

We believe many studies comparing active fund performance with market indices are immediately flawed due to the in-consistent treatment of fees. Active fund returns are measured net of fees, yet invariably no fees are deducted from the index return. This falsely implies that market returns can be obtained at zero cost. A passive approach involves buying a tracker fund which charges fees, typically 0.1% to 0.75% each year. A more valid comparison requires these charges to be deducted from the index return. Over the longer term, this makes a meaningful difference to returns. Using averages is misleading In assessing active fund performance. Many proponents of passive investing focus on the average active manager by calculating the mathematical average performance of active funds. However, this can be misleading. In any given sector there may be a large number of very small funds which, in relative terms, constitute a small percentage of total client investment within the sector. Should a very small fund really be equally weighted with another fund that is many times its size?

A more representative analysis would focus on the money-weighted average, not a straight mathematical average. Small outlying funds can significantly distort the calculation of an average or median return. The focus should be on where clients actually invest in a sector, not an average fund in which no one invests.

Is Cost the Knockout Blow?

Passive funds’ low headline fees have become their primary selling point. However, low cost does not necessarily equal good value. Many funds incur various hidden charges, which can blur significantly the cost differential between active and passive portfolios.

Beware of Hidden Costs

Passive investors cannot ‘buy the index’ at no cost. They need to buy an index fund with an ongoing charges figure

(OCF) ranging from 0.1% to 0.75%, depending on the provider used. The OCF is not the only cost of mutual funds. As previously mentioned, many costs are incurred but are not transparent.

▪ Passive funds need to trade constantly in order to track changes in the weights of index constituents, incurring significant cumulative dealing costs (bid-offer spreads, broker commissions etc.).

▪ In less efficient markets where liquidity is low, as in many emerging markets, dealer spreads can be significant. All mutual funds, both passively and actively managed, pay these costs. However, many active managers will have a long-term investment horizon with less trading as positions are held for an extended period, which minimizes trading charges. They must give the companies they select time to realize the benefits of their corporate strategies, or at least have these benefits recognized more broadly by the markets. In addition, all active funds, even those which trade more often due to their style, need to cover the expense of the trade from the excess return they generate. This means that all trading decisions should be justified by the return potential. No such cost-benefit analysis is carried out by passively managed funds.

▪ The key point is that any comparison between the annual costs of a passive fund and those of an active fund must be done on a fair and equitable basis.

▪ Considering only the full costs of active funds and ignoring many of the hidden costs of passive investment misrepresents reality.

In summary, we believe that overall costs should be evaluated in conjunction with the outcomes they achieve. For passive funds, this will usually entail performance below that of the index. For active funds, there is the ability not only to potentially beat a given index after costs, but also to target both a specific return level and risk profile.

Summary of Our Beliefs

▪ Truly active investing can outperform over the mid-longer term.

▪ It is possible to identify in advance active managers likely to outperform.

▪ Passive investment involves hidden risks and requires diligence when selecting fund managers.

▪ Passive costs are also underestimated, and comparisons with active funds are frequently not made on a fair, like-for-like basis.

▪ Many asset classes and investment approaches can only sensibly be accessed through actively managed approaches.

▪ Passive investing is an imperfect and at times unavailable choice for certain asset classes and investment goals.

▪ Active strategies perform best in markets with the greatest breadth and with the most independent investment opportunities, making them an essential component when tailoring an overall approach for specific financial goals.

▪ Active investing plays a vital role in the effective functioning of markets.

▪ Ultimately, each approach has its own merits under specific circumstances.

Conclusion

Active investment and the role it plays for investors continues to be put under the spotlight. Proponents of passive approaches usually do not differentiate between a wide array of active investment styles – for example many of the 'closet benchmark hugging' funds that are included in their analysis are not truly active. Those funds adopting high active share and therefore taking a more focused approach to the merits of the individual stocks held have been shown to provide significant alpha generation net of fees.

Fees can have a material impact on realized returns over the long term. However, low cost does not necessarily equate to good value over the long term. Not all of the costs associated with passive funds are immediately obvious to investors, and the cost comparisons frequently made between the two approaches are often misleading. When choosing between an active and a passive fund, investors should look beyond the headline annual management charge or ongoing charges figure and aim to understand all charges levied by each. Notably, too, passive investing can entail significant risks to investors due to index biases. The potential concentration risk and possible lack of diversification that could result can seriously impair investor outcomes. In addition, passive strategies are often simply not suitable for certain markets or asset classes, while their inherent backward-looking bias also leads to a related momentum dependence.

In contrast, active management's greater focus on company-level dynamics and stock-specific risk helps managers to concentrate on those companies displaying the most attractive investment merits. This frees managers to look right across the market, rather than restrict them to an index that may be a narrow subset of the overall market. This less constrained approach allows managers to tie up minimal capital in large index-weighted stocks and encourages higher active share. A greater focus on stock specific risk can therefore mitigate any potential concentration in 'index proxy' stocks and enhance diversification. This flexibility, not enjoyed by passive alternatives, can be a highly important feature in protecting and growing investor wealth over the long term.

As can be seen, in direct contrast to the somewhat simplistic arguments often offered by supporters of passive investing, the underlying reality is much more balanced and nuanced. Cost is obviously a consideration, but not the only consideration, with the debate more accurately needing to become one focused on cost versus the long-term value provided.

Clearly, passive investment products have their role to play in shaping overall investment solutions. However, an understanding of investor circumstances and market conditions are critical to determine what is best. Active investment strategies can and will continue to make their own significant contributions to optimizing long-term investment outcomes.

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