



Actively Managed Passive Investing

By Andrew Brigham

The phrase, **actively managed passive investing**, seems contradictory. The goal of the passive manager is to replicate the performance of a target index. Variability around the target is not desired and is punitively called a “tracking error.” Alternatively, active managers select specific companies that they hope, in aggregate, will outperform a comparable investment benchmark. An actively managed passive strategy enjoys the benefits of low cost indexing, without narrowly adhering to well publicized investment indexes.

Traditional index funds are market capitalization-weighted portfolios. In 1971, the first index-based investment strategy was introduced by Wells Fargo Bank, tracking the S&P 500. In 1975 John Bogle, of the newly formed Vanguard Group, introduced the first index fund to retail investors. “Bogle’s Folly,” as it was called at the time, humbly began with \$11 million; that same fund now controls assets in excess of \$120 billion.

The success of index investing has demonstrated two investment mantras: (1) markets are extremely efficient and, (2) it is difficult for active managers to beat the indexes given the hurdles of higher management fees and higher portfolio turnover (causing higher transactions costs and tax liabilities.) Academic studies demonstrate that the few active managers that outperform an index rarely persist across subsequent years. In other words, past performance is not a proxy for manager skill, but rather for luck or for taking additional risk.

Traditional, passive-based index investing has its faults, however. Index funds that track the Russell 2000 serve as a good example. The Russell 2000 consists of the smallest companies of the Russell 3000 (the largest 3,000 companies) and is widely regarded as the de facto benchmark for small cap managers. However, there are roughly another 3,000 companies smaller than the ones that make up the Russell 2000. On a relative market capitalization basis, the Russell 2000 is a better mid-cap benchmark and does not capture the risk/return characteristics of true small cap stocks. Often, active managers may invest in this group of smaller stocks and achieve a higher return than the benchmark. This is advertised as “alpha,” or manager skill; however, it is simply the higher return inherent in accepting a higher amount of risk by investing in smaller stocks.

Furthermore, the Russell 2000 is reconstituted every year. Opportunistic active managers buy stocks that are likely candidates to be added and sell those most likely to be removed. An index fund looking to replicate the performance of an index must then buy new additions at artificially high values and sell those that have been depressed, incurring a substantial cost ultimately borne by the investor. This front running lowers the returns of the index that has rigid pre-determined guidelines, something that does not happen in the actively managed passive strategy.

Actively managed passive strategies target specific equity market risks; they do not track broad market indexes, nor do they seek to differentiate between individual companies. They adhere to the basic premise that risk and return are related. The underlying risk of a company drives its cost of capital, which is directly related to its expected investment return. The relationship is

obvious and even graded in debt markets. Certain company characteristics, or factors, have been identified to be very strong determinants of risk and, therefore, these same factors can be used as predictors of returns.

In 1993, Eugene Fama (Univ. of Chicago) and Ken French (Dartmouth College) introduced the Multifactor Asset Pricing Model in a paper titled, "Common Risk Factors in the Returns of Stocks and Bonds." The multifactor pricing model identifies two primary factors as descriptors of public equity market risk. They are: (1) relative size, as defined by market capitalization and, (2) relative value, as defined by the book assets of a company compared with its market price. The paper concludes that risks associated with these factors explain the bulk of returns of any equity portfolio. The active manager concept of "alpha" evaporates when subjected to the scrutiny of their model.

The actively managed passive strategies utilized by M Wealth create portfolios (i.e., mutual funds) based on these risk factors. Securities are broadly selected for these portfolios so that, when combined, they create a targeted risk profile such as small-cap or value. Investors benefit through access to low-cost, risk-targeted funds that avoid high transactions costs associated with "style drift" exhibited by managers that frequently alter their strategies.

Additionally, investors in taxable environments can benefit from the flexibility actively managed passive strategies provide. For example, even in very positive market conditions, a subset of the portfolio will decline in value. Managers are able to actively sell securities that decline and harvest losses continuously, accruing the known economic benefits of tax offsets. Harvested stocks are replaced with stocks of similar weightings to maintain a well diversified risk target. Indexing has proven very successful. Actively managed passive strategies extend the investing palate beyond index funds to allow for targeted equity risk while benefiting from the known advantages of low costs, broad diversification, and tax management.

If you have additional questions about actively managed passive investing, please contact a member of the M Wealth team at 800.508.1820.