A Hybrid Approach to Active vs. Passive Investing

The investing world has changed dramatically since the credit crisis. Technological advances have continued to reduce trading costs in the equity markets and global central banks have embarked on and sustained zero-interest-rate policies. According to Merrill Lynch, 83% of the world’s equity markets are currently supported by countries with such policies. From a historic perspective, the current low level of global interest rates, both real and nominal, is only parallel to the depression era of the 1930s. These conditions have resulted in a global stock market that is driven by broad economic announcements as opposed to company fundamentals. The evidence of this trend can be seen in the high correlations amongst sectors and stocks as they react as a group to economic news such as employment or inflation statistics.

When it comes to investing in the public equity markets, investors have generally been faced with the choice between active or passive strategies. Active managers attempt to beat the market through selecting individual securities that they believe will outperform or by making tactical allocations to overweight or underweight a sector. Passive strategies can largely be thought of as trying to capture the performance of a particular market as a whole. However, passive strategies are typically constructed using arbitrary rules that can meaningfully impact investors’ exposures. For example, the S&P 500 Index is a capitalization-weighted index, meaning that the largest companies drive the performance of the index more meaningfully than the smallest companies.

At Morton Capital Management, our main philosophy has historically been to invest with active managers, with the idea being that those managers can adapt to changing market environments instead of being locked into biases such as overweighting only the largest companies. However, in the current environment where a rising tide has lifted all ships it has been challenging for many equity managers that employ an active management approach. While we know that stocks cannot continue their steady climb indefinitely, the timing for any kind of reversal is not something that anyone can predict or control. Instead, this environment has compelled us to refocus on the factors that we can control: namely, costs, tax efficiency, and targeted market exposure.

In this position paper, we will delve further into some of the inherent flaws with traditional active and passive strategies in the equity markets. We will also make the case for a hybrid approach that focuses on controlling costs, promoting tax efficiency and gaining “smart” exposure to segments of the market on which we want to focus.
Active vs. Passive Investing

Most active funds are created for the purpose of outperforming a specific passive index, or benchmark. However, the data shows that the longer an active strategy is in business, the less likely that it will outperform its benchmark. The Center for Research in Security Prices (CRSP) at the University of Chicago has analyzed the track record of all equity mutual funds. In the chart below, the gray box represents the U.S.-domiciled equity funds in operation for the previous one, five, and ten years. The striped green area represents the funds that survived and stayed in business, while the blue area represents active funds that actually outperformed their respective benchmarks.

The data illustrates that it is much more likely for funds to outperform over short-term periods as opposed to longer-term periods. In 2013, for example, 49% of funds outperformed their benchmarks. Over a ten-year period, 52% of funds survived, but only 19% managed to outperform their respective benchmarks. In the fiercely competitive mutual fund industry, it is difficult for managers to gain an information advantage and outperform. Some fund managers are better than others, but it might be difficult to identify them in advance by relying on their track records. The small percentage that do outperform also do not achieve this on a consistent basis. In other words, the same managers that survived and outperformed in a five-year time frame are not necessarily the ones that outperformed over the ten-year time frame. Another major reason for underperformance is the expenses associated with active funds. The exhibit below illustrates that high expense ratios are a major contributor to active funds underperforming relative to their benchmarks, especially over longer time frames.
In addition to fund management fees, trading costs can also negatively impact a fund’s performance. The exhibit below illustrates that high turnover can significantly detract from the performance of a fund over longer time frames.

At Morton Capital, we have had a bias toward active managers with lower turnover, and, when possible, lower overall expense ratios. However, even the less costly active funds are typically more expensive than investing in passive strategies that generally carry lower expenses and can be more tax-efficient. While passive funds have the advantage of lower costs, we would argue that there are often large flaws in the logic behind their construction. Investors who put money into popular market benchmarks, such as the S&P 500, may be expecting broad, unbiased market exposure when what they are really getting is a strategy that is overweight on large growth-oriented companies. The nature of such capitalization-weighted indices is that they buy more of stocks after they get more expensive and sell other stocks after they get cheaper. While this may or may not be an effective strategy over different time periods, it is fundamentally biased toward a certain segment of the market instead of providing broad-based exposure.

Another flaw to passive indices is their rigid rebalancing schedules. Funds that are designed to track a commercial benchmark are generally rebalanced once or twice a year. These required rebalancing dates can result in higher trading costs as stocks must be bought and sold based on preset dates and rules regardless of market trends or liquidity. Also, as new information is incorporated into market prices, and securities start to exhibit different characteristics, the indexed portfolio can move away from its target universe or asset class. This is referred to as style drift, and it happens to indices between reconstitution dates, leaving investors to hold stocks they may not want to own. Therefore, as illustrated below, passive strategies can incur style drift prior to rebalancing and are forced to purchase stocks that are added or sell stocks that are deleted from the index on specific dates during the year.
Overall, passive or indexed approaches to investing are often flawed due to their rigid structures, which can cause unforeseen inefficiencies or consequences. While passive funds are cost-effective solutions in many instances, we believe that their thoughtless construction can result in unintended consequences.

**A Hybrid Approach**

While active and passive funds have their respective positives and negatives, we feel that there is a hybrid solution that incorporates the advantages of each. Backed by decades of rigorous academic research, Dimensional Fund Advisors (DFA) focuses on adding value on top of benchmark returns by minimizing expenses and turnover while also targeting areas in the market that they believe have “dimensions” of higher expected returns. DFA was formed in 1981 and is now a leading global investment firm with $381 billion in assets under management (as of 12/31/14). DFA’s strategies are only available to registered investment advisors like Morton Capital that complete the DFA educational process. DFA’s investment thesis is centered on academic research and the firm is dedicated to translating this research into practical investment solutions.

The illustration below differentiates DFA’s approach from active (a.k.a. “Stock Pickers”) and passive (a.k.a. “Index Funds”) strategies with respect to trading costs and turnover in the portfolios.

While scientific research and portfolio structure are the foundations of DFA’s investment philosophy, effective implementation in competitive, efficient markets is essential as well. Both portfolio management and trading are two vital parts of implementing these strategies. In managing portfolios, DFA’s teams focus on achieving consistent, broadly diversified exposure to dimensions of higher expected returns while trying to minimize risks, trading costs, and unnecessary turnover. Unlike a traditional index fund, DFA traders are not forced to purchase specific stocks regardless of their trading volume or liquidity. Instead, DFA’s trading discipline allows them to consider purchasing from a menu of stocks with similar characteristics, which can help keep execution costs low.
Dimensions of Expected Returns

DFA generates its menu of portfolio options through its research on dimensions of higher expected returns. Expected returns of an asset are driven by the price investors pay and the cash flow the asset generates. A “dimension” is simply a factor that can explain differences in returns. For a factor to be considered a dimension of expected return, it must have several characteristics: it must have a logical explanation (be sensible), be persistent across time periods, be pervasive across markets (geographies), and be cost effective to capture in well-diversified portfolios. DFA’s research has identified the following dimensions of higher expected returns in the equity markets:

1) **Company Size – Small-cap Premium**: Small-cap stocks have higher expected returns than large-cap stocks.

2) **Relative Price – Value Premium**: Value stocks have higher expected returns than growth stocks.

3) **Profitability – Profitability Premium**: High-profitability stocks have higher expected returns than low-profitability stocks.

To be clear, these factors or dimensions of higher expected returns do not necessarily hold over shorter periods of time. For instance, over any given quarter or year, small-cap stocks may underperform large-cap stocks or growth stocks may outperform value stocks. However, over longer periods of time, these factors have proven to add incremental returns compared to passive, indexed strategies.

Conclusion

Going forward, we will be looking to incorporate DFA’s strategies as core U.S. and international equity holdings. We believe that employing DFA will lower costs and provide more consistent returns over the long run. Even though the DFA positions may ultimately be significantly larger percentages than our historical weightings, the broad diversification that DFA achieves makes larger positions appropriate and more tax-efficient. We will continue to access active equity managers as complementary positions in more niche and theme-based asset classes or strategies where we believe these allocations can add value.

The transition to the DFA strategies will take time for our existing clients, many of whom have large embedded capital gains in their current holdings. Our advisors will be reviewing each client portfolio on an individual basis and taking these types of factors into consideration during the transition. As always, we appreciate your continued confidence and trust in us. Please do not hesitate to contact your advisor if you would like to discuss DFA’s philosophy or your portfolio in more detail.

~Morton Capital Investment Team

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