Before we get into the long debated conversation of Active vs. Passive, let’s put it into perspective. While the decision regarding active or passive management is important, asset allocation is by far the most important consideration when building an institutional or individual portfolio. The determination of how to allocate funds between major asset classes (equities, fixed income, cash, etc.) and their related substyles must be the first step. The outcome of your asset allocation decision will have the greatest impact on the risk/return characteristics of the total portfolio. Once the asset allocation policy is set, then the focus can turn to implementation…and so begins one of the fiercest debates in the investment industry: Active or Passive?

Passive Management: Portfolios that utilize a passive strategy do not attempt to “beat the market.” Instead, they select a market benchmark like the S&P 500 and try to track the index very closely without incurring high expenses. These are typically simple portfolios and are selected based on having the lowest expense ratios and tracking error.

Active Management: Portfolios that utilize an active strategy will select an index that broadly represents the opportunity set they invest in, and then attempt to outperform that benchmark by making better investment decisions. These portfolios have a larger range of potential outcomes and will also have higher expense ratios.

Not all Asset Classes are Created Equally
The crux of the Active vs. Passive is the fundamental opinion on whether a portfolio manager can beat a specified benchmark over the long term in excess of the fees or whether the performance discrepancies are a random event that will equalize over time. When determining whether active management would be beneficial in an individual asset class, one helpful point to consider is the magnitude of return dispersion compared to the expense ratio headwind experienced by asset managers in the asset class.

In the chart below, the last 20 years of performance is compared for the Morningstar foreign large-blend and Intermediate-Term Bond categories. The primary intent of the chart is to show the dispersion of long-term returns provided by active managers in each category and how that range of outcomes compares to the average expense ratio. The 25th to 75th percentile range represents the amount of return that separates the best and worst portfolios and thus also can serve as a proxy for the amount of active management opportunity that exists in the asset class. The Foreign Large Blend range was 2.23 percent vs. the Intermediate-Term Bond range of 0.63 percent. The cost to run non-U.S. equity portfolios is higher than it is to manage U.S. bond portfolios with average expense ratios of 1.48 percent and 0.91 percent, respectively. This data suggests that non-U.S. equity portfolio managers have more opportunity to outperform the benchmark, net of fees, than their U.S. fixed income counterparts. It is interesting to note that over the last 20 years, three of four Foreign Large-Blend managers have outperformed the MSCI EAFE while only one of four Intermediate-Term Bond managers was able to beat the BarCap U.S. Aggregate. This certainly does not mean that U.S. bond managers cannot beat the benchmark over long periods of time; it simply suggests that it may take a higher level of investment management skill to overcome the expense headwind in a low dispersion asset class.
Retirement Plan Design

When designing an investment plan lineup, there are a number of issues to consider beyond the prior performance discussion. In many circumstances, it may be advantageous to offer both active and passive investments within the same lineup. For example, a plan could structure its domestic equities offering to include active growth and value portfolios complemented by passive-blend options. This structure would allow a participant to build a diversified portfolio, implemented with either active or passive managers, based upon the personal views of the participant.

An additional consideration would be that there are costs associated with passive investments that are not reflected in the index returns. Expense ratios typically consist of both investment manager fees and the revenue sharing that is used to offset plan expenses. However, revenue sharing is often not added onto passive investments, so those plan costs must be paid from other sources such as a check from the plan sponsor or a deduction from participants accounts. When those additional costs are added back into the equation in a low-dispersion asset class like Intermediate-Term Bond, a passive portfolio would fall much more in line with a median active manager.

Unsettled debate

The debate on the superiority of active or passive management is one that will never be fully settled as there will always be market participants who have a strong view either way. Importantly, there are many investment situations where it is beneficial to use active, passive or a combination of the two. Further, there will also always be active portfolios that are able to outperform their benchmark and thus have a positive impact on the retirement accounts of plan participants. In the end, when using active management, plan sponsors and consultants have an obligation to work together to identify portfolios that have shown the ability to consistently outperform their benchmark.