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Debunking active management myths – Part 1

With $504 billion flowing into passively managed products and $316 billion fleeing actively managed mutual funds in 2016 in the U.S.[1], the active-versus-passive debate appears to be tipping in favor of passive management. To be clear, at Russell Investments we believe the binary choice between active or passive is a false one. Resist it. Active AND passive investing are both credible strategies within a multi-asset portfolio.

To help separate myth from truth in this debate, we will publish a series of blog posts over the course of the next few weeks:

- Myth #1: Active management can't add value after taking fees into account.
- Myth #2: U.S. large-cap ETFs are proof that passive beats active.

Today, we begin by discussing the first myth: "Active management can't add value after taking fees into account."

The reality

We believe there are active managers in every asset class who possess the skill to outperform the market, net of their management fees. Note, the operative word in the previous sentence is "*skill*." Beating the benchmark with active management requires finding superior active managers. Average managers don't cut it.

The basis for our belief

Passive investing attempts to *replicate* the market and generate performance in line with a broad cap-weighted market index over a full market cycle. But, what exactly is that "market" that a passive investing approach tries to replicate? That market is in fact the sum of all the investment decisions made by active managers. In a sense, a market index's performance, over a full market cycle, *represents* the average performance of all those active managers.

As a result, when it comes to after-fee performance, the theoretical *average* active manager (delivering *average* performance) underperforms the market by the exact amount of their fee. But this is only true for the *average* manager. Below average managers would underperform by more.

The theoretical *average* passive strategy's after-fee performance would also fall short of the market index. That shortfall would be exactly equal to the amount of their fee. But because the fee of passive products is typically lower than that of actively-managed products, the average passive manager tends to outperform the average active manager by the difference of their respective fees. But let's be clear: The passive solution is essentially guaranteed to underperform the market after management fees.

What about *skilled* active managers - those who beat the benchmark?

There is a tremendous range of performance among active managers. Depending on the asset class and period considered, the return spread can be as large as 61%.[2] At Russell Investments, we believe there are active managers in every asset class that possess the skill to outperform the market over a full market cycle - and we believe that skill can be identified in advance. This belief is the basis for the industry of manager research - a skillset we helped pioneer nearly fifty years ago and still invest heavily in today for this very purpose. In fact, some of the largest, most demanding investors in the world - many of whom are our consulting clients - rely on manager researchers like Russell Investments to identify outperforming active managers.

Some important factors for investors to bear in mind:

- **Skill matters.** For investors seeking to capture the extra return potential that active management attempts to deliver, we believe it is important to work with a credible provider of manager research capable of identifying and combining skilled active management.
- **Time matters.** The market moves in cycles and even skilled active managers may underperform at times within a cycle. We believe you should pack your patience and keep the faith - give it time to pay off.

The bottom line

The fact is, investing of any sort is inherently risky. And we agree that the **average** active manager doesn't add value after fees. To give investors the highest likelihood of beating the benchmark, you need to find outperforming managers. And then you need to give your strategy time to pay off.

And sure, the low-fee structure of passive investing has obvious appeal. But in recent years, many investors have assumed that active management can't add value after fees. This assumption is, in part, because the fervor around passive investing has created its own mythology. Some follow the passive trend without question. Others choose to make data-driven decisions. If you're a decision maker, we encourage you to take an objective look at the real-world application of active and passive.

Disclosures:

[1] Source: Morningstar. Passive products include long-term and sector mutual funds and ETFs. Excludes leveraged long/short products, money market funds and fund of funds. Active management includes all mutual funds, except money market funds and fund of funds.

[2] Based on Morningstar Large Cap Blend category cumulative return for the five years ending 12/31/2016. The worst fund's performance was 23% vs the best fund's performance of 84%.

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