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Market Ethos

The latest market insights from the Richardson Wealth team

RICHARDSON Wealth

Active versus passive

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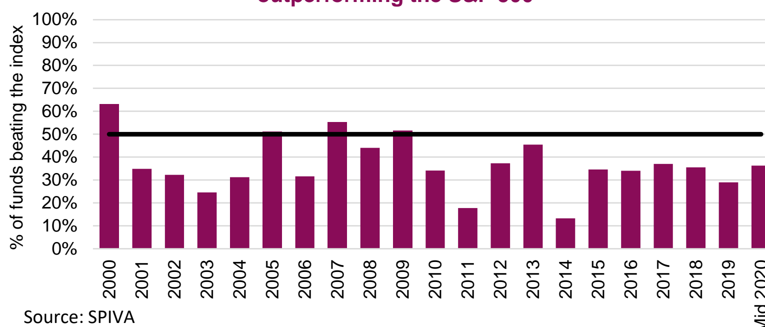
One of the most dramatic trends within the investment universe over the past decade has been the rise in popularity of exchange traded funds (ETFs). There are many factors that have contributed to this trend, not least of which are cost and ease of use; however, the recent outperformance of passive strateiges over active strategies ranks right up near the top.

Passive strategies simply follow an index, in many cases a market capitization-weighted index such as the S&P 500 or TSX Composite. Active management denotes a portfolio manager making active decsions in the market in an attempt to add value, control for risk or enhance a portfolio characteristic such as income. Today, ETFs are no longer synonomous with passive investing. There are ETFs ranging from those that track a broad index, those that track specifically engineered indices to those that are truly active. However, much of the total ETF assets and their rise in popularity was driven by the fact that they provided an inexpensive vehicle to invest in a passive index.

From a performance perspective, an active fund manager has to generate enough outperformance to counteract higher fees in a fund versus a passive index, as well as other factors like transaction costs and the potential tax drag from trading. And the data clearly demonstrates that managers, on average, have a difficult time doing this. **Chart 1**, from the S&P SPIVA reports, shows that funds have not enjoyed much success in beating the index.

Chart 1: % of active large cap U.S. equity funds outperforming the S&P 500



Source: SPIVA

Why did we decide on this topic? Given all that has happened in 2020, we wanted to see how active managers fared. This year has been incredibly challenging for all investors, so perhaps a quick highlight reel is in order:

1) 2020 started with high-flying momentum names reaching the stratosphere. Remember Virgin Galactic tripling in six weeks, on the excitement of commercial

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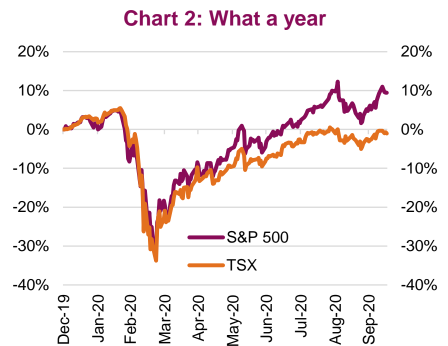
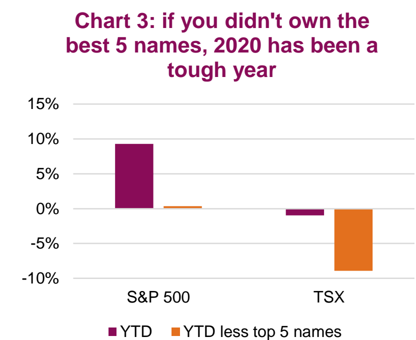
space travel? (*Today you can't even convince people to fly domestic*). While markets reached new highs, a pandemic was quietly starting to spread in China, and elsewhere.
2) In February, the unknown future path of the pandemic sent equity markets into the fastest bear market in history, with the S&P 500 dropping over 35%.
3) The market recovery began six weeks later, even before the economic data started to show readings of global recession.
4) In August, new highs were reached, driven by growth and companies benefitting from the changing behaviours of living with a pandemic.
5) September witnessed a brief pricking of the bubble in some tech/growth names, but this proved short lived (**Chart 2**). Oh, and we still have 2 ½ months to go.

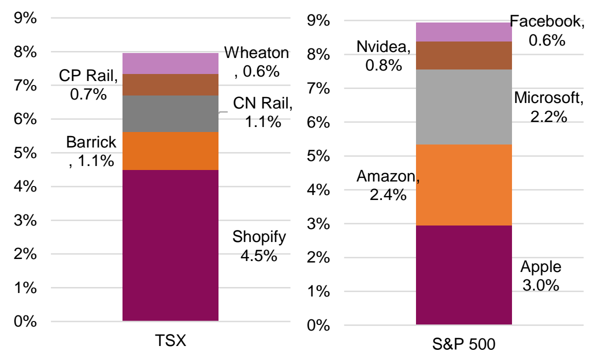


Ok, it is fair to say that navigating this would be challenging to bear impossible. A manager would have had to start on offense, switch completely to defense for the bear, then back to offense for the recovery, then a brief period of defense in September, then back to offense. Oh, and then figure out how the market will trade into and after the U.S. election. But with these big changes also come opportunities to add value.

While changes in market direction certainly create more fertile ground for active managers to position for changing trends faster than an index, this has not been the case in 2020 as the mega caps have driven the market. For instance, imagine Energy was about to go on a decade-long rise for some reason. Yes, you have to use a lot of imagination for this at the moment! Given Energy is only 2.0% of the S&P, it would take many years of outperformance before this sector would start having a meaningful impact on the S&P 500. Advantage active managers.



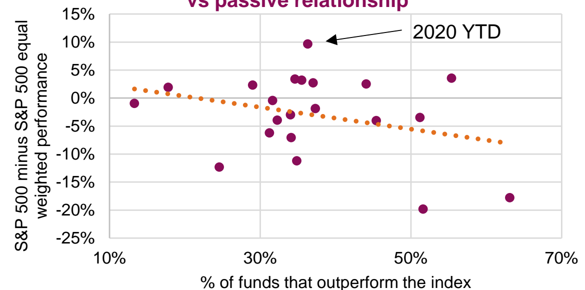
This year has not seen a new trend emerge; instead 2020 has seen more of an acceleration of previous trends. The result has actually been a very narrow index, not just for the S&P 500 but for the TSX as well (**Chart 3**). If you remove the top-5 performing names from the S&P or the TSX, the index performance is substantially worse. S&P 500 become flat on the year and the TSX drops deep into negative territory. The top-five names and their contribution to year-to-date (YTD) index performance is shown in **Chart 4**.



In other words, if an active manager did not own one or a few of those top names, it has been a tough year to keep pace with such mega cap-driven markets. Clearly this year's performance has advantaged market capitalization-weighted passive strategies.

Market breadth as a determinant of active vs passive

Years that have seen broader market breadth – meaning performance is more evenly distributed – have provided a more friendly environment for active management. This is pretty logical: if active managers are more diverse across the index, they will do better when positive performance is more evenly distributed. Market cap-based passive strategies will do better when leadership is narrow and focused on the companies with larger weight (eg. YTD 2020).



You can see this relationship by comparing the equal weight S&P 500 performance versus the market cap-weighted performance (**Chart 5**). In fact, given the narrow dispersion so far this year, active managers should have done worse relative to the index. Countering this was likely the ability to partially pivot during this "bull, bear, bull" year.

Investment implications

We are neither firmly in the active or passive camp. The last number of years have certainly been an environment that is more passive friendly (market capitalization based). But as with everything, it is not that simple! For instance, growth managers have dominated the growth index. As of mid-year, 74% of large-cap growth managers beat the large-cap growth index over the past 12 months. For mid-cap growth managers, 83% won and small-cap growth 89% won. And many managers will opt to take on less market risk, sacrificing some performance for a somewhat smoother ride.

Both active and passive strategies have a place in portfolios. We often recommend investors tilt more towards active in less-efficient markets or those in which the index has become too risky due to composition. A market-cap-weighted index (passive) is simply the value of the companies included in the index. There is no oversight on diversification and nobody controlling for risk. That being said, passive strategies can offer very cost-effective market exposure.

Currently, we would suggest investors tilt more towards active. Even the very efficient S&P 500 is now riskier than normal given a handful of names carry such a large weight in the index. Recent trends may continue but at some point they will reverse. And given the weightings, that will not be pleasant for some of the market-cap-weighted indices.

Source: All charts are sourced to Bloomberg L.P. and Richardson Wealth unless otherwise stated.

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