Enhanced practice management: The case for combining active and passive strategies

For advisors who have elected to use active management, either on their own via security selection or through professionally managed funds, one hurdle is that outperformance is difficult to achieve (Philips et al., 2014).

Figure 1 demonstrates two challenges of picking actively managed funds. First, in each five-year period that we evaluated, the median fund underperformed its prospectus benchmark by more than 50 basis points (bps) annually. Looked at in a different way, in each period, more than 50% of the funds failed to deliver on their objective of outperformance. Second, the performance spread between the top 5% and bottom 5% of funds was more than 8 percentage points annually. This degree of dispersion can lead to client risk, as we discuss on the next page.

Complicating this is that over the full ten-year period, nearly 45% of all funds that were alive on January 1, 2004, were liquidated or merged at some point before December 31, 2013.

![Figure 1. Advisors and their clients face a wide distribution of potential outcomes when using active management](image)

**Notes:** Chart includes all diversified active U.S. equity funds. Excess returns are measured relative to a fund’s stated benchmark. Results in each period reflect only those funds that survived the full five years.  
**Sources:** Vanguard and Morningstar, Inc.
As Figure 2 shows, the risk to an advisor’s practice when using active funds exclusively is that in volatile markets and uncertain times, underperformance can lead to an elevated risk of clients leaving one’s practice. We submit that this risk is larger than can be offset by positive client referrals during the good times.

That is, although the upside of outperformance may be a marginally greater share of wallet or referrals, underperformance can lead to a client’s questioning of the strategy or withdrawing of assets—plus nonexistent referrals.

Indexing can help alleviate this asymmetry by truncating the risk of unwise investor behavior and negative feedback loops for the advisor’s practice.

Moreover, adding a slice of passively managed funds or ETFs can help free up resources typically spent on manager research and oversight. These resources can then be redirected toward improving relationships with existing clients or attracting new clients.

**Figure 2. Adding passive funds to a portfolio can shrink performance distribution around the market, reducing flight risk: A theoretical example**

Elevated risk of losing clients: Portfolio comprises active funds only.

Reduced risk of losing clients: Portfolio comprises both active and passive funds.

Source: Vanguard.
Figures 3a and 3b demonstrate the implications of dispersion among fund performance and the cyclicality of outperformance. For this example, we ranked all funds over the first five-year period shown in Figure 1, then selected the top 20% of funds. We then tracked the performance of those top funds over the next five-year period (ended 2013). Figure 3a shows the results of that exercise. It is interesting that although these funds were the top performers over the first period, their performance did not persist, and instead formed a distribution similar to our theoretical example in Figure 2.

Also, only 24% (289) of the funds that were top performers over the first five years even managed to outperform over the next five years, while a sparse 7.5% (90) turned in what we would call “significant” results of more than 2% annual outperformance.

On the other hand, 33% (395 funds—see Figure 3a) realized “significant” underperformance of –2% or more annually, while another 169 funds were liquidated/merged at some point between 2009 and 2013.1

Figure 3. From theory to practice

a. Distribution of excess returns over five years ended 2013 for funds that ranked in top quintile as of 2008

![Graph A](image1)

b. Same distribution but adding 50% allocation to each fund’s style benchmark (10-bp annual haircut to benchmark returns)

![Graph B](image2)

Notes: Figure 3a includes all diversified U.S. equity funds that ranked in the top quintile for the five years ended 2008. Figure 3b includes the same funds as Figure 3a, but combines each fund with a passive index matching the fund’s investment style in a 50/50 ratio. To reflect implementation expenses, the index returns are reduced by 10 bps annually. Excess returns are measured relative to a fund’s stated benchmark. Data reflect excess returns over the period 2009–2013 for the 1,205 funds in the top quintile from 2004 through 2008.

Sources: Vanguard and Morningstar, Inc.

1 For more on the performance of funds that were merged or liquidated, see Schlanger and Philips (2013).
The impact on a portfolio of adding a diversified passive index fund or ETF is notable. Figure 3b uses the same funds as Figure 3a, but adds a 50% allocation to a benchmark matching the funds’ investment style. To reflect implementation expenses, we reduced the benchmark returns by 10 bps annually. Practically speaking, similar results can be achieved by using a broad-market index fund to help control relative risk in the aggregate portfolio.

First, as would be expected, the active/passive portfolio produced lower positive excess returns (22% of funds, or 265 funds, continued to outperform).

However, perhaps more important, the active/passive portfolio also reduced relative downside risk. The number of significant underperformers was reduced to 161, or 13% of the available funds (versus 33% for the primarily active portfolio in Figure 3a).

Mitigating such significant underperformance can be critical to successful long-term client relationships. The advisor who uses passively managed products may be better able to shift client conversations from the sometimes difficult topic of investment performance to estate and family wealth planning, which are not subject to the risks of the market. These services can be a more reliable base upon which to build an enduring practice.

References