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The Active/Passive Scorecard
A Directors Guide

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Ready for Next

BACKGROUND

Looking about the funds industry, it's not hard to find a few statistics that would seem to spell doom for actively managed funds: according to the Investment Company Institute's 2017 Investment Company Fact Book, actively managed domestic equity mutual funds had outflows in every year since 2005 (totaling over $1.1 trillion in outflows), while index domestic equity mutual funds and ETFs had inflows in each of these years and boast inflows of more than $1.4 trillion. Furthermore, the growth of passive products has been unrelenting and assets in indexed equity mutual funds today comprise 25% of all equity mutual fund assets. While comparable figures for actively managed bond and mixed-asset funds are lower, it's worth noting that they've also seen their indexed portion rise from less than 5% of assets ten years ago to more than 11% today.

Table 1 shows the evolution in active mutual funds versus ETFs over the past ten years. While traditional mutual funds still make up over 90% of all share classes available to investors, ETFs have seen a continual increase in the number of products available and, perhaps more significantly, have grown from 5% of industry assets as of June 30, 2007, to being 15% of assets as of June 30, 2017. This continued growth certainly raises questions for board members with oversight of active products, whether that be to understand a new form of competition, or to force a new business model for active products.

The Market Is Narrow

By many popular estimates, today's bull market in stocks is roughly nine years old—the longest since World War II (though some might argue that this run is shorter because the first four years were the recovery phase).

However, the rising tide has not lifted all boats equally. In fact, in a nod to the stock market of the 1960s that was led by the gang called "Nifty Fifty" stocks, this market had been led higher by just six large-cap stocks — Amazon, Apple, Facebook, Google, Microsoft, and Johnson & Johnson. Through the third quarter of 2017, all of them were up between 15%-48% as their collective stock market capitalization rose above $3.4 trillion.

By the mid-1970's the Nifty Fifty trend dissolved and while many of those firms are still around today (Coca-Cola, IBM, Wal-Mart), their dissolution as an investment trend opened the door for new ideas and stock picking opportunities.

The Passive Landscape Is Changing

In Table 2, snapshots of passive fund assets today, five, and ten years ago reveal the degree to which market shares are changing—especially for those firms outside the seven largest. Firms that appeared in the top ten in any of those years were tracked and the trajectory of their ranks are shown in the change column as grey (unchanged), red (declined), or green (increased).

Table 1

	Average Total Expense Ratio - 2007	Total AUM 06/30/2007 ($Millions)	% of Overall Assets	Share Class Count	% of Share Class Total	Average Total Expense Ratio - 2012	Total AUM 6/30/2012 ($Millions)	% of Overall Assets	Share Class Count	% of Share Class Total	Average Total Expense Ratio - 2017	Total AUM 06/30/2017 ($Millions)	% of Overall Assets	Share Class Count	% of Share Class Total
Active Only	1.122	8,803,107	95%	11,274	97%	1.093	10,792,724	90%	17,166	92%	1.035	17,032,781	85%	26,849	93%
Passive Only	0.462	484,944	5%	341	3%	0.551	1,170,947	10%	921	5%	0.505	2,977,090	15%	1,549	5%
Active and Passive	1.102	9,288,052	100%	11,615	100%	1.066	11,963,671	100%	18,740	100%	1.004	20,009,871	100%	28,793	100%

Backdrop: Markets Still Need Active Investors

Passive (or index tracking) investments are getting a lot of positive press these days for their ability to deliver low-cost, tax-efficient performance to retail and institutional investors alike. However, the great feature of price discovery—that is, determining how much a stock or bond is worth based on prevailing financials, news, and economic outlook—is not a characteristic of any passive product. It is the role of active managers to serve this function. One recent criticism of active management is the inability of the average manager to successfully allocate investment capital better than their benchmark. However, as we'll see, there is both reason and context that should also be considered.

PERFORMANCE OVERVIEW

Table 2

Top Ten Passive Fund Managers by Year

	2007	2012 Ranking	2012 Change	2017 Ranking	2017 Change
1	Vanguard	1	0	1	0
2	BlackRock	2	0	2	0
3	State Street	3	0	3	0
4	Fidelity	4	0	4	0
5	BNY Mellon	5	0	7	-2
6	Charles Schwab	7	-1	5	+2
7	Invesco Powershares	6	+1	6	0
8	T. Rowe Price	13	-5	14	-1
9	Dreyfus	18	-9	22	-4
10	Guggenheim	16	-6	12	+4
13	ProShares	9	+4	15	-6
16	TIAA	11	+5	8	+3
19	WisdomTree	15	+4	9	+6
23	PIMCO	10	+13	16	-6
36	Van Eck	8	+24	13	-5
45	First Trust Advisor	20	+25	10	+10

Some firms, such as TIAA and WisdomTree, have made steady progress through the ranks and are today among the ten largest passive fund providers. Others, such as Van Eck, PIMCO, and ProShares have seen their prominence grow and decline. Perhaps the most stunning story belongs to First Trust Advisors, which was way down in the ranks (#45) ten years ago and today ranks #10.

Passive Doesn't Always Beat Active

While the number of passive products has increased, it cannot be said that they've all outpaced their active peers. Given the variety of indexes that they track (and never mind that the term "passive" is a bit of a misnomer, as all indexes are rebalanced and reconstituted on some frequency) their average performance may be greater or less than active funds. In Table 3, all Lipper equity and bond fund classifications were filtered to include only those classifications with a minimum of 30 active and passive funds where 25-75% of them are indexed (most bond fund classifications contain very few (if any) indexed funds and some groups, such as S&P 500 Funds, don't contain any active ones).

The performance of the average passive fund is subtracted from the average active fund; green boxes indicate active outperformance and red is underperformance. Active managers have been astute investors in Industrials, Pacific ex-Japan, and Emerging Markets in the last five years, while underperforming in Global Natural Resources, Science & Technology, and Mid-Cap Core.

Table 3

Classification	All	Index Tracking	Percent Indexed	Active - Passive Performance Differential 2013	2014	2015	2016	2017
Industrials Funds	43	31	72%	5.83	3.34	-0.03	1.25	1.61
European Region Funds	96	64	67%	1.70	-0.43	3.01	-4.87	-2.38
International Equity Income Funds	75	50	67%	-1.73	0.92	1.57	-5.45	1.66
Specialty/Miscellaneous Funds	48	32	67%	46.78	22.78	15.58	20.06	21.66
General U.S. Treasury Funds	37	24	65%	-1.26	-0.36	-0.53	0.00	0.44
Latin American Funds	34	22	65%	3.92	4.04	1.49	-10.24	5.40
Health/Biotechnology Funds	57	35	61%	1.09	0.18	-0.67	1.34	1.12
Japanese Funds	32	19	59%	-2.29	-2.67	1.53	2.31	7.26
Financial Services Funds	58	33	57%	-3.44	0.34	0.21	-4.18	1.62
Utility Funds	30	17	57%	2.80	-2.07	-3.52	-0.45	1.71
Natural Resources Funds	52	27	52%	-7.90	1.78	0.89	4.54	-3.04
China Region Funds	54	28	52%	3.09	-9.97	-4.25	6.23	7.32
Science & Technology Funds	83	42	51%	0.26	-3.87	-0.76	-4.60	0.93
International Multi-Cap Core	145	65	45%	1.68	-0.05	4.07	-2.04	0.84
Energy MLP Funds	56	25	45%	-2.86	2.38	-0.35	6.22	-2.05
Pacific Ex Japan Funds	50	22	44%	2.86	10.18	1.99	-5.72	7.19
Global Natural Resources Funds	68	29	43%	-8.32	-4.08	-5.61	10.78	-10.33
Global Infrastructure Funds	38	12	32%	18.33	10.23	4.99	-4.26	-3.47
International Income Funds	59	18	31%	-1.86	0.08	0.18	3.02	0.87
Corporate Debt Funds BBB-Rated	101	30	30%	0.38	0.81	-1.18	0.36	0.49
Inflation Protected Bond Funds	78	23	29%	-0.51	0.92	0.75	0.38	0.04
International Small/Mid-Cap Core	36	10	28%	7.19	0.26	4.82	-5.59	4.69
Emerging Markets Funds	345	93	27%	2.12	2.72	4.02	-4.24	3.65
International Large-Cap Core	41	11	27%	-4.01	1.40	-0.83	0.24	-0.98
Real Estate Funds	102	26	25%	0.54	-0.42	1.45	-3.86	-3.45
Mid-Cap Core Funds	172	43	25%	-0.64	-1.54	-0.86	-3.00	-0.92

A SCORECARD FOR DIRECTORS

Most of the classifications that passed the filter are specialized—the satellites in a core and satellite portfolio allocation. Core classifications, such as Large-Cap Core and Multi-Cap Core, have underperformed their average passive peers in recent years, but not by stunning amounts. Through September 2017, both classifications are behind passives by roughly 65 basis points.

Where Does A Board Start?

Against this backdrop, fund boards have many factors to consider in the active vs. passive debate, whether that be as part of the 15(c) process or as a means to understand a market disrupter. Perhaps the most prevelant subject in the active vs. passive debate is the lower cost of passive products. While the board of active funds likely will not base their discussion of fund pricing on that of passive products alone, there are several reasons the pricing of passive products will come to the fore. During the 15(c) process a discussion of the Gartenberg factor pertaining to the nature, extent, and quality of the services being provided by the investment adviser certainly leads to questions about the different services an active manager provides clients and what those services are worth. This discussion frequently centers around more than just performance and also includes strategy execution, forward-looking views of the market, and when or if the portfolio manager is ready to shift portfolio positions to capitalize on a "black swan" event in the market. Essentially, the question becomes, for the additional cost of active portfolio management, are investors likely to receive favorable returns under a variety of market conditions?

While the media often focuses on the underperformance of active mutual funds, our research indicates these are generalizations. In Table 3 Broadridge finds that, when compared to a sufficient number of passive peers, actively managed funds have outperformed passive products 58% of the time for the five one-year periods shown. This outperformance is based on net total returns and shows that even with lower relative expenses passively managed products are not certain to outperform active funds. One consideration that many boards have when reviewing funds during 15(c) and in discussions about the long-term viability of a fund is whether the active fund is able to provide additional returns on a regular basis. The performance advantages passives have shown have all occured during a long bull market, it may stand to reason that actively managed funds may do relatively better in a bear market.

To aid in a comprehensive industry review boards are starting a macro-level review of active funds versus passive funds. The quantitative data provides a quick benchmark against passive funds and allows boards to begin a dialogue with management related to the cost/benefits provided by active management. Tables 4 and 5 below show the actively managed Natural Resource Fund is more expensive than all the passive products it is compared to; however, the fund is consistently in the first and second quintile for performance. In addition, the benefit the fund provided investors for the two-, three-, and four-year periods is significant. During each of these time periods both the average and median return for the passively managed products was negative; however, the fund had postive returns in two of the periods and was negative by 6 basis points in the third period. The outperfomance during a down market demonstrates one of the fundemental benefits actively managed products provide. This type of information and analysis provides boards a fuller picture of the active versus passive debate and shows that the decision is not exclusively about price and performance.

Table 4

	Actual Management Fees	Nonmgmt Expenses	Total Expenses
Natural Resources Fund	0.96%	0.54%	1.50%
Rank versus Passive	16/16	16/16	16/16
High	0.96%	0.54%	1.50%
Low	0.05%	0.00%	0.12%
Median	0.37%	0.13%	0.60%
Average	0.40%	0.16%	0.56%
20th Percentile	0.30%	0.05%	0.35%
40th Percentile	0.36%	0.10%	0.57%
60th Percentile	0.42%	0.18%	0.61%
80th Percentile	0.52%	0.23%	0.65%

Table 5

AT 5/31/2017	One Year	Two Years	Three Years	Four Years	Five Years	Ten Years
Natural Resources Fund	13.57%	-0.06%	0.61%	6.02%	8.87%	3.36%
Rank versus Passive	5/17	3/15	3/15	2/14	4/14	3/11
High	22.11%	16.15%	8.88%	11.09%	16.11%	8.14%
Low	-12.75%	-34.96%	-41.54%	-28.04%	-21.56%	-13.88%
Median	-1.19%	-12.54%	-11.71%	-6.24%	1.36%	0.11%
Average	1.67%	-10.78%	-13.43%	-5.91%	0.61%	-1.46%
20th Percentile	14.25%	-3.50%	-0.94%	5.24%	9.15%	3.36%
40th Percentile	1.45%	-7.12%	-10.39%	-3.09%	2.71%	0.89%
60th Percentile	-3.80%	-13.92%	-16.69%	-8.69%	-0.08%	-0.82%
80th Percentile	-10.08%	-18.15%	-20.73%	-11.50%	-5.02%	-3.66%

As boards and management have moved to lower the cost of active funds to stay competitive and try to divert some of the inflows passive funds have taken from them in recent years, a second question is frequently asked: how does the lower revenue impact the overall well-being of the active manager? And furthermore, does the continued downward pricing pressure create a situation where the health of a fund company is at risk, therefore creating a negative impact to investors? There are many options to be considered beyond the traditional reduction in management fees (such as an expense cap or contractual reduction) that boards and management may want to consider if they feel an expense reduction is needed. The merging of similar products is one route to consider, as is looking at outsourcing some or all operational functions. The cost to keep up with the many areas of specialization needed to run a mutual fund can be very costly, especially for smaller complexes. Outsourcing various nonmanagement and regulatory oversight type functions is a realistic route to bring in the needed skills while also keeping costs under control. Boards need to consider the overall viability (profitability) of the advisor when making decisions about any product and consider if the additional expense of an active product provides additional benefits to the investor.

Additionally, understanding the investor composition of funds is critical when making determinations with active funds versus passive products, most specifically ETFs. The traditional active mutual fund investor is a retail investor seeking professional management of their savings for retirement and other major life events. The makeup of investors for ETFs is far more diverse, and includes a large number of institutional investors searching for exposure to a particular market or parking cash until they find a suitable investment. These differing investor types have different end needs and managing and servicing these needs will vary.

Table 6

Year-over-year product creation across active and passive mutual funds and ETFs

Example: Equity Income Funds Classification

Active/Passive Scorecard	Active	Passive	All
Number of Funds	**157**	**44**	**201**
ETFs	2	42	44
Mutual Funds	155	2	157
AUM ($mils)	**336,920**	**123,916**	**460,836**
ETFs—1 yr Growth	138%	17%	17%
Mutual Funds—1 yr Growth	5%	27%	6%
Peer Group—1 yr Growth	-2%	N/A	-2%
Market Share	73%	27%	
Total Expense Ratio (wtd avg)	**0.74%**	**0.22%**	**0.60%**

Asset changes by type as well as peer group, plus market share

Expense ratio differences are presented as weighted averages

New Product Launches

In addition to the oversight of existing funds, boards and management companies alike are considering passive products when launching new active funds. As shown in Table 1, active mutual funds have shown a steady decrease in average total expenses over the past ten years, due in part to the pressure exerted by ETFs. Coupled with the strong net inflows attributed to passive products, today's market is a hard landscape to cross when launching a new active product.

During the product development stage many boards are reviewing flows into active and passive products, as well as expenses, AUM, and market share of each type of fund (Table 6). This kind of review allows boards to gain a degree of comfort with the challenges a new launch will face and address potential issues prior to its release. By reviewing the number of products launched, net flows into those products, and the expenses of both active and passive competitors boards are able to test and validate managements expectations for the product. In today's market, gaining scale is increasingly difficult and boards need to have realistic expectations of the lifepath of new funds.

CONCLUSION

At times it is easy to get caught up in the story that actively managed funds are dead. While there are certainly challenges for the active fund portion of the industry, for many reasons active funds will remain relevant for many years to come. In order for active funds to continue to provide investors with wide investment choices, boards must continue to take a strong role in their oversight. This includes more than monitoring expenses and performance, it includes ensuring that each fund is positioned to find and take advantage of productive investments in both bear and bull markets. Boards also should ensure the overall viability of their asset manager so that investors may continue to have sufficient investment choices. Perhaps a key focus for boards is to consider that costs passed to shareholders without indentifiable value should be more vigorously scrutinized, while ackowledging that services that provide a clear benefit to investors do not come free.

Takeaways For Directors

- Active investing is critical to the price discovery mechanism. Without it, the weighting scheme of the largest index funds (usually market capitalization or liquidity) would feedback into the market without a correcting force.
- The current market momentum is led by six very large stocks—a situation that could certainly change, just as the "Nifty Fifty" stocks in the 1960s and 1970s were found not to be immune from the bear market of the mid- to late-1970s.
- The passive funds landscape is changing, especially due to the rising popularity of exchange-traded funds. This presents challenges to many firms, especially those that are weighing whether they want to enter the ETF marketplace. The last ten years show that, aside from the very largest players, passive product market share is not solidified by any means.
- Just as there are many types of active funds, varieties of passive products mean that investors are not assured of outperforming the average active fund. Pricing is certainly a strong motivator, but performance is still the first metric that investors consider.
- Active also means flexible. Every market cycle ends with a downturn and active managers have the ability to avoid the worst potholes on the road—something index funds can't do until they are reconstituted. Successful managers will make the case that relatively higher expenses reflect a flexibility cost that passive funds investors may realize through inflexible performance in a downturn.
- When attempting to understand active funds versus passive funds, whether as market background or as part of 15(c), it is important to acknowledge how pricing pressure on active managers has an impact on the overall health of the firm and the services being provided to investors.

Sources

Performance, Expense, and Asset data sourced from Lipper
ICI data: https://www.ici.org/pdf/2017_factbook.pdf

Comments and questions from readers of this white paper are welcome. Additionally, if you would like to have more detailed data presented related to your funds we can incorporate that into a study . Please direct any feedback to:

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