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MANCHESTER
CAPITAL MANAGEMENT, LLC

Insight

Deciding Between Active and Passive Management is not a Passive Decision

-Manchester Capital Management Strategy Team

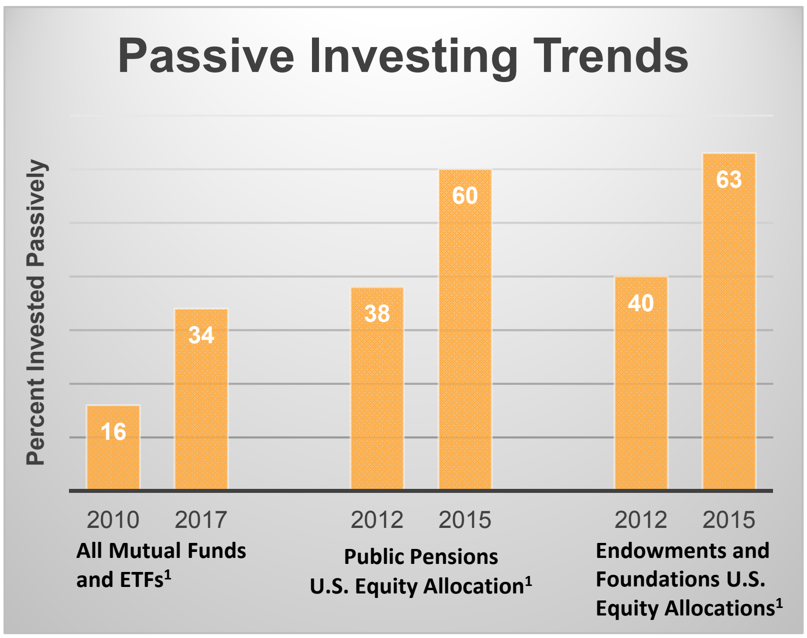

Figure 1: Source for mutual funds and ETFs – Morningstar; source for public pensions, endowments, and foundations - Greenwich Associates

Active managers have historically been rewarded for distinguishing between strong and weak companies, but a “rising tide” of low rates has neutralized this advantage. The Federal Reserve and other global central banks have heavily influenced the market since 2008. The performance of the major stock market indices has been spectacular in this low-growth, low-inflation, quantitative easing-infused cycle. Risk on/risk off environments, encouraged by the central banks, have encouraged money to flow into passive products and punished active managers. Persistently low interest rates lowered the cost of capital for all companies, reducing the differential between stronger and weaker performers. This had the effect of increasing correlations, not only among stocks but across asset classes.

This trend of investors shifting investment allocations from active to passive management has accelerated in recent years. As can be seen in the graph above, the percentage of passive investments in mutual funds, pension plans, exchange traded fund assets (or ETFs), endowments, and foundations has increased in the last few years alone.

One school of thought is that there is a dearth of opportunity today – professional investors are better trained and have greater access to information, therefore their relative skill is shrinking. If excess returns are becoming scarcer, investors should pay less to seek them. Morningstar calculates that average fees for all funds have declined from 81 basis points in 1990 to 59 basis points today, with the brunt of the fee decline felt by active managers.[2]

Active management continued to underperform passive in 2016 as only 32% of fundamental equity managers beat their respective benchmarks according to a J.P. Morgan study.[3] Passive funds have great appeal in an extended period of rising asset prices such as the one we have experienced since the global financial crisis. The majority of flows have been into market cap weighted funds that are, by definition, unevenly distributed. Most actively managed portfolios are closer to equal weighted and therefore less exposed to the larger companies garnering the bulk of the fund flows.

New to the Firm

Manchester Capital Management is excited to introduce Kathy Lynch.

- Senior Accountant
- Bill Pay
- Client Concierge Services

Kathy is filling the new role of Senior Accountant in which she will provide additional depth to our existing client concierge services as our Montecito based accounting and bill pay services specialist.

Throughout her 20 years of experience, she has established long-term relationships with investment management firms, high net-worth individuals, and a wide variety of businesses.

Kathy is passionate about giving back to the community. She currently is developing a children's cooking program for at-risk youth. She loves cycling, hiking, and spending quality time with her daughter, extended family, and Oreo Cookie, her AKC blue ribbon K-9.

In periods of higher market volatility, however, active stock picking and risk management can add value. As interest rates have begun to rise, stock correlations have fallen to the lowest level in ten years, a positive for active management.[4] We are seeing a significant rotation in the market away from low volatility and momentum stocks (which became self-reinforcing with constant flows into passive indices) and into value stocks, helping active managers regain lost ground.

> *"The market can't be made up solely of passive investors – it needs some investors to collect information and reflect it in prices."*

The market can't be made up solely of passive investors – it needs some investors to collect information and reflect it in prices. If fewer managers are drilling into financial reports to pick the best stocks and avoid the worst, it could undermine the market's capacity to price shares efficiently. Evidence is mounting that passive investing has increased valuations of stocks going into the index as well as correlations of constituent stocks.[5] There are numerous overvalued assets that have no justification for their overvaluation other than index funds have to own them. That said, betting against these stocks has been a losing trade because it's hard to fight against the buying power coming from fund flows.

At Manchester, our allocation to active versus passive strategies remains flexible, allowing us to take advantage of opportunities active managers may present. Conventional wisdom says investors should diversify between stocks and bonds to spread out potential risk. Allocating assets to active and passive should be viewed similarly. Our current return projections for stocks and bonds are roughly half historical averages, putting a premium on active managers' abilities to generate excess returns because most investors won't be able to hit return targets through benchmark returns alone.

We believe we should seek active managers in asset classes with high dispersion of returns. We look for managers who are active. We focus on managers with a demonstrated ability to add value, with less emphasis on style purity. We seek managers who differentiate themselves though techniques such as adapting a different time horizon or capitalizing on behavioral inefficiencies. We believe passive strategies will continue to serve as a great source of low-cost market exposure but believe the stars may be aligning for a period of market-beating performance from select active strategies as well.

ENDNOTES:

[1] Anne Tergesen and Jason Zweig, "The Dying Business of Picking Stocks," The Wall Street Journal, October 17, 2016

[2] Michael Maubossin, "Looking for Easy Games", Credit Suisse, January 4, 2017

[3] Dubravko Lakos-Bujas, "U.S. Equity Strategy", J.P. Morgan, January 18, 2017

[4] Bianco Research, January 12, 2017

[5] Belasco, Finke and Nanigian, "The Impact of Passive Investing on Corporate Valuations", Managerial Finance, August, 2011

DISCLOSURES