Indexing vs. Active Management

THE ADVISER INVESTMENTS PERSPECTIVE

One of the big debates in the investing world that never seems to end is whether it is better to take an active approach to managing money, or opt for a passive strategy, more commonly known as indexing.

With the active approach you put your money in the hands of a professional you believe has the expertise to pick and choose the right investments to produce returns for your portfolio that can beat a benchmark index. Over the years, it has become evident that the vast majority of managers who oversee mutual fund portfolios fall short of giving investors returns that beat a relevant benchmark index. According to Standard & Poor’s, more than 80% of actively managed U.S. equity mutual funds failed to outperform a benchmark index over the ten years through 2015.

That goes a long way toward explaining the increased popularity of the passive approach. With indexing you take the human element (a portfolio manager) out of the equation and invest directly in a mutual fund or exchange-traded fund (ETF) that tracks an index. Your bet is that it is better to simply shadow an index’s return than to run the risk that a portfolio manager you invest with will be part of the majority of managers that fails to outperform. Indexing is the investing world’s take on the old adage: If you can’t beat ‘em, join ‘em.

Adviser Investments believes both active and indexing have their merits. We also believe that one of the keys to successful investing is to be an informed investor. Knowledge breeds confidence, and having the conviction to follow a well-conceived investment strategy is central to reaching your long-term goals. With this special report, Indexing vs. Active Management: The Adviser Investments Perspective, we explain the pros and cons of both investment styles in the hope of helping you better understand the key elements of each approach. After we have laid out the nuts and bolts of Indexing vs. Active Management, we will walk through where we stand in the great debate and explain how we incorporate our philosophy in the management of more than $3 billion for individuals and organizations.

The Passive Pay Off

A discussion of indexing must start with an explanation of what exactly an index is. After all, passive investing is simply choosing a mutual fund or ETF that tracks an index. (If you would like to learn more about ETFs, please call us at 800-492-6868 and request a free copy of our special report The ETF Option.)

An index is a basket of securities that represent a market segment. For example, the Dow Jones Industrial Average (DJIA) you hear about so often is an index of 30 stocks. Given

<table>
<thead>
<tr>
<th>Leading Indexes</th>
<th># of Holdings</th>
<th>What the index tracks</th>
</tr>
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<tbody>
<tr>
<td>Dow Jones Industrial Average</td>
<td>30 U.S. stocks</td>
<td>Large U.S. corporations</td>
</tr>
<tr>
<td>S&amp;P 500</td>
<td>500 U.S. stocks</td>
<td>Large U.S. corporations</td>
</tr>
<tr>
<td>MSCI EAFE</td>
<td>Approximately 1,000 international stocks</td>
<td>Large corporations from more than a dozen developed international markets in Europe, Australasia and the Far East.</td>
</tr>
<tr>
<td>MSCI Broad Market Index</td>
<td>More than 3,500 U.S. stocks</td>
<td>Large, midsize and small-cap stocks that represent more than 99% of market capitalization of the U.S. market</td>
</tr>
<tr>
<td>Russell 2000</td>
<td>2,000 U.S. stocks</td>
<td>Small-cap stocks</td>
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that there are more than 5,000 stocks listed on the major U.S. stock markets, the popular DJIA only represents a very small slice of the total market. Another popular index is the Standard & Poor's 500 stock index (S&P 500). Comprised of 500 blue-chip stocks, this index is a better barometer of the market, but it too falls short of being a true benchmark of the entire U.S. stock market. There are dozens of indexes that are used as market benchmarks. Some of the most popular indexes are listed in the table on page 1.

The firms that sponsor these indexes are in charge of deciding what securities to include. Employees of The Wall Street Journal determine the composition of the DJIA. A selection committee at Standard & Poor’s oversees the S&P 500 and the firm’s other indexes. Some of these indexes are rarely tinkered with; the goal is for there to be minimal turnover—that is, changes in the underlying securities.

That said, these indexes are not set in stone. For example, in 2015, there were 22 changes (each addition is coupled with a deletion) to the S&P 500.

INDEX FUND PERFORMANCE ADVANTAGE
Over the past few years, interest in investments that track indexes has picked up steam. Currently there are over 360 mutual funds and more than 800 ETFs in the business of tracking an index. The primary reason for passive investing’s increased popularity is the simple fact that many portfolio managers don’t produce returns that are better than their benchmark index.

In 2015, 66% of large-cap mutual funds failed to post a return that was better than the S&P 500. Small-cap managers did even worse; the benchmark small-cap index beat 72% of portfolio managers. Mid-cap fund managers did comparatively well in 2015 on the whole; only 57% of managers who focused on mid-cap stocks failed to beat a benchmark mid-cap index.

When you look at three-year periods, the story was even gloomier against benchmarks for large-cap (76% underperformed) and small-cap funds (82% were outpaced) and mid-cap funds, where 62% underperformed. Over the five-year period through 2015, 82% of large-cap and 88% of both small-cap and mid-cap actively managed funds failed to outperform benchmark indexes.

INDEX AND ETF FEE ADVANTAGE
One of the main reasons the majority of mutual fund managers fail to keep pace with their benchmark index is because the annual fees charged by an active fund tend to be much higher than for an index fund or ETF. This annual fee, called an expense ratio, is levied to cover operating and administrative costs. The average expense ratio for an actively managed large-cap stock mutual fund is about 1%. But the average for a large-cap index fund is about 0.35%, and can be as low as 0.10% or so. ETF expense ratios are often even lower than the charge for an index mutual fund.

All those numbers may seem small, but one of the most important keys to successful investing is to appreciate that every penny you are able to keep in your portfolio rather than pay in ongoing fund expenses is another penny that can compound over time and help you meet your long-term goals. Take a look at the impact expenses have on the long-term growth of an original $10,000 investment:

<table>
<thead>
<tr>
<th>Why Fees Matter</th>
<th>Fund A</th>
<th>Fund B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross (pre-expense) return</td>
<td>10%</td>
<td>10%</td>
</tr>
<tr>
<td>Expense Ratio</td>
<td>1%</td>
<td>0.35%</td>
</tr>
<tr>
<td>Net After-Expense Return</td>
<td>9%</td>
<td>9.65%</td>
</tr>
<tr>
<td>Net return of $10,000 investment over 20 years*</td>
<td>$55,024</td>
<td>$62,719</td>
</tr>
</tbody>
</table>

*Assumes 10% average annual rate of return

THE TAX FACTOR
Indexing may also help you keep your investing tax bill low.

When fund managers sell a portfolio holding for a profit the law requires that they pass the “realized capital gain” along to shareholders each year. This has nothing to do with any trading you might do during the year; even the most devout buy-and-hold fund investor who doesn’t touch his or her portfolio can be hit with a tax bill at the end of the year if a fund had any realized capital gains.

Indexing can reduce the chance of any tax bill while you remain invested, given that there is no “active” buying and selling of securities. Still, an index mutual fund doesn’t completely eliminate the possibility of a tax bill. When there are changes in the underlying holdings of an index, an index fund will have to make the same changes, and that can lead to a tax bill for shareholders if any holdings are sold at a gain that are not offset by losses. That said, changes due to “index rebalancing” are infrequent in large,
market-tracking indexes and typically represent a small portion of a fund's assets.

**INDEXING = NO SURPRISES**
Proponents of passive investing are quick to point out that this approach also takes the guesswork out of understanding what you own. Because your investment is tied to an index there is no mystery as to the holdings in your fund or ETF: You will own the same securities (or a representative subset) that comprise the underlying index. So, assuming you’ve done your homework and understand what the index you’re tracking invests in, there’s little chance you will wake up one morning to find out the fund manager has taken a big risky bet in a single stock or industry you aren’t comfortable with, or that the manager has gone bearish and moved 20% of your stock fund into cash.

Proponents of indexing say that the “no surprises” approach makes it easier to execute a strict asset allocation strategy given that you know exactly what you are invested in.

The Active Advantage
After that walk through the world of indexing you might be thinking that active investing is for fools. Not so fast. There is a very strong argument for active investment management over indexing, particularly as practiced by Adviser Investments.

**HARD DOESN’T MEAN IMPOSSIBLE**
While it is true that on average 60% to 70% of active managers can’t beat their benchmark index, let’s flip that fact around: 30% to 40% can and do beat their benchmarks. If you can identify the successful minority of fund managers who produce those index-beating returns your portfolio is going to outperform a passive investment approach. In a moment we will explain how Adviser Investments has established an enviable long-term track record by finding the leading managers of Vanguard and Fidelity mutual funds who have a history of beating their benchmark indexes. The table to the right shows a few examples of some actively managed funds that have recently bucked the trend and managed to beat their index.

**NOT ALL ACTIVELY MANAGED FUNDS HAVE HIGH FEES**
As mentioned earlier, the average actively managed fund has an expense ratio of about 1%, and plenty of funds charge 1.5% or more. But once again, if you do your homework, there are many actively managed funds that have relatively low expense ratios. In fact, the average expense ratio for actively managed Vanguard mutual funds is about 0.50%; that’s less than half the industry average. A low-cost fund run by a talented portfolio manager has a good shot at providing investors with index-beating returns given that their expense “headwind,” the difference between the active fund’s expense ratio and that of an index fund, is quite small.

**A HUMAN BEING CAN MANAGE RISK**
When stocks or bonds hit a rough patch an index fund or ETF is going to ride that market drop in lock-step with its benchmark index. But with an actively managed fund there is the chance that an adept manager can reduce the fund’s losses by using a variety of techniques: Scaling back the most volatile stocks in the portfolio or perhaps increasing the portion of fund assets invested in cash. Consider that in 2002 when the S&P 500 lost more than 22%, Fidelity Contrafund fell less than 10%.

**THE TAX ANGLE CAN BE OVERPLAYED**
If the bulk of your investments are in a tax-deferred account such as a Rollover IRA, you shouldn’t care about the supposed tax inefficiency of actively managed mutual funds; your account is immune from any tax bills generated by the fund from year to year. Your only tax bill comes when you withdraw your funds; and if you happen to be

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**Active Funds That Outperform**

<table>
<thead>
<tr>
<th>Fund</th>
<th>Benchmark</th>
<th>5 yr Annualized Gain</th>
<th>5 yr Benchmark Gain</th>
</tr>
</thead>
<tbody>
<tr>
<td>Vanguard Strategic Small-Cap Equity</td>
<td>MSCI US Small Cap 1750 index</td>
<td>12.52%</td>
<td>11.55%</td>
</tr>
<tr>
<td>Vanguard Global Equity</td>
<td>MSCI All Country World index</td>
<td>7.84%</td>
<td>6.62%</td>
</tr>
<tr>
<td>Fidelity Low-Priced Stock</td>
<td>Russell 2000</td>
<td>10.78%</td>
<td>10.43%</td>
</tr>
<tr>
<td>Fidelity International Growth</td>
<td>MSCI EAFE Growth</td>
<td>6.08%</td>
<td>4.49%</td>
</tr>
</tbody>
</table>

Performance data through 7/31/16. Source: Vanguard, Fidelity.
invested in a Roth IRA you may be able to avoid the tax bill completely.

When your money is invested in a taxable account, you do in fact have the prospect of being hit with a tax bill every year. But it’s important to realize that fund managers aren’t oblivious to the tax implications of their trading. Just like you can do with your own portfolio, a fund manager is able to offset any potential capital gains for shareholders with any realized capital losses. And there is plenty of data showing that many actively managed funds are just as tax efficient as an index mutual fund.

What’s most important is not the size of your tax bill, but how good your fund is at producing strong after-tax returns. If you own a fund that avoids generating a tax bill but doesn’t have strong performance, what good does that do you? Conversely, an index-beating fund manager who generates a tax bill from time to time is still giving you superior after-tax returns. What you’re left with after the tax bill is what matters most.

BEWARE THE LARGE-CAP BIAS OF INDEXING
The bulk of money invested in index mutual funds and ETFs is concentrated in portfolios that focus on large cap stocks; that is, the classic, big blue chips. For example, ETFs devoted solely to U.S. large-cap stocks represent almost one-third of total ETF assets, while ETFs focused on medium and small-cap stocks account for a total of 10% of ETF assets. Moreover, the notion that a large-cap index that holds hundreds of stocks gives you broad diversification is a bit misleading. In fact, because these indexes are market-weighted, the bulk of assets end up concentrated in a small number of stocks. The 10 largest holdings in the S&P 500 account for nearly 20% of the assets in an S&P-tracking fund, and the 50 largest of the 500 stocks in the index account for over 50% of assets.

Another way to look at the lack of diversification: While it’s true that the stocks in the S&P 500 represent 50% of the market capitalization of U.S. stocks, those 500 stocks represent fewer than 10% of the total number of publicly traded companies in the U.S.; if you stick with just the S&P you are missing out on the other 90% of stocks that can provide both diversification and superior performance to your portfolio.

The Adviser Investments Perspective: Indexing vs. Active Management
At Adviser Investments we are in the business of finding portfolio managers we believe have the talent to outperform their benchmark indexes. Our more than 50 investment professionals rely on proprietary in-house research to locate the top managers. We have proven that it is indeed possible to consistently do better than an index-only passive approach.

While the bulk of the over $3 billion we manage for more than 2,500 clients (individuals, trusts and institutions) is invested in actively managed funds, our overall approach is what we call Best of Both Worlds: We often use ETFs and index funds to complement actively run portfolios in certain market segments where we believe indexing is superior.

For example, actively managed emerging market mutual funds tend to have high annual expense ratios and charge investors a redemption fee when they sell their shares within a year. By using ETFs for emerging markets we avoid these fees. By lowering the overall cost of investing for our clients we increase their net returns.

HOW WE FIND THE INDEX BEATERS
The Adviser Investments staff utilizes a proprietary research system that digs deep beyond the surface of recent performance to unearth the truly talented portfolio managers who have a history of delivering index-beating performance for shareholders. Our research is centered on the following beliefs:

■ We Focus on the Manager, Not the Fund. There are no great funds, but there are great fund managers. That’s an important distinction. It does you no good to invest in what looks like a great fund based on recent performance if the manager responsible for that return has since left the helm. Conversely, if a talented manager takes over a mediocore mutual fund, then that can be a great investment opportunity. That’s why at Adviser Investments our focus is on Buying the Manager, Not the Fund.

■ We Rely on Sophisticated Return Analysis. Published fund performance statistics are simply snapshots of arbitrary time periods; say the past quarter, or year or five years. Adviser Investments believes a far superior method for evaluating a manager’s talent is to look at performance over multiple, rolling periods; this gives us dozens of data points to assess, rather than one static beginning and end date. We also compute a fund’s worst return—we call it Maximum Cumulative Loss—so we
have a clear sense of how well a manager weathered down markets. One of the most overlooked contributors to long-term outperformance is how well a fund manager is able to reduce losses in a falling market.

- **We Avoid Index Wannabes.** It makes little sense to invest with an active manager whose portfolio closely tracks a benchmark’s; if the manager is just going to shadow dance with an index, we would be better off in a lower-cost index mutual fund or ETF. That’s why we study a fund’s R^2 (called R-squared). This measures how much of a fund’s performance is related to the performance of its benchmark index. An R^2 of 100 means 100% of the fund’s performance for a given time period can be attributed to the performance of its target index. In other words, it’s an index-wannabe. Given that our goal is to identify managers with a penchant for producing index-beating returns, we want to see an R^2 that is well below 100.

- **We Measure Relative Risk.** At Adviser Investments, a strong return is not enough to catch our interest. We insist that a fund manager produce a return that compensates our clients for the risk (volatility) that the fund incurred along the way. Studying a fund’s Beta—its volatility in relation to the rest of the stock market—is an important step in determining if the fund has a solid risk-reward profile. We invest with an eye toward outperforming over a full market cycle. This means we particularly want outperformance in down markets. The larger the loss, the greater the return necessary to get even again. Our goal is to keep those losses within reasonable limits relative to the returns the manager can generate in up markets.

- **We Get Personal.** Statistics are important, but when you are handing your money over to an active portfolio manager (or team of managers) it also is imperative to know the people actually running the fund. At Adviser Investments, we conduct intensive manager interviews so we can have a deep understanding of their investment philosophy and their approach to handling our clients’ money. We also like to find out whether a manager has any of his or her personal money invested in the fund. We believe a manager who “eats his own cooking” is extra motivated to do well when he is not just the manager, but a fund shareholder as well.

- **We Stick With the Best Fund Families.** Adviser Investments’ unparalleled experience researching and dissecting the Vanguard and Fidelity mutual fund firms has earned us the reputation of being one of the most respected independent fund research firms. We believe that by focusing on Fidelity and Vanguard our clients have access to superior portfolio managers, deep research teams and top-of-the-line administrative support. While the bulk of our assets are invested in these two major fund firms, we use other fund families as well. Most often this occurs when Vanguard or Fidelity closes a fund to new investment.

- **We Know when To Be Passive.** As mentioned earlier, we use index funds and ETFs when we believe they represent a better investment choice than an actively managed fund. This is sometimes the case with international funds, especially in emerging markets, or for clients who wish to devote a portion of their assets to a specific market segment, such as gold, energy or commodities. While there are literally hundreds of ETFs available to investors, many of which presume to track the same market segments, their underlying holdings and industry concentrations can vary dramatically. In addition, some indexes use market capitalization to determine how to “weight” the stocks in their portfolios while others use dividend yield, or price-earnings or even equal-weighting strategies to build their funds. We understand the differences and make sure we aren’t investing in a “faddish” or poorly conceived index-tracker.

The bottom line for Adviser Investments is your bottom line. We believe that there is a place for both indexing and active management in building a strong, diversified and steady portfolio for clients of all investment objectives. We would be happy to discuss our investment philosophy, our work with individuals, trusts and institutions, and how we build customized portfolios with you.

*For more information, please contact Adviser Investments at 800-492-6868 or info@adviserinvestments.com.*

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