WHITE PAPER

"Passive" Isn't Passive

In 1976, John Bogle established the first passive index fund (what is now the Vanguard 500 Index Fund). Decades later, the concept of "passive investing" and the utilization of index funds is dominating headlines and gaining momentum amongst investors more than ever before. Mutual funds, exchange traded funds ("ETFs"), and exchange traded notes ("ETNs") that track broad (or sometimes extremely narrow) indices have attracted assets at a record pace over the past few years.

BY DREW BERG, CFA
PRINCIPAL

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See the following chart that compares net flows into actively managed mutual funds ("Equity Mutual Funds" on the chart) versus passively managed index ETFs ("Equity ETFs") from January 2001 through June 2017.

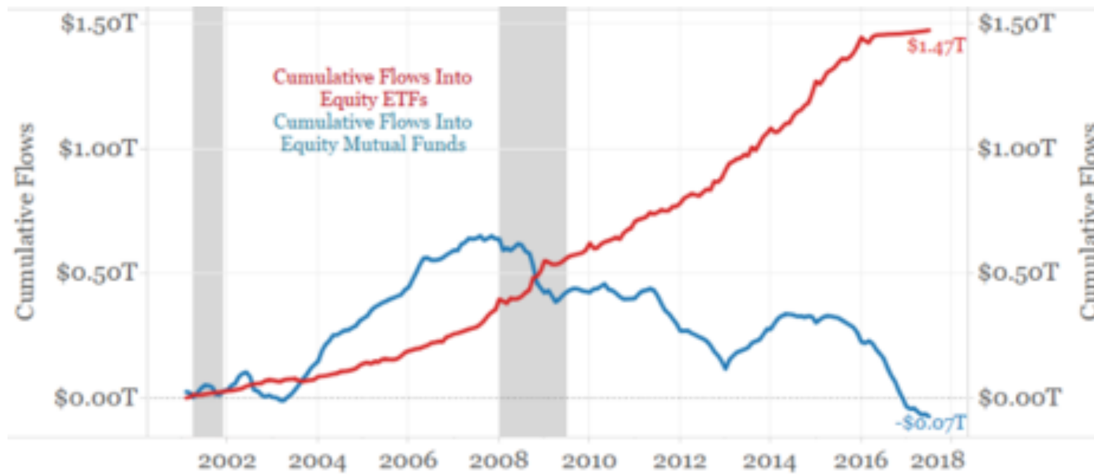

Chart Source: Bianco Research; Data Source: Investment Company Institute

Though the aggregate amount of assets in actively managed funds is still larger, there's no question that the dramatic difference in net flows over the last 8+ years has been a game changer. And it should be noted that while there are thousands of equity index funds now in existence, more than half of the assets that have flowed into passive equity funds since 2008 have been into funds that track the S&P 500 Index. Past performance may not be a reliable indicator of future return, but it's a very good predictor of future popularity!

There are a number of drivers behind this seismic shift, a subject that is probably deserving of its own paper. But suffice it to say that poor relative performance by active domestic equity managers since the end of the financial crisis, the proliferation of new index vehicles that provide one-stop, low cost exposure to various capital market categories and investment strategies (again, both broad and narrow), and a global investment environment awash with cheap money that has successfully lifted all boats with little discernment for traditional fundamentals or future earnings growth prospects are both the key variables at play and intimately interconnected to one another.

There's also plenty of material available for a separate paper on whether or not this trend towards "passive investing" and away from actively managed funds will eventually mean-revert or represents a true, long-term paradigm shift. So I won't touch that topic here, either.

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Instead what I'd like to focus on is the great irony that most headlines about "passive investing" and most investors who claim they prefer a "passive investing" approach are using the term "passive investing" wrong.

A very popular current refrain is that the S&P 500 Index has clobbered all comers over the last 8 years (though one should note that international equities have out-paced large cap U.S. stocks in calendar 2017), and that over the long-term stocks go up, so why should I worry about utilizing active management or trying to diversify my investments? I should just put all my money in SPY or VFIAX (the world's largest S&P 500-tracking index ETF and mutual fund, respectively) and let it run. Investing is easy!

As long as you (a) have a very long investment time horizon and don't plan on touching the assets for decades, (b) don't mind the odd extreme bear market where you can lose 30-40% of your assets, (c) can stay disciplined through those terrifying times and remain invested (so that you get all of the upside coming out of the correction, which is very important), and (d) don't mind going through long periods of time where your large cap U.S. equity exposure is outperformed by international stocks (the two have a very cyclical long-term relationship), then such an investment strategy might look reasonable on paper given your circumstances (though few investors can actually check all those boxes). And congratulations, you've identified a true passive investment strategy that requires no active managers or active management decisions! (We'll ignore the fact that this was actually an active decision on the front end and just focus on the passivity of the strategy once it's actually setup and running.)

But the term "passive investing" is typically thrown around when talking about a portfolio that consists of multiple index funds. "Most active managers can't beat their benchmarks, so I'm just going to use index funds from now on. And why am I paying an advisor when I can just build a passive portfolio myself and do just as well? Passive investing is the best approach for me."

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Unfortunately this representative investor is confusing two very different concepts. Index funds are indeed a passive instrument where there is no (or very little) active management decision making going on within the portfolio. The components of the index being referenced are used to guide all of the portfolio management decision below the hood, and that's that. But building a portfolio of multiple index funds is in no way a passive activity. Think of the active decisions that go into the process, both on the front end and on an on-going basis:

1. **What investment categories do I want to have exposure to in my portfolio?**
2. **How much exposure do I want to each category?**
3. **What fund do I want to utilize for each category, which includes choosing:**
   - **Mutual fund, ETF, or ETN?**
   - **What index to mirror (e.g., S&P 500 or Russell 1000 for large cap U.S. stocks)?**
   - **What fund company to use?**
   - **What share class to select? (Each has different minimums, fee structures, etc.)**
4. **When should I make my first purchases?**
5. **Should I fully implement my portfolio plan all at once, or dollar cost average into each position? Or some positions but not others? And in how many steps? And over what period of time?**
6. **As the capital markets move and my holdings drift from their original allocations, when should I rebalance the portfolio? Do I rebalance all the way back to targets or just part of the way? And do I rebalance all positions or just some?**

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7. **As my circumstances, my investment preferences, and the market environment change, how should I change my allocations? When should I change my allocations?**

You can see how the amount of active decision-making can become large and complicated very quickly, even if you're just using a few passive index funds, and especially if you're attempting to have any reasonable degree of diversification in the portfolio. And I haven't even touched on decisions pertaining to taxes, where to custody your account, types of trading (e.g., limit orders for ETF trades), etc.

And therein lies the contradiction between the simplistic notion of "passive investing" and the reality of portfolio management: active management and decision-making is always involved at multiple levels and at multiple points in time. That's not to suggest that the utilization of index funds or even an entire portfolio of index funds isn't appropriate in the right circumstances. Just make sure you understand the reality of any investment and portfolio management strategy before you dive in, and know who's going to be responsible for all the active decision-making that's required.

ATLANTA

400 Galleria Parkway, Suite 1400
Atlanta, GA 30339
Phone: 770.226.5333

GREENSBORO

701 Green Valley Road, Suite 300
Greensboro, NC 27408
Phone: 336.217.0151

MEMPHIS

6075 Poplar Avenue, Suite 900
Memphis, TN 38119
Phone: 901.761.7979

NASHVILLE

3102 West End Avenue, Suite 600
Nashville, TN 37203
Phone: 615.386.7302

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