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Passive vs. Active Investing A Moving Target?

The 2008 bear market meltdown has vanquished many investors with precipitous declines in portfolio valuations, with losses exceeding 50% all too common. Besides inflicting enormous financial and emotional pain, **the massive correction has also reignited one of the oldest arguments within the investment community, the debate between active versus passive money managers, with both claiming superior performance.**

Before weighing in on the arguments, we need first to broadly define the practices of the participants and, second, understand the theoretical underpinnings of the two camps. Succinctly stated, **active managers are those who practice the "art" of stock picking and/or market timing, while passive managers generally employ a buy-and-hold, target asset allocation approach, most often utilizing a mix of index mutual funds or exchange traded funds (ETFs) representing various equity indices.** In order to maintain their target asset allocations, holdings are rebalanced to target levels based on either a fixed timeframe or a set of triggering "out of balance" rules.

Conventional Wisdom

One of the earliest advocates of passive investing was Princeton finance professor Burton Malkiel, author of the 1973 classic, *A Random Walk Down Wall Street*. Even today, **Malkiel remains a committed proponent of the efficient market hypothesis which states that stocks are always efficiently priced with any short-term inefficiencies quickly arbitraged away due to the instant availability of market information.** In a recent interview with John Dobosz of Forbes magazine, Malkiel held firm to his long-term beliefs stating, "Institutions (who are responsible for 98% of all trading) can't beat the market because they are the market, and individuals can't expect to do any better."

While admitting that there is "some evidence" that value stocks do a little better than growth stocks and that small companies have historically outperformed larger companies (consistent with the research performed by Fama and French at the University of Chicago and now the basis of the Dfa family of mutual funds), Malkiel reminded that neither condition has been consistently true and that "to the extent that you get a higher rate of return, it may just be a compensation for higher risk."

Malkiel was even more dismissive of technical analysis and the suggestion that investors like noted author Bill O'Neil could profit by detecting patterns in stock movements, likening such an approach as "most akin to astrology." And with respect to behavioral finance, a field pioneered by fellow Princeton professor and Nobel Laureate Daniel Kahneman, and perhaps the most up and coming category of financial market research, Malkiel sees value only in its explanation of why investors are overconfident or over-optimistic, not in its ability to provide market-beating insight.

Smooth Sailing in Smooth Markets

Malkiel and the Efficient Market proponents clearly represent the conventional wisdom: active money managers cannot outperform the passive

indexes. Bolstering Malkiel's arguments and supporting such "wisdom" were a series of studies of both bond and equity mutual fund performances vs. a set of index funds. In a bond market study dating back to 1977, by Blake, Elton and Gruber, 361 actively managed bond funds were shown to underperform simple index strategies by an average of 85 basis points per year. **In a similar study of 143 actively managed equity mutual funds between 1965 and 1984, the average performances trailed the index funds by 159 basis points per year.** Finally, Mark Carhart of the University of Chicago studied a total of 1,892 funds that existed any time between 1961 and 1993. His findings showed that an equal-weighted portfolio of the funds under performed by 1.8% per year.

The case for active managers was hard to make, particularly during the decade of the 1990s as the benchmark S&P 500 index posted a 15.75% annual return from its June 30, 1989 level of 318 to 1373 exactly ten years later, with only one material 15% setback between August and October of 1998.

What a Difference Fresh Data Makes

The new millennium has been less kind to index investors. The following decade between June 30, 1999 and June 30, 2009 has seen the same S&P 500 index fall by one third, from 1373 to 919, an annualized loss of nearly 4%. And, unlike the virtual straight-line market ascent of the 1990s, the roller coaster ride since 2000 has been breathtaking. Consider the following peaks and valleys:

Aug. 31, 2000 S&P 500 at 1518

Sept. 30, 2002 S&P 500 at 815
25-month decline of 46%

Oc. 31, 2007 S&P 500 at 1549
1.9x the low, 13+%/yr. gain

Mar. 31, 2009 S&P at 798
49% decline

Translating these statistics into consumer language: starting at August 31, 2000, **a passive S&P 500 index investor saw his portfolio value nearly halved in just over two years, waited for five years (7 years from the initial valuation) for it to return to its original value, only to see it once again plummet by half during the following 17 months.** Prospective gains of 10%/yr from the March '09 low would return the portfolio to its August 2000 value in 2016, a seven year wait. **Even if we were to assume such a rebound, the "buy and hold" index investor would have gyrated through 15 ½ years of market ups and downs with no appreciable return.**

Scenarios like the one outlined above are providing plenty of fodder for active management proponents. While some (certainly not all) active managers have been willing to admit that passive management may outperform when stock markets are going up, as a rising tide lifts all boats, they argue that **active managers will earn their keep in bear markets when they can either dodge the under performers required to be included in an index or, even better yet, "time" their way out of the market altogether.**

Before launching into a description of one such trading system, let us confirm the standard disclaimers. We accept the fact that there is no single magic "black box" that emits infallible buy and sell signals. We also recognize that historical statistics, particularly those involving securities prices, can be "data mined" and "back tested" into a trading strategy that,

had it been known in advance, could have made its followers enormously wealthy. Most importantly, **we fully subscribe to the required disclosure that "Past performance is not an indication of future results."**

Can We Really Dodge Disaster?

The dual challenge for active managers, and specifically market timers, has been to design a strategy that would capture the bulk of gains during bull market advances, while still protecting against those periods when supposedly uncorrelated asset classes succumb to market forces and collapse in unison – the classic bear market. The number, variety and complexity of such market timing systems are illustrated by the 1,360,000 "hits" returned from a simple Google search of the topic.

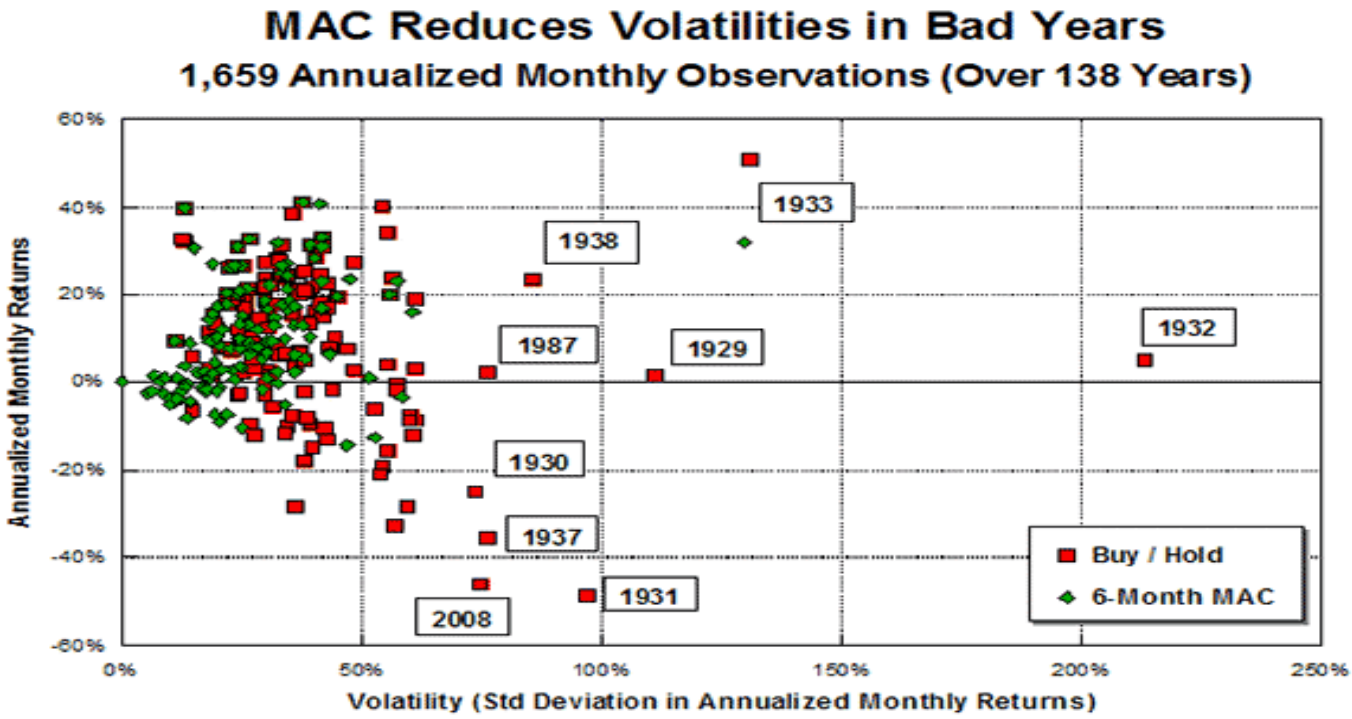
Challenging Conventional Wisdom

Thus, to keep things simple, we have chosen a recent study of the Moving Average Crossover (MAC) system developed by Theodore Wong and presented in his June 16, 2009 article, *Moving Average: Holy Grail or Fairy Tale* (AdvisorPerspectives.com). As stated by Wong, **MAC is one of the simplest and among the most followed stock trading systems. You buy when the price rises above its moving average, and you sell when it drops below.** The study compared the Compound Annual Growth Rates (CAGRs) of the benchmark S&P 500 total return index (with dividend reinvestment) versus a wide range of Moving Average lengths, from two to twenty-three months utilizing monthly data for 138 years from 1871 to 2009. The buy-and-hold benchmark returned 8.6% over the stated period while **CAGRs for monthly moving average periods below 11 months consistently beat buy-and-hold.**

To compare risk adjusted returns, Wong introduced two measures, first a ratio of monthly CAGR to standard deviations, the most frequently used measure of market volatility. **By this measure, the MAC system beat buy-and-hold across all Moving Average (MA) lengths.** As concluded by Wong, "The stability in risk adjusted return performance and their insensitivity to the MA length show that MAC is a robust system." The second risk measure was drawdown, or the percentage decline from the most recent equity peak. Considering both the average and maximum drawdowns, **the results were even more compelling as the buy-and-hold strategy suffered an 85% maximum drawdown due to the crash from the 1929 peak to the 1932 trough and an average drawdown of negative 26%.** By comparison, the maximum drawdown for MAC is -15% with the average drawdown no worse than -4% across all moving average lengths.

A Picture of Risk

The most convincing argument in Wong's study is his graphic presentation of annualized monthly returns vs. volatility as represented by the Standard Deviation in the Annualized Monthly Returns. Those familiar with Markowitz's Efficient Frontier will recognize the performance scatter gram that favors data points in the "Northwest Quadrant," representing a combination of high returns and low risk. Reproduced below, the graph shows annualized monthly returns (reward) versus standard deviations of annualized monthly returns (risk). **The green squares represent the 6-month moving average data, while the red squares represent the buy-and-hold benchmark. Sometimes a picture is worth a thousand words.**



(Credit: Theodore Wong, AdvisorPerspectives.com)

Just when we are convinced that the conventional wisdom is correct and that our search for the Holy Grail is futile, we discover a simple system that seemingly outperforms the market on both an absolute and risk-adjusted basis. If only it were so simple.

Our purpose in revisiting this unending debate is not to try to answer the question of funds vs. indexes or buy-and-hold vs. market timing. Instead, **our objective is to demonstrate that, above all else, risk matters and should be the driving force behind every investor's portfolio allocation.** Whether a fund manager outperformed or underperformed his S&P 500 benchmark by 1% in 2008 is of little consequence to the investor who lost either 36% or 38% of his money. **More important is whether this equity allocation was 20% or 80%, which determined whether the portfolio impact was a loss of 7 ½% or 29 ½%.**

Unquestionably, establishing and strategically shifting a portfolio's asset allocation is the most critical decision in investment management. Hopefully, we have shown that **blind faith in either a pure buy-and-hold strategy or a mechanical market timing system can be disastrous.** And, contrary to popular thinking, the market doesn't only go up. In fact, as reported by Theodore Wong, draw downs over the past 137 years have been far more frequent that one might assume as equity was underwater 92% of that timeframe. **The 1929 market crash took twenty-six years before it finally broke even in 1955, and it's anyone's guess when the Dow will regain its peak at 14,000.**

The Missed Opportunities Myth

Yet, investors and managers still have to cope with the emotional distress associated with "missing out" on a market surge. To dispel some of the myths about missed opportunities, we cite several of the key statistics presented by Theodore Wong in his companion article, *What the "Missing Out" Argument Misses*. Again using the S&P 500 total return index with dividend reinvestment, and utilizing daily data from 1942 to present, "missing" the best fifty market days lowered the buy-and-hold return from 10% to 6.1%. Interestingly, eliminating just the worst ten days increased performance to nearly 12% while missing the worst 50 days boosted the return to 15.2%. Most revealing is the fact that **the returns achieved by missing both the best and worst 10, 20, 30, 40, or 50 days beat the buy-and-hold strategy in every case.**

Coming full circle, we return to the irresolvable debate of active vs. passive investment management which will undoubtedly rage on with each new market cycle providing fresh data that can be massaged anew to "prove" one's preference. **While the debate is interesting, your time will be far better spent focusing on those things that you really can control. How much you spend, how much you save and how you control risk through the allocation of portfolio assets will ultimately play a far greater role in meeting your long-term investment objectives.**

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