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# Is Passive Investing Wise?

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We are witnessing a massive trend towards passive investing. Ads for tech focused Exchange Traded Funds fill the financial press.

But is this wise?

Yes and no. On average, the returns for actively managed funds will approximate the market's return, so after their higher expenses, they will underperform a low-cost index fund designed to track the return of the S&P 500. No less than Warren Buffett has recommended to his wife (after he dies) and for people who don't have the time or inclination to thoroughly research and monitor their investments that index funds are the way to go.

## Buy High, Sell Low

However, investors in passive vehicles may not fully understand how they work. Whether it's index funds, index ETFs or smart beta funds, once the guidelines are set, they are followed without discretion and without any regard to company fundamentals or any reflection on a company's stock's price.

For example, Amazon was .77 percent of the S&P 500 index on Sept. 30, 2013 versus 3.37 percent on Sept. 30, 2018. This means an S&P 500 index fund's exposure to Amazon went up almost five times versus 2013 *after* a seven-fold increase in Amazon's stock price from $312 per share to $2,003. The index fund was not recommending a large 3.37 percent weighting five years ago in anticipation of the stock going from $312 per share to $2,003. Your exposure went up only after the stock price went up relative to other stocks in the index.

An active manager would attempt to do the opposite – have a large weighting in a stock in anticipation of high returns not post the run up. If one of their holdings went up almost seven times in five years, it's hard to imagine they wouldn't be selling or trimming the position as opposed to adding to it.

Passive investing is essentially momentum-based, adding exposure to a company as its price rises relative to an index and lowering exposure if its relative price falls. This is close to buy high and sell low, while active investing is more focused on buying companies that are undervalued due to price declines. This means prices can be distorted when large amounts of money flow into passive vehicles paying no attention to valuations, especially for companies that are held in many exchange traded index funds.

## A Crowded Trade

Conventional U.S. stock funds that invest passively without regard to price or earnings prospects now hold $1.9 trillion in assets triple what they had in 2007. Add in $1.7 trillion in U.S. exchange traded funds, another type of index portfolio, and passively managed funds account for 42 percent of all U.S. stock fund assets.

According to data from Morningstar, roughly similar amounts went into active and passive equity mutual funds from 2005-11 but the flows into active and passive funds began to decline in 2012 and, in 2015, turned into outflows while inflows into index funds accelerated.

If money were to flow out of equities, the stocks that have been disproportionately bought will have to be disproportionately sold. It's not clear where the buyers will come from if the passive funds must sell their holdings in a crunch since the trade is so crowded.

## Downside Protection

Essentially, with momentum-based guidelines mimicking an index and holding no cash, passive vehicles have no downside protection. You get all the upside in an index and all the downside, as well. Not surprisingly, there have been periods in the past when downside protection was valuable and active funds outperformed an index such as the S&P 500 despite higher expenses.

According to work done by Joseph Mezrich at Nomura Instinet, the percentage of funds outperforming the S&P 500 on a five-year basis was in the 90 percent range in 1982 as index funds suffered more from the market downturn caused by Paul Volcker raising interest rates. By 1988-90, after a strong run for the S&P 500, the percentage of funds outperforming the index on a five- year basis was back down to approximately 15 percent.

The same pattern was continued by the 1991 market downturn, which caused an increase in the funds outperforming the index by 1994. Not surprisingly, again by 1999, only five percent of active funds were outperforming the index due to the screaming and top-heavy tech-related market gains of 1998-99.

This, of course, was followed by an increase to almost 60 percent of active funds outperforming the index by 2004 due to the tech-related market bust you probably remember.

Today, the number of outperforming funds is again low at about 15 percent. If this sounds repetitive and cyclical, that's because it is.

Investors in index funds should remember that, if looked at over longer periods, the market can be more volatile than recent performance would indicate. It's unknown what affect the large amount of passive investing will have on the next downturn but if history repeats it's highly likely the poor recent performance of active funds versus the index will improve.

Looking at 20-year returns through Dec. 31, 2016, the average equity fund investor's return was 4.79 percent, badly trailing the 7.68 percent* return for the index with similar poor results shown for the average index fund investor.

Most people can't buy and hold as Warren Buffett suggests due, in our experience, to the emotional mistake of selling during downturns. By mitigating the downturns, we believe active management can make it easier for investors to stay invested and benefit from compounding their money over long periods of time.

Please feel free to contact us if you would like more information about our investment philosophy.

**Dalbar and Associates*

*South Atlantic Capital Management Group claims compliance with the Global Investment Performance Standards (GIPS*). The firm has been independently verified by Ashland Partners and its successor company ACA Compliance for the periods January 1, 1992 through June 30, 2018. Verification assesses whether (1) the firm has compiled with all the composite construction requirements of the GIPS standards on a firm-wide basis and (2) the firm's policies and procedures are designated to calculate and present performance in compliance with the GIPS standards. The Core Equity Composite has been examined for the periods January 1, 1992 to June 30, 2018. To receive a GIPS compliant presentation and/or the firm's list of composite descriptions please email your request to info@southatlanticcap.com .*

*Since its inception January 1, 1992 through September 30, 2018 our Core Equity Composite performance ranks in the top 1% gross of fees and top 4 % net of fees versus all Large Cap managers on PSN Informais's database. PSN is a global database of approximately 2,000 Investment Managers representing more than 20,000 domestic and international investment products, and it is a division of Informa Investment Solutions, Inc. South Atlantic Capital is measured against the Large Cap managers within the PSN database. There are 868 Large Cap Managers' returns that are compared to the returns of South Atlantic Capital for the past year and 146 Large Cap Managers whose returns have been on the database since January 1, 1992. Rankings are not indicative of future performance.*