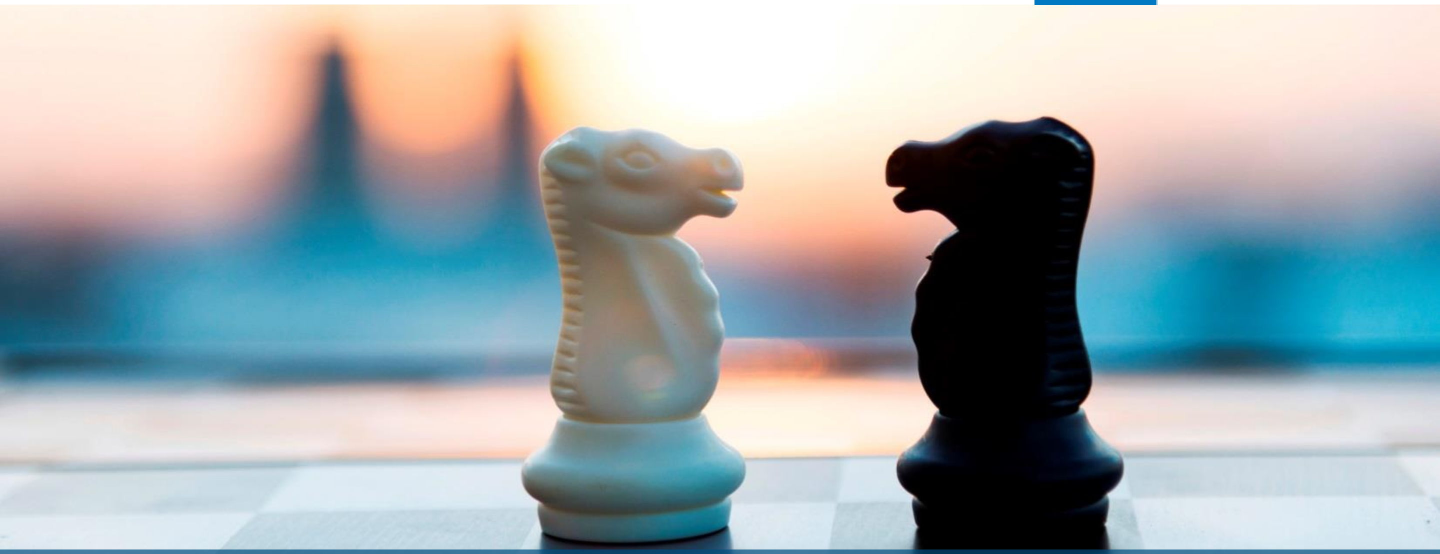


Living Together:
Active and Passive Strategies Can Coexist

Competitors can make for great stories. Take Coke vs. Pepsi, Microsoft vs. Apple, McDonald's vs. Burger King and now some would say, active vs. passive investing.

The media often turns this debate into an either/or battle. However, both strategies have their benefits and trade-offs (see Figure 1). While we, at Argent Capital®, believe in active management, we also understand the place for passive investment in some portfolios. When deciding on an active or passive investment strategy, or combination of both, we believe it is important for an investor to examine their investment objectives, appetite for risk, and level of skill in reviewing asset managers.

So this begs the question, "Why are so many people willing to discount active management as an investment philosophy today?" A look at three of the most common questions surrounding active management gives a view into why passive has become such a popular investment style and perhaps, why active should remain a vibrant and important asset strategy.

Figure 1. **Attributes of Active and Passive Investing**

Attribute	Active	Passive
Ability for above market returns	Yes	No
Availability of down market protection	Yes	No
Investment management fees	Yes	No (or low)
Buy/sell decision based on research	Yes	No
Buy/sell decision based on index, not research	No	Yes
Possible below market returns	Yes	Nominal (after fees)
Flexibility in sectors/stocks	Yes	No

According to various studies, the average active investor can't beat the market. Even Warren Buffett wants his surviving family to index when he is gone. Why would I select active management?

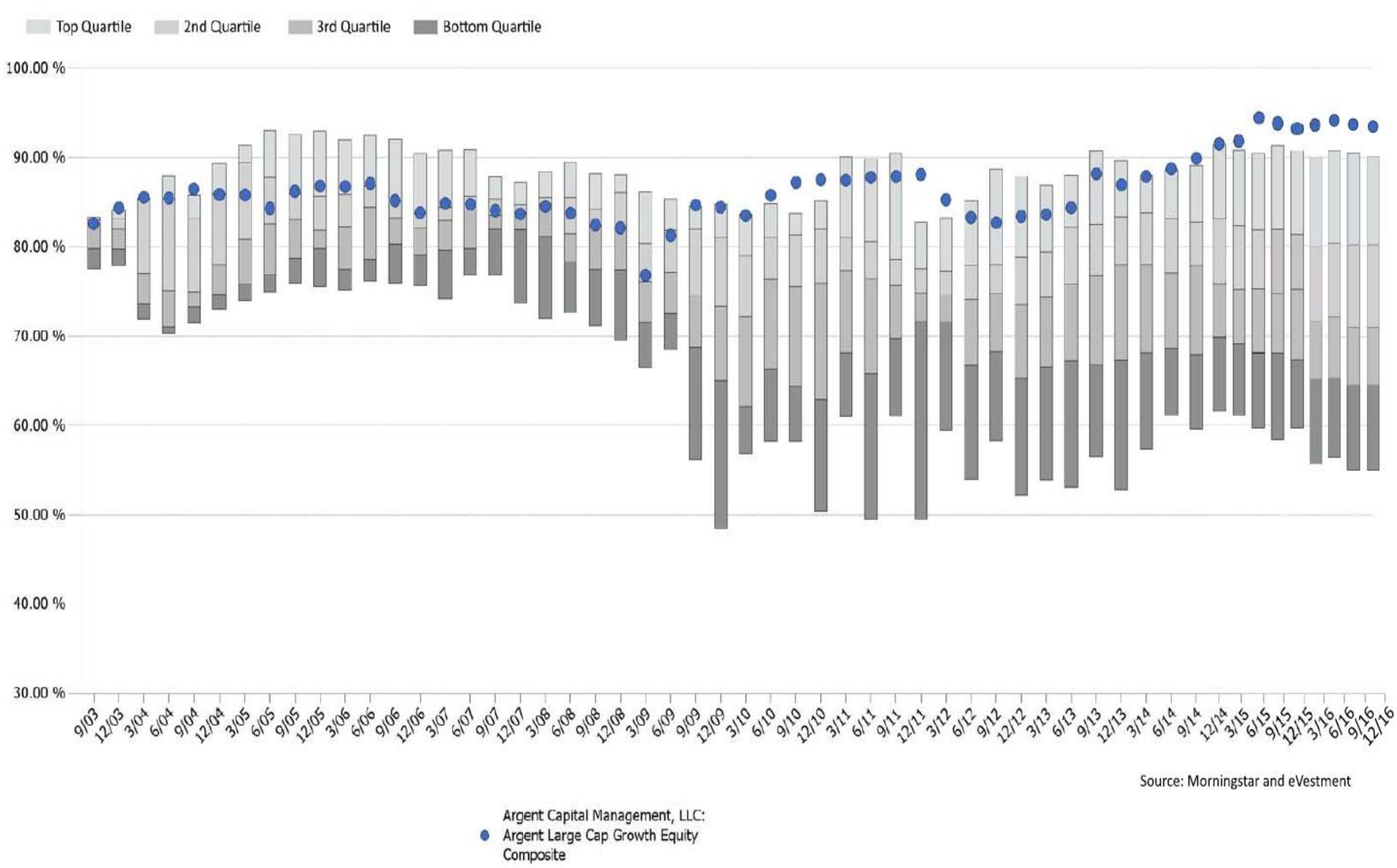
Average and above-average active managers

The *average* active investor often does not beat the market, but how do you select an *above-average* active manager? According to a 2014 study by Martijn Cremers and Ankur Pareek, two factors, active share percentage and a fund manager's patience, assist in identifying above-average managers.[1] The study analyzed a large sample of actively-managed, all-equity U.S. retail mutual funds from 1995-2013. The study found that those with both high active share (percentage of a manager's portfolio that differs from a benchmark index) and patient investment strategies where managers hold stocks longer instead of trading frequently (low turnover), tended to outperform their benchmarks by an average 2.3 percentage points a year, net of fees.

Argent's flexible but disciplined investment strategy contains both elements that characterize above-average managers: high active share and low turnover. The Argent Large Cap Growth Equity Strategy has a high active share (92.3% as of 4Q16, see Figure 2, Argent's Large Cap active share compared to peers) and a long-term investment horizon of 3-5 years resulting in a low turnover ratio (the ratio of all sales to buys in a calendar year over the number of fund shares outstanding) of 30.6%. These factors have assisted Argent's consistent, long term outperformance.

Figure 2.

Argent Large Cap Growth - Active Share[2]
Relative to Peer Group
09/30/2003 - 12/31/2016



Passive strategies have cycles

Another important consideration for review is the timeframe for studies. Much of the research and advocacy on passive investing has taken place during a bull market (2009 to 2014). As a consequence, most research shows that on average, passive strategies have produced solid returns over long periods of time. The research fails to take into account what happens during different market conditions, which can have a significant impact on which strategy performs well. Historically, passive investments tend to outperform in rising markets and actively managed investments perform better in negative, or flat to moderate markets.

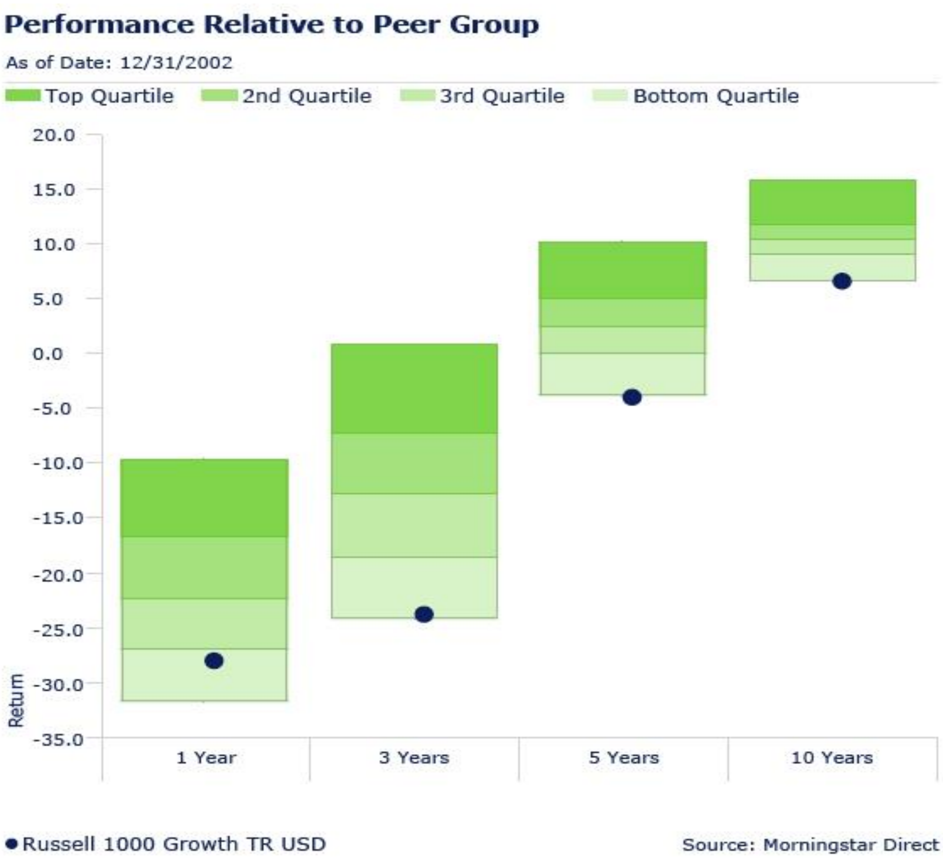
When examining Morningstar data, active large cap funds outperformed passive funds nine out of 10 times from 2000-2009 and passive funds outperformed active from 2010-2015.

In times of market corrections and rising rate environments, active funds also fair better than passive. For example, from 1987-2015 there have been 21 market corrections. During this time period, active outperformed passive funds 76% of the time. Throughout this same time period, active strategies outperformed passive strategies 82% of the time during rising rate environments.[3] No one can predict the future, but entering into a bear or flat market, market correction, or a rising rate environment may cause a passive strategy to look much less attractive.

Additionally, making a decision to shift into a passive strategy while currently in an active strategy would disregard the cyclicality of market trends. For example, if an investor decided to shift to a passive strategy in 1999 because they had below market returns from their active manager, they would have realized the full effect of the tech crash in 2000 and the 2008 Financial Crisis.

Figure 3.

Russell 1000 Growth Index Performance Relative to Active Managers



Takeaway

The key to remember is that some active managers can outperform the market, but they need to have the requisite philosophy and a consistently applied investment process to make them above average managers. Additionally, performance of both active and passive funds can be highly dependent on market conditions. Taking these factors into account is vital when selecting an investment strategy that is right for you.

Aren't passive funds "safer" than active funds?

Passive funds are safe in a sense that they will assure you market performance, for better or for worse. At times, we see investment committees communicating to their advisors that they want their performance to match a selected benchmark because it is "safer." However, passive strategies are only as safe as the asset class it replicates. A purely passive strategy can leave investors fully exposed if the market drops. There is a lack of risk management with indexing. Passive investors take on market risk in full while an active manager can mitigate some of the market risk through thoughtful investment decisions. Active managers have a risk point where they will reposition in a stock or sector that has fallen out of favor.

One way a passive investor can become exposed to market risk is when a stock or sector receives a higher weight in its index. If a stock performs well it increases its market capitalization and obtains a higher weight in the index. As a passive investor, you can become heavily exposed to a stock (or sector) that is doing well now, but may or may not do well in the future. For example, at the height of the tech boom in March of 2000, the tech sector made up a 34% weighting in the S & P 500 Index, leaving investors in passive funds highly exposed. [4]

As an active investor, Argent has the philosophy of *Intelligent Growth* investing which seeks companies that have a large upside potential and a lower than average downside risk, meaning the stock has greater growth potential than loss potential.

Takeaway

The argument that a passive strategy is safer because it guarantees market returns is valid if you are only concerned with matching the benchmark. This philosophy can disappoint investors when an index becomes heavily weighted in a stock or sector and they have no means to secure downside protection when the sector or stock drops.

Isn't indexing the best option because it ensures market performance? You don't have to worry about underperformance.

Currently passive investment strategies have been riding the wave of outperformance. If you are in an active strategy now, you may feel the pressure to react to an active manager's short term underperformance of the benchmark by moving to a passive strategy. The phenomenon of institutional managers being hired after large positive excess returns and terminating them at their lows is well known.[5] When faced with an underperforming active strategy, this is a case where an investor's objectives regarding returns come into play. If an investor is satisfied with the benchmark's performance, passive investing may be the best option.

But in order to achieve above market returns, an investor must have the endurance to withstand periods of underperformance. A good active manager should consistently communicate their strategy giving you an understanding of what they are doing and why they are doing it.

Even skilled active managers, because of their process, can experience underperformance that can run multiple time periods. Active managers need time for their process to return results. For example, Argent has beaten the Russell 1000 Growth, net of fees, for the trailing 15 years (as of 4Q16) and since our inception in 1998.

While Argent has not outperformed our benchmarks every year, our years of outperformance have offered greater gains than relative losses in years of underperformance. Thus, time has been of critical importance to our success.

Takeaway

Indexing will ensure market performance, but most investors aren't satisfied with market returns. When investing in an active strategy, which has the ability to achieve above market returns, it can take time for the investment process to deliver results.

Key Points

- There is a place for both active and passive funds depending on your investment goals, appetite for risk, and time and ability to assess active managers.
- Bull market cycles tend to favor passive investing.
- Bear or flat market cycles, market corrections, or periods of rising interest rates favor an active investing strategy.
- If you are looking for an active manager, make sure you select a manager with a high active share and a patient investment strategy.
- When selecting an active management strategy, give the investment strategy time to deliver results.

Conclusion

Although the debate between active and passive investing will most likely continue far into the future, we take a different approach, seeing a world where both strategies can coexist. What makes this discussion compelling is the idea that investors now have a ***choice*** between active or passive, or perhaps a strategy that combines both.

Endnotes

[1] Konigsberg, Ruth, "New Study Identifies the Most Underappreciated Investment Skill," http://time.com/money/3652118/new-study-identifies-the-most-underappreciated-investment-skill, (January 5, 2015).

[2] Source: eVestment & Morningstar. For comparison purposes, the strategy is measured against the Russell 1000 Growth® Index. Russell Investment Group is the source and owner of the Russell Index data contained and reflected in this material and all trademarks and copyrights related thereto. Russell Investment Group is not responsible for the formatting or configuration of this material or for any inaccuracy.

[3] Source: FactSet, Morningstar, 1/16.

[4] Hum, Robert, "Technology Stocks Reclaim 20% of the S&P 500 Weighting," http://www.cnbc.com/id/46399386, (February 15, 2012).

[5] Goyal, Amit and Sunil Wahal, "The Selection and Termination of Investment Management Firms by Plan Sponsors," *The Journal of Finance*, Vol. LXIII, no. 4 (August 2008): 1805-1847.