COMMITTEE REPORT:
INVESTMENTS

By **Preston McSwain**

How Can Trustees Be Prudently Passive?

By actively following the evidence

Interest in what's commonly called "passive" investing is clearly growing, and trustees are considering index funds and exchange-traded funds (ETFs) more often.

It's not enough, however, to follow someone's advice to invest in index funds.

Actual passivity contradicts the trustee's duty to act as a prudent fiduciary. Passive investment products are potentially as complex as any other, and prudence demands careful evaluation.

So, let's cut through a few misconceptions and myths about this type of investing and learn how to be more prudently passive.

Never Passive

First, repeat after me: No investment manager or investment strategy is passive.

Even managers of an S&P 500 index fund or ETF, whom many would say are the most passive investors in the world, are quite active.

These managers must: evaluate the proper use of futures, swaps or other derivatives to manage allocations, additions and withdrawals; audit daily updates from index fund data providers; trade before, during and after index changes; decide how to handle corporate actions in a timely and efficient manner; and execute everything at the lowest trading, administrative and custody costs to make sure they track the S&P 500 within a few hundredths of a percentage point every year net of all fees.

Preston McSwain is a managing partner and founder of Fiduciary Wealth Partners in Boston

ETFs Can Be Anything

Next, remember the term "ETF" doesn't signify an active or passive investment approach at all. Instead, it refers to an investment product structure and nothing more.

Like the term "hedge fund," the term "ETF" is a catch-all.

An ETF can be designed to replicate a traditional index such as the S&P 500. It can be sector specific (financial stocks only). It can include a mix of stocks, bonds, commodities or derivatives. It can be designed to increase, decrease or trade on market risk. It can be run by concentrated high risk or low volatility managers. In short, an ETF can represent any type of investing.

Today, there are more ETFs than individual stocks, and by my latest count, the big three alone—that is, State Street, BlackRock and Vanguard—currently offer 463.

The list of so-called "passive" ETFs is a little smaller, but trustees still need to actively evaluate a vast array of options and strategies that can be market cap weighted or equal weighted, sector or style specific, and they need to evaluate the differences and appropriateness of various indices (S&P versus Russell, MSCI versus FTSE, etc.). Trustees must also understand new factor-based or smart beta funds and decide if it's appropriate to use physical or synthetic index replication strategies. Oh, and let's not forget various large-cap, mid-cap, small-cap, domestic, international, global, emerging markets and frontier products, which can have subsets with embedded currency hedged overlays.

The Hard Problem

So, how can a trustee prudently navigate the passive versus active debate and invest in a prudent manner?

Paraphrasing the wisdom of Berkshire Hathaway's Warren Buffett and Charlie Munger and the origins

of the word "prudent," I would argue that a fiduciary should stay focused on a judicious and rational review of the evidence to avoid big mistakes and wisely remember that excitement can be an enemy of what's most suitable and profitable.

The problem is that talk about money can be exciting and, as I touched on above, investment terms can sometimes be misused and emotionally charged.

Just think about the terms "active" and "passive."

According to the dictionary, the word "passive" means "inert" and is synonymous with "docile," "acquiescent" and "compliant."

How do you feel when you hear those who invest in index funds being called "The Passivists"[1] or when investment firms suggest that you should be active, smart or scientific versus passive?

Also, does "passive" sound prudent in the eyes of beneficiaries, who expect you to be actively working on their behalf?

Recently, I heard a great comment about this from Charles Ellis, who was the chair of Yale's investment committee for nine years alongside David Swensen.

Ellis was asked: "What is the biggest risk [trustees face] when investing in index funds?"

His answer? "Being called passive."

For many years, I made a living as a successful salesperson of stock-picking managers, alternative strategies and complex investment models.

Believe me when I say that the industry spends a lot of time and money on training people how to sell emotional presentations to different audiences. They know well that it's much easier to acquiesce to the excitement of the presentation than to stay anchored on the prudent solution to the problem: the evidence.

Independent Evidence

Staying focused on the evidence isn't easy, and a critical first step is understanding the point of view and potential biases of data sources.

You might hear concern from some commentators about ETFs being "worse than Marxism"[2] or "worse than the misuse of antibiotics."[3]

Ironically, the investing behavior of the sources of some of these concerns doesn't seem to reflect much concern.

For example, CNBC recently reported that hedge funds now own over $50 billion worth of ETFs and that "some managers have the majority of their portfolios in ETFs."[4] And, as far back as 2013, a *Weathmangement.com* article was already pointing out that many active managers held large amounts of index ETFs.[5]

Yes, as it turns out, some of the largest investors in "passive" ETFs are the same active managers raising concerns in public commentary.

Back to Buffett, remember, "never ask a barber if you need a haircut."

Translation: Fund managers or advisors who pick funds for a living can be overly conflicted. In full disclosure, I'm one of these advisors, so as I recommend to our clients, stay focused on data from independent studies and third-party non-asset managers.

Another lens trustees are more recently being encouraged to apply is whether they should be more scientific or smart in their investment fund choices.

Prudent Sources

Two of the most well-respected sources of data in our industry are S&P Dow Jones Indices and Morningstar. Both show prudence by making sure their analysis compares apples to apples (large-cap versus large-cap, growth versus growth, global versus global, etc.), includes all funds that were available to investors (correcting for what's called "survivorship basis") and carefully looks at probabilities and consistencies over extended time periods (yes, long-term evaluation is key).

I think it's also sensible to look at peer-reviewed academic papers.

Once you've assembled a set of independent sources, anchor your thinking on a reasonable set of criteria. The following list isn't complete, but I suggest a careful review of what the evidence shows about the following:

- Probability of success
- Smart choices
- Fees and taxes
- Down markets and bubbles

Probability of Success

I would argue that a judicious trustee has the responsibility to evaluate what types of investment funds have the highest probability of achieving the target returns of each asset class that's been defined by a well-documented investment policy statement (IPS).

Importantly, notice that I said, "documented by an IPS." If you don't have one for each trust, please have the foresight to stop here and develop one for each trust that memorializes goals and needs, and based on an analysis of long-term return probabilities and risks, sets long-term, diversified asset allocation targets and minimum and maximum allocation risk control ranges around those long-term targets.

Assuming you have an IPS, also notice, I didn't say a responsibility to outperform an asset class.

I'm sure this can be debated, but if you think Buffett, Munger and many other seasoned professionals are correct when they suggest that the key to success is avoiding mistakes, then the independent evidence seems to be clear.

The probability is quite high that anyone who tries to actively pick an active investment manager will make a lot of mistakes.

When considering this, you can find independent studies that go back to the late 1990s,[6] but some of the most comprehensive ones come from S&P Dow Jones, which has been analyzing data on this subject every year for 15 years.

Sometimes illustrations are powerful, and "A Poor Showing," this page, speaks volumes. It shows how few active managers, who invest across a broad range of domestic and global asset classes, outperformed their benchmarks over the past 15 years.

Only 2.52 percent of U.S. large-cap core managers outperformed the S&P 500 and, contrary to what many suggest, the evidence shows mid-cap, small-cap, developed international and emerging market active managers also have a low probability of outperforming.

And, sorry advisor peers, apparently, we aren't very good at picking the winners among the few that outperform.

According to a study published by *The Journal of Finance*, researchers from the University of Oxford and University of Connecticut found "no evidence" that recommendations from institutional investment consultants "add value, suggesting that the search for winners, encouraged by consultants is fruitless."[7]

A Poor Showing

% of active managers that outperform their benchmarks

Fund Category	15-Year Returns (period ending Dec. 31, 2016)
Large-cap core funds	2.52%
Mid-cap core funds	1.41%
Small-cap core funds	5.36%
Developed international funds	10.64%
Emerging market funds	10.11%

— S&P Dow Jones SPIVA Scorecard for the

Why finding a top active manager at the correct time is so difficult, however, might be best answered by performance persistence studies.

The most recent S&P Dow Jones manager persistence study looked at the returns of over 2,800 U.S. funds and found that 880 had outperformed their benchmarks for the 3-year period ending Sept. 30, 2013.

After tracking the persistence of these outperforming funds, they found that only 0.5 percent of all the funds and **no large-cap, mid-cap core or small-cap managers were still outperforming after the subsequent three years ending Sept. 30, 2016.**[8]

Meaning, as they also found in a previous study, it's quite difficult for any fund to persist as a top performing fund.[9]

In addition, Morningstar, in their most recent 10-year study, states that "there is some evidence that relative [top] fund performance persists in the short-term," but that it doesn't seem to be due to "manager skill."

They then conclude that: "In most cases, the odds of picking a future long-term [active management] winner from the best performing quintile in each category aren't materially different than selecting from the bottom quintile."[10]

Additional Smart Choices

The S&P Dow Jones and Morningstar studies focus on

how traditional market-weighted indices performed versus traditional stock-picking active funds.

Another lens trustees are more recently being encouraged to apply is whether they should be more scientific or smart in their investment fund choices.

Framing the debate by claiming that a certain strategy is "smart" is quite clever, and the old sales guy in me smiles at the subtle inference that other types of investing are dumb.

One thing is for sure, though. Smart and Scientific Beta (SB) factor ETFs are getting a lot of attention, so again let's look at the data.

Many academic studies and heated debate exist among the SB community. Some make good arguments that actively constructed ETFs—which favor say, small-cap, value or momentum stocks—might be able to outperform traditional index funds over the long term.

When considering this debate, just be sure to focus on the definition of long term, the consistency and magnitude of the possible outperformance and how the data is being compiled and presented.

Related to this, look at the studies from institutions such as Wharton, which found "no evidence that SB ETFs significantly outperform their risk-adjusted passive benchmarks" and consider a piece by the Yale School of Management that concluded that "[SB strategies] likely aren't the most efficient way to achieve [some] goals."[11]

As I heard someone say last week, investors are being sold on the idea of foregoing "dumb" beta options that cost five basis points to track an asset class, in favor of "smart" ETFs that cost 100 basis points, which might have the opportunity over a 10-year to 20-year period to outperform the same asset class by 50 basis points.

Ask yourself, is it smart or dumb to buy something, based largely on statistical (gross of any fee or transaction cost) hypotheticals that disclose the possibility of large multi-year periods of underperformance, when using the assumptions above, the numbers are as follows: Fifty basis points outperformance minus 100 basis points in fees equals underperformance of negative 50 basis points.

Fees and Taxes

Yes, what matters is performance after costs are considered, and the costs to consider come in two major forms: fees and taxes.

A discussion on taxes could get quite lengthy, but as we know they're certain and important. When you look at after-tax returns, simple index funds are hard to beat.[12]

Concerning fees, trustees should always be shrewd, even in their evaluation of funds and ETFs that track indices such as the S&P 500.

In saying this, I'm not talking about the current fee wars being raged at the thousandth of a percentage point level (no that isn't a typo).

What I'm cautioning is making sure you avoid S&P 500 index funds that can have total expense ratios of 100 basis points or more versus the ones that only charge four basis points or less.

Take, for example, the Rydex S&P 500 funds listed below, which seek investment returns that match the performance of the S&P 500 index. (After each fund is its expense ratio.)

> It's prudent to evaluate how investments are likely to perform in down markets.

1. Rydex S&P 500 Fund Class A (RYSOX): 1.55 percent
2. Rydex S&P 500 Fund Class H (RYSPX): 1.55 percent
3. Rydex S&P 500 Fund Class C (RYSYX): 2.31 percent

To be fair to Rydex, it says those funds will match the performance of the S&P 500 "before fees," but how can they come close after fees?

Rydex's mutual fund fact sheet shows that their lowest fee and highest performing S&P 500 fund has underperformed the index by approximately 1.5 percentage points per year over the past 10 years.[13]

By comparison, low cost index funds match the performance of the S&P 500 within hundredths of a percentage point.

Down Markets and Index Bubbles

Finally, it's prudent to evaluate how investments are likely to perform in down markets. I often get questions about market bubbles, how the market will perform in the future and what tactical asset allocation changes or bets a trustee should make around long-term IPS allocation targets.

When this happens, I quickly try to remind everyone of the following: "It's tough to make predictions, especially about the future."—Yogi Berra

Berra's wisdom aside, over the course of close to 30 years in the business, I've looked far and wide across the market and academia, and I've yet to see credible evidence that anyone can consistently and tactically time asset classes or the market over long-term time periods (evidence to the contrary is welcome, but please make sure it's long-term and shows consistency that's highly probable).

When picking products, stay anchored on long-term and consistent data from independent sources.

Based on this, I'll stick to what the evidence shows about managers' ability to outperform in down markets. Two independent studies give us useful data.

According to S&P Dow Jones, a report from 2008 showed that "a majority of active funds in eight of the nine domestic equity style boxes" underperformed their appropriate index in 2008 and that active strategies produced "similar outcomes" in the 2000 and 2002 bear markets.[14]

In another detailed study completed in 2001, the Schwab Center for Investment Research found the following after analyzing the performance of over 2,100 large-cap actively managed funds and 120 large-cap index funds during market declines between December 1986 and March 2001:[15]

- Index funds outperformed actively managed funds in 55 percent of the down markets.
- In the worst downturns, defined as declines of 10 percent or more, index funds outperformed actively managed funds 75 percent of the time.
- In the longest downturns, defined as declines of five consecutive months or longer, index funds outperformed actively managed funds 100 percent of the time.

Finally, what about the rumored index fund and ETF bubbles?

It would significantly increase the word count to go into all the analysis that seems to refute these concerns, but I'll take a brief moment to discuss one:

Large flows into index funds and ETFs have gone too far and are in danger of undermining market efficiency.

Let's again look at what the data implies. The latest reports from the Investment Company Institute[16] and others suggest that approximately one-third of equity investment assets in the United States are now in index strategies or SB ETFs.

And, even though flows and trends toward index strategies are likely to persist, based on just emotion alone, I never see the allure of active management diminishing enough to reach a market inefficiency tipping point (see latest flows to active funds).[17]

Maybe the simplest point to think about is this:

If big flows into index funds make markets less efficient, one would expect the probability of active management success to have been increasing over the past 10+ years, when flows to index vehicles have been significant. As I've discussed, however, the percentage of active managers outperforming over this period has become consistently smaller, not larger.

Unconventional Trustee Success

So, as a trustee, how can you do better[18] and be more prudent when making investment decisions?

Foremost, stay focused on your plan and IPS. If not, you're likely to buy someone else's strategy at the wrong time.

Next, when picking products (for example, index funds, ETFs or active managers), stay anchored on long-term and consistent data from independent sources.

This isn't easy, so to help, I'll end with a sage quote from a leading fiduciary, David Swensen, who on behalf of Yale has proven himself to be one of the most successful Chief Investment Officers in the world:

> When you look at the results on an after-fee, after-tax basis over a reasonably long period of time, there's almost no chance that you end up

beating a [prudently passive] index fund.[19]

Endnotes

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