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Enhanced practice management: The case for combining active and passive strategies in the UK

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- One implication of the transition toward a fee-based practice model is that "client risk" (for an adviser's practice) may increase if clients decide to pull assets or terminate a relationship because of a mutual fund's underperformance versus common market indices.
- This "client risk" exists because it is often short to intermediate-term performance that can put a relationship under pressure, even for long-standing clients.
- Mitigation of this client risk is a frequently overlooked benefit of adding broad-based passively managed investments – that is, index funds or exchange-traded funds (ETFs) – to a portfolio primarily comprising actively managed funds.

For advisers who have elected to use active management, either on their own via security selection or through professionally managed funds, one hurdle is that outperformance is difficult to achieve (Westaway et al., 2014).

Figure 1 demonstrates two challenges of picking actively managed funds. First, over each five-year period that we evaluated and over the full ten years ending 31 December 2013, the median fund underperformed its prospectus benchmark. Looked at in a different way, in each period, more than 50% of the funds failed to deliver on their objective of outperformance. Second, the performance spread between the top 5% and bottom 5% of funds was more than 7 percentage points annually. This degree of dispersion can lead to client risk, as we discuss below.

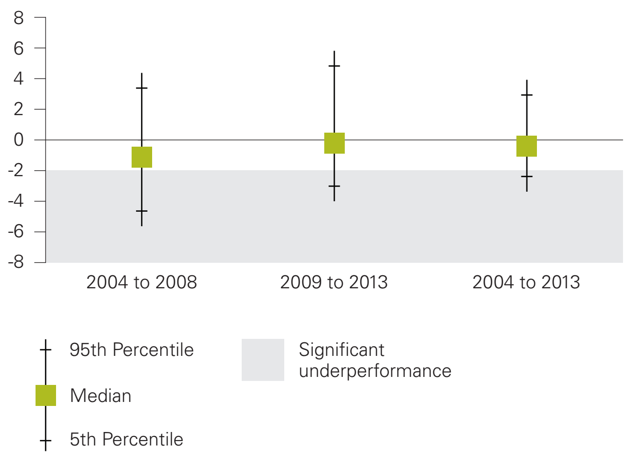
Complicating this is that over the full ten-year period, nearly 42% of all funds that were alive on 1 January 2004 were liquidated or merged at some point before 31 December 2013.

As Figure 2 shows, the risk to an adviser's practice when using active funds exclusively is that, in volatile markets and uncertain times, significant underperformance can lead to an elevated risk of clients leaving one's practice. We submit that this risk is larger than can be offset by positive client referrals during the good times.

That is, although the upside of outperformance may be a marginally greater share of wallet or referrals, underperformance can lead clients to question the strategy or withdraw assets–plus nonexistent referrals.

Indexing can help mitigate the risk of unwise investor behaviour and negative feedback loops for the adviser's practice. Moreover, adding a slice of passively managed funds or ETFs can help free up resources typically spent on manager research and oversight. These resources can then be redirected towards improving relationships with existing clients or attracting new clients.

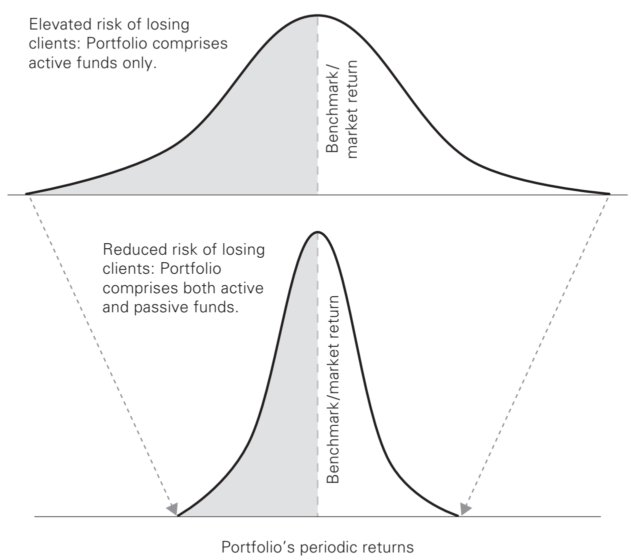
Figure 1. Advisers and their clients face a wide distribution of potential outcomes when using active management



Notes: Fund universe includes equity funds available for sale in the UK from the following Morningstar categories: UK equity – flex cap, large-cap blend, large-cap growth, large-cap value, mid-cap, small-cap; Europe equity – Europe OE: flex-cap, large-cap blend, large-cap growth, large-cap value, mid-cap, small-cap; Euro zone equity – flex-cap, large-cap, mid-cap, small-cap; Global – flex-cap, large-cap blend, large-cap growth, large-cap value, mid-cap, small-cap; US equity – flex-cap, large-cap blend, large-cap growth, large-cap value, mid-cap, small-cap; Emerging markets equity – emerging markets. Performance is for periods ending on 31 December 2013. Performance is calculated relative to prospectus benchmark. Fund performance is shown in GBP terms, net of fees, gross of withholding tax, with income reinvested, based on closing NAV prices. Results in each period reflect only those funds that survived the full five years.

Sources: Vanguard calculations, using data from Morningstar, Inc.

Figure 2. Adding passive funds to a portfolio can shrink performance distribution around the market, reducing flight risk: a theoretical example



Source: Vanguard.

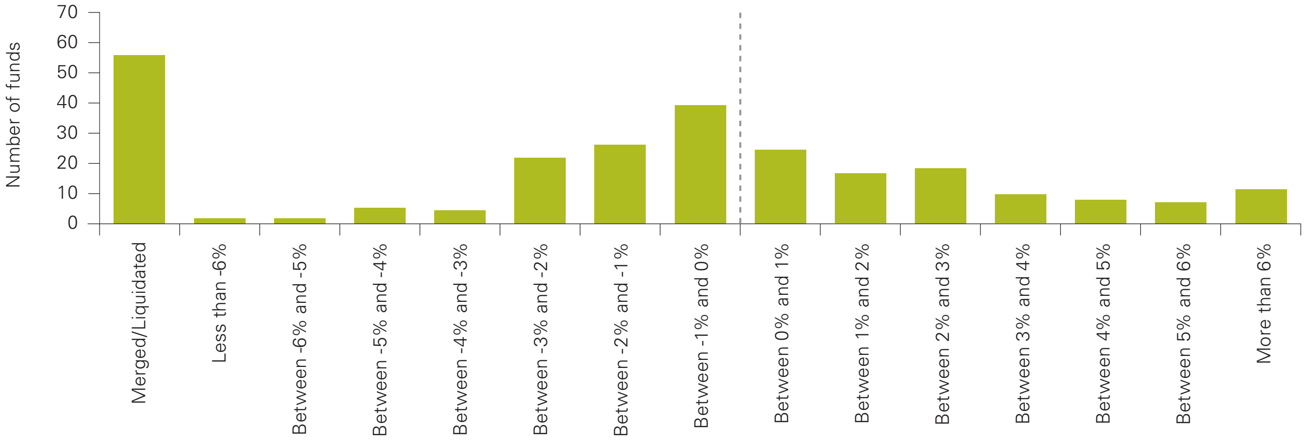
Figures 3a and 3b demonstrate the implications of dispersion among fund performance and the cyclicality of outperformance. For this example, we ranked all funds over the first five-year period shown in Figure 1, then selected the top 20% of funds. We then tracked the performance of those top funds over the next five-year period (ended 2013). Figure 3a shows the results of that exercise. It is interesting that, although these funds were the top performers over the first period, their performance did not persist, and instead formed a distribution similar to our theoretical example in Figure 2.

Also, only 38% (109) of the funds that were top performers over the first five years even managed to outperform over the next five years, while an even lower proportion of 22% (62) turned in what we would call "significant" results of more than 2% annual outperformance.

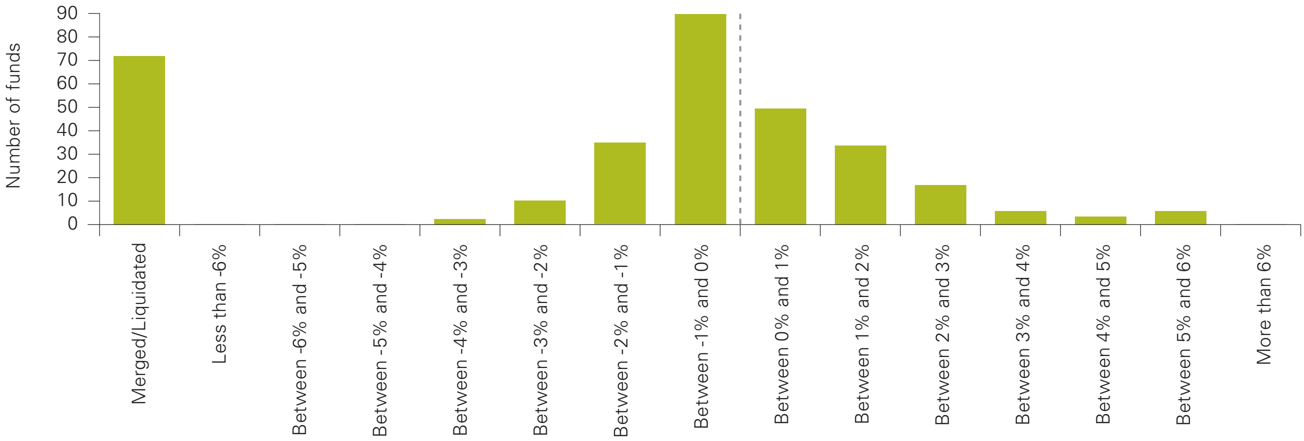
On the other hand, 14% (40 funds–see Figure 3a) realised "significant" underperformance of -2% or more annually, while another 64 funds were liquidated/merged at some point between 2009 and 2013.[1]

Figure 3. From theory to practice

A. Distribution of excess returns over five years ended 2013 for funds that ranked in the top quintile as at 2008



B. Same distribution but adding 50% allocation to each fund's style benchmark (including a 10-bp annual haircut to benchmark)



Notes: Fund sample is defined in the notes to Figure 1. Figure 3b includes the same funds as Figure 3a, but combines each fund with a passive index matching the fund's investment style in a 50/50 ratio. To reflect implementation expenses, the index returns are reduced by 10 bps annually. Excess returns are measured relative to a fund's stated benchmark. Data reflect excess returns over the period 2009–2013 for the 224 funds in the top quintile from 2004 through 2008.

Sources: Vanguard calculations, using data from Morningstar, Inc.

1 For more on the performance of funds that were merged or liquidated, see Schlanger and Philips (2013).

The impact on a portfolio of adding a diversified passive index fund or ETF is notable. Figure 3b uses the same funds as Figure 3a, but adds a 50% allocation to a benchmark matching the funds' investment style. To reflect implementation expenses, we have reduced the benchmark returns by 10 bps annually. Practically speaking, similar results can be achieved by using a broad-market index fund to help control relative risk in the aggregate portfolio.

First, as would be expected, the active/passive portfolio produced lower positive excess returns (35% of funds, or 102 funds, continued to outperform). However, perhaps more importantly, the active/passive portfolio also reduced relative "trail risk" of significant underperformance. In fact, the number of significant underperformers was reduced to 11, or 4% of the available funds (versus 14% for the primarily active portfolio in Figure 3a).

Mitigating such significant underperformance can be critical to successful long-term client relationships. The adviser who uses passively managed products may be better able to shift client conversations from the sometimes difficult topic of investment performance to estate and family wealth planning, which are not subject to the risks of the market. These services can be a more reliable base upon which to build an enduring practice.

References

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