Revisiting the Active vs. Pasive Debate in Today's Markets

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Recently, we have seen a considerable increase in volatility in the market, with wide swings in the major market indices. The volatility started with the announcement of the highest annualized wage growth since June 2009, which ignited renewed fears of inflation. However, the outsized move was exacerbated when traders exited trades that benefit from low volatility in the marketplace. The traders were concerned about increasing bond yields, higher inflation and potentially rapid economic growth causing more volatility ahead.

Since the beginning of the economic recovery, the appreciation in the stock market has caused price earnings ratios (P/E ratios) to rise. The P/E ratio of the S&P 500, based on trailing twelve-month "as reported" earnings, is currently 25 times, compared to 17 times five years ago; therefore, stocks are now considerably more expensive. We are also in a low interest rate environment, which means the cost of capital is low. Companies with high debt on their balance sheets can leverage earnings growth better than companies with strong balance sheets. Due in part to this, investors have sought out companies with higher leverage, as they have largely outperformed companies with strong balance sheets. During this time period, actively managed equity funds, on average, did not outperform passively managed index funds.

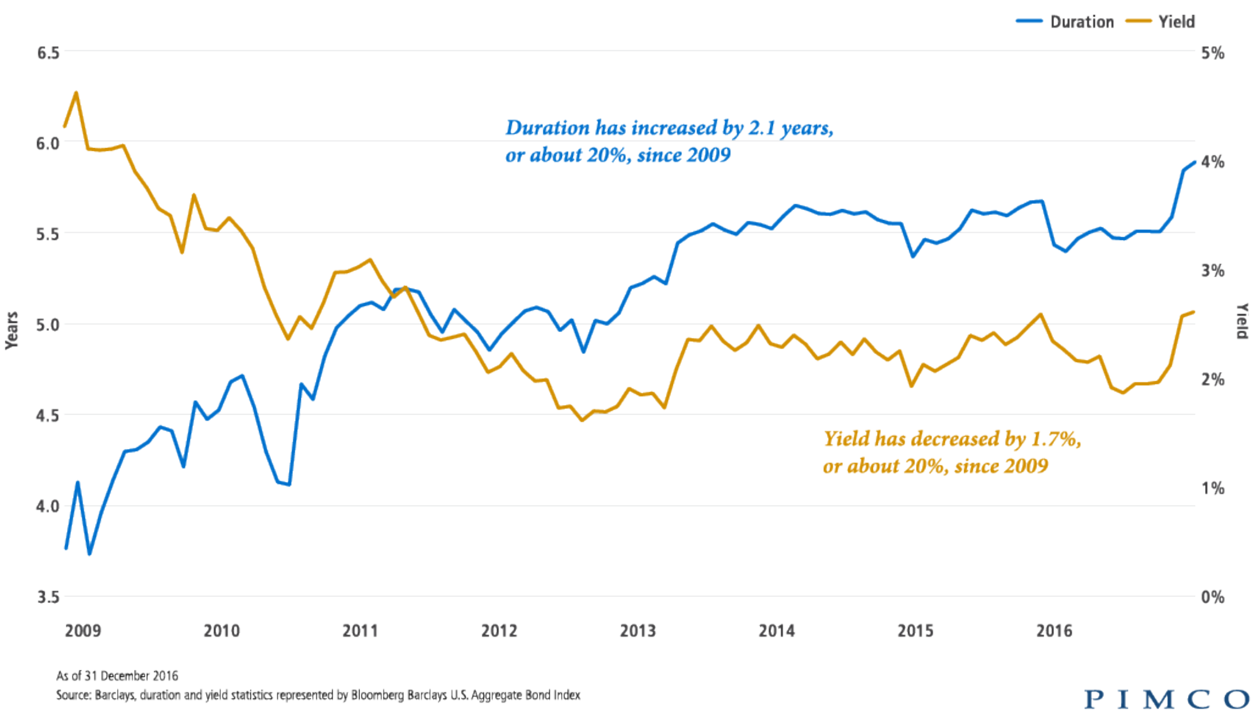
In an environment where interest rates are rising, volatility has returned, and inflation is potentially increasing, investors may focus more on quality of earnings and risk. An active manager may have a higher expense ratio, but the securities selected for investment will have a quality bias, such as strong earnings growth, recurring revenue or strong management. Passive funds focus on market capitalization, with no regard for fundamentals; the index may include companies with strong balance sheets and companies on the verge of bankruptcy. Passively managed funds are a good choice for an efficient market class such as large capitalization equities; however, in a market where valuations are extended or the asset class is inefficient, actively managed funds should not be ruled out due to expenses alone.

Assets have also increased in passively managed fixed income funds, with a majority of funds benchmarked to the Bloomberg Barclays U.S. Aggregate Index. However, fixed income is much different than equity, and the considerations are broader. As illustrated below, most active fixed income managers have out-performed the index net of fees.

	Total Return Net of Fees (%) through 12/31/2017				
	1 Year	3 Year	5 Year	7 Year	10 Year
Bloomberg Barclays U.S. Aggregate Index	3.54	2.24	2.10	3.20	4.01
Median Passive Manager[1]	3.50	2.16	2.03	3.12	3.89
Median Active Manager[2]	**4.07**	**2.49**	**2.33**	**3.64**	**4.47**
Top Quartile Active Manager[3]	4.78	2.92	2.79	4.08	4.88

Source: Morningstar. As of 31 Dec 17
Past performance is no guarantee of future returns. There is no assurance active strategies will outperform passive strategies.

An S&P 500 index fund is easy to replicate, as there are 500 securities which are updated quarterly and are perpetual. This is not the case with the Bloomberg Barclays Aggregate Index, since approximately 20% of the index changes monthly. Bonds mature, new bonds are issued and coupons depend on the interest rate environment. As the chart below illustrates, since 2009, duration (a measure of risk) has increased and the yield has decreased on the index.



Unlike Index funds, actively managed fixed income funds do not have to match the benchmark duration. Each fund has its own mandate, but generally they can increase or decrease duration to protect the portfolio in a rising rate environment or achieve additional return in a declining rate environment. They also have the ability to position the portfolio with greater emphasis on certain sectors of the yield curve which they consider to be attractive. Actively managed funds can make tactical allocations to asset classes deemed undervalued.

Active managers have a wider opportunity set of fixed income securities in which to invest, including financial derivatives, global bonds and lower-quality debt. The Bloomberg Barclays Aggregate Index is a market-cap weighted index which includes bonds with more than one year left until maturity. It also has only fixed-rate bonds and includes investment-grade bonds that must meet a minimum issue size. Roughly 95% of the index is Treasuries, pass-through mortgage-backed securities and investment-grade credit. Currently, the index is 32% investment-grade corporate bonds. Since this is market capitalization-based, the most debt-laden companies have the highest weight in the index. Passive investing in fixed income allows for only limited return from credit upgrades. Active management can benefit from security level credit research. The benchmark index is U.S.-based. The absence of global bonds eliminates the ability to diversify returns through the inclusion of sectors that are not highly correlated with U.S. interest rates or the U.S. business cycle.

While the past five years have seen a large increase in passively managed fund assets, there are places in an investment menu to incorporate both passive and active investing. Investors should consider the merits of both styles of investing and decisions should not be predicated on expense ratios alone. In a period of rising rates and extended market valuations, incorporating fundamental analysis and considering valuation may result in better risk-adjusted returns over the long term.

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For more information on our services, please contact **Mike Volo,** Senior Partner, at **781.997.1426** or **mvolo@cammackretirement.com**.

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