In Indexing We Trust

Passive Investing Appears To Be The Standard For Investing And Managing Trust Portfolios

By Scott Simon

Illustration By Vasily Kafanov

Many trustees (as well as investors in general) are active investors. They believe that they, or someone they hire, can "beat the market."[1] The investment industry, as well as the financial press, both have substantial interest in promoting and encouraging this belief. Such factors and tendencies may lead many trustees to presume that active investment strategies are the best way to implement portfolio asset allocations.

The Reporter's General Note on Restatement (Third) of Trusts (the Prudent Investor Rule) Section 227 appears to turn this presumption on its head[2] "The greater the trustee's departure from one of the valid passive strategies,[3] the greater is likely to be the burden of justification [for selecting the proposed active strategy] and also of continuous monitoring [of it]."[4] This language, as well as the overall tenor of the Uniform Prudent Investor Act and the Restatement, which were passed in 1994, suggests strongly that a valid passive investment strategy is the standard against which the proposed active investment strategy should be compared. In short, passive investing appears to be the standard for investing and managing trust portfolios.[5]

Identify A Valid Passive Investment Strategy

When contemplating the creation of a portfolio, the trustee may find it helpful to first identify a valid passive investment strategy and then compare the proposed active investment strategy to it.[6]

The Act identifies the trade-off between risk and return as the fiduciary's "central consideration" when investing and managing trust assets. Risk and return data for asset classes are well established and widely available. These data show that the risk and return relationships among asset classes tend to remain relatively stable over the long term.[7] Asset class data is used in popular financial planning software (as well as more sophisticated asset optimization programs) to build portfolios.

It seems to make sense to utilize investment products that resemble, as closely as possible, the risk/return components of the asset classes comprising portfolio asset allocations. Passive funds are such investment products. For example, the expected return of an S&P 500 index fund is essentially the same as the expected return of the fund's underlying asset class benchmark, the S&P 500 Index. The actual returns should therefore be essentially the same. It may be that such investment products give the trustee using them more confidence that the portfolio asset allocations the trustee creates will be implemented accurately. Their use would also seem to allow the passively investing trustee to carry out his monitoring duties relatively easily.

Assess The Proposed Active Investment Strategy

The practical two-part test suggested by the Restatement Commentary can be used to assess the proposed active investment strategy. The second part of the test may be particularly helpful to the trustee. According to this part, the trustee should (1) determine the "return expectations" of the proposed active investment strategy, (2) "realistically evaluate" them and, (3) based on such evaluation, determine whether the proposed strategy can be "justified." If the proposed active investment strategy can be justified, then departure from a valid passive strategy is permitted.[8]

Determine The Return Expectations Of The Proposed Active Investment Strategy

The "return expectations" of the proposed active strategy are equivalent to the expected return of the strategy. There are a number of methods that the trustee can use to estimate expected return. These methods include (1) historical past performance, (2) future projected performance, (3) some combination of (1) and (2), or (4) others.

Realistically Evaluate The Return Expectations Of The Proposed Active Investment Strategy

Portfolio selections involve making decisions in uncertainty. The trustee must therefore understand that, when contemplating portfolio selections, future return is uncertain. That is, the return generated by a particular investment product (an individual stock, mutual fund, etc.) is a random variable subject to uncertainty. Because of this uncertainty, the future magnitude and sequence of the return of an investment product (whether active or passive) is unknowable. This makes it impossible for the trustee to identify, in advance, which investment products will be superior in the future. The uncertainty of the future returns of investment products is rarely seriously acknowledged by the professional investment industry that serves many trustees. On the contrary, many industry participants compete vigorously to see who can sound the most authoritative in convincing investors that they know which particular investment products will be superior in the future.[9]

Because return is uncertain, it's unmanageable.[10] The inability of the trustee to manage return[11] makes it difficult to realistically evaluate the return expectations of the proposed active investment strategy. However, the trustee does have the ability to manage investment costs, taxes, and risk.[12] Indeed, the Act and the Restatement emphasize heavily the key role played by these factors in realistically evaluating the return expectations of proposed active investment strategies.[13] For example, the variance (i.e., risk) of a stock (or a relatively small group of stocks) can be two to three times greater than the variance of the asset class of which the stock (or group) is a part. As a result, the expected return of a stock (or group) can be quite different than the expected return of the stock's (or group's) underlying asset class.

This kind of risk can be managed by investing in passive funds, since there is usually little variance between a passive fund and its underlying asset class.[14]

The significance of the unmanageability of return in comparison to the manageability of costs, taxes, and risk is put into perspective by paraphrasing a prominent executive at a mutual fund company:[15] Past returns are past and future returns are unknowable, but saving a dollar in costs and taxes is equivalent to a risk-free return, and reducing uncompensated risk can also increase return.

The Reporter for the Restatement cites another factor in evaluating the return expectations of proposed active invest-

ment strategies:[16] "Market efficiency information is especially relevant in assessing these expectations." The Reporter appears to be alluding to the popular belief that a greater number of "talented" money managers can find investment "gems" in inefficient markets.[17] Despite its widespread acceptance, this belief appears to be mistaken. Because of the zero-sum nature of all financial markets, mathematically only a minority of investors can ever outperform a market. The size of the outperforming minority, however, is determined by the costs of investing in a market, not the efficiency of a market. Market efficiency relates only to whether the minority that outperforms a market is skillful or just lucky.[18] Since trading and research costs tend to be higher in inefficient markets, the size of the ever-changing minority of investors that outperforms such markets is actually smaller than the ever-changing minority outperforming efficient markets.[19]

Determining Whether The Proposed Active Investment Strategy Can Be Justified

It's probable that many trustees justify adoption of proposed active investment strategies on the basis of the track records of money managers (or mutual funds or individual stocks).[20] For example, such a trustee may select exclusively from Morningstar five-star mutual funds.[21] It appears that such justifications should carry little (if any) weight. Reporter's General Note on Restatement Section 227 explains:[22] "[E]vidence shows that there is little correlation between fund managers' earlier successes and their ability to produce above-market returns in subsequent periods." The SEC reiterates this warning against reliance on track records by requiring that all mutual funds offered for sale feature some version of the following language: "Past performance is no indication of future results." A commentator admits bluntly:[23] "We know that the past [i.e., track records] is meaningless [as a method of picking future superior investments], but it is all we have."[24] Track records appear to be valid only insofar as they show what's happened in the past. There's little correlation, though, between what happened before and what will happen in the future.[25] In fact, data show the perverse tendency for superior track records to be followed by inferior track records (reversion to the mean).[26]

Some trustees may not care about track records; they simply want to find "skillful" money managers. It appears, however, that justifications for adoption of proposed active investment strategies based on the skill of their managers should also carry little (if any) weight.[27] The reason is that such managers are nearly always identified as "skillful" simply because they have superior track records.[28] For example, the money manager typically hired by a management consultant has a superior track record (i.e., in the top quartile) over a relatively short time period (i.e., the past three to five years). If—as stated plainly by warnings from the Reporter's General Note and the Securities and Exchange Commission (SEC)—track records have little validity, then trustees may be acting irresponsibly in many situations where they equate investment skill with superior track records. While much of the investing public equates investment skill with superior track records, it would seem that trustees responsible for investing money are under a duty to know better.[29]

Although the future returns of all investment products are uncertain, it would seem that the expected returns of stocks (or relatively small groups of stocks, or even active mutual funds[30] are relatively less certain than those of passive funds. The reason is that the returns of many active investment products diverge from their indexes or other benchmarks in both the short and long terms. As a result, the performances of these products often don't match the benchmarks that measure the performances of their respective underlying asset classes as well as the performances of passive funds match theirs. This can vastly complicate the ability of an actively invested fiduciary to implement asset allocations and carry out his monitoring duties properly. Justifications for many proposed active investment strategies would therefore seem problematic.

Evidence Supporting The Prudence Of Passive Investing

Two commentators paraphrase a prominent executive at a mutual fund family who explains why fiduciaries that use passive investment products can demonstrate prudent investment conduct:[31]

I can take away the difficult task of finding a stock picker or market timer that has a high probability of future consistency. Remember, without future consistency, concentrated investment positions in a few markets or a few stocks can be an investment disaster. One wrong call can destroy years of past profits made from correct market forecasts. Rather than risking all by trying to beat the market, I can offer you market-based returns at very low cost. This fact alone should be sufficient to assure that the indexed investment will be among the top performers in the long run. Future returns are unknowable, but saving a dollar in expenses is equivalent to a risk-free return. The more dollars that remain in the investment program, the more likely future portfolio wealth accumulation will be positive. As a fiduciary, indexing is an easy and reasonable way to demonstrate prudent asset management.

The suggestion that passive investing appears to be the standard for investing and managing trust portfolios may be unsettling to some. Nonetheless, the Reporter's General Note and the overall tenor of the Act and the Restatement lend credence to this assertion. The evidence supporting the prudence of passive investing seems compelling for a number of reasons.

First, the zero-sum nature of financial markets means that all passively managed money invested in a particular market will earn the market return. In contrast, 50% of all money invested in a market (whether invested in mutual funds, separate accounts or other investment vehicles) will always earn a return less than the market return. This simple mathematical fact is sobering enough.[32] What makes it even more disquieting is that these active investment vehicles unpredictably take turns underperforming.[33] This compounds the uncertainty facing the actively invested trustee (or his agent) when selecting investment products.

Second, the costs and taxes associated with passive investing are relatively lower. As a result, they don't significantly

impact the market return earned by passive funds. In contrast, the costs and taxes associated with many active investing programs are relatively higher. This can have a large impact on the return earned by investment products used in such programs. In fact, when costs and taxes are taken into account, significantly more than 50% of actively managed money underperforms in a market. Costs and taxes, as noted, are key factors in evaluating the return expectations of proposed active investment strategies in order to justify their use.

Third, passive funds are broadly diversified, so they are a relatively lower risk. In contrast, actively managed portfolios are less diversified because they're comprised of investments that differ from the market portfolio. By definition, this makes such portfolios a relatively higher risk. Indeed, efforts made by active money managers to maximize portfolio return ordinarily generate greater variance, resulting in less wealth for many such portfolios in comparison to equivalent passively managed portfolios. Risk, as noted, is a key factor in evaluating the return expectations of proposed active investment strategies in order to justify their use.

Fourth, passive funds don't experience style drift as quantitative index methodology of the indexes ensures that indexes stay within the styles defined by their methodology. Style drift can lead to a number of problems for the trustee holding such investment products in his portfolios. For example, it can make monitoring difficult. Style drift can also lead an active fund to underperform its benchmark, possibly causing the trustee to replace the fund with another fund and generate additional costs. In addition, style drift can render imprecise the implementation of portfolio asset allocations. An important presumption on which a portfolio's asset allocation is based is that the products used in the investment strategy to implement the asset allocation will be reflective of the asset classes comprising the allocation. Because of style drift, however, many active funds don't reflect accurately the asset class with which they're associated.[34]

Fifth, passive funds aren't subject to "manager risk" as are active investment products. This is the risk that an investor incurs when it hires a top-performing money manager and later discovers that the manager's performance was due to luck, not skill. Even when the performance results from skill, the risk continues because it's not known in advance whether the skill is repeatable. Avoiding manager selection risk can be a compelling method of managing portfolio risk, thereby helping to reduce the chances of fiduciary liability.

A number of commentators seem to support the suggestion that passive investing appears to be the standard for investing and managing trust portfolios.

The Reporter for the Restatement observes:[35] "[Restatement] commentary … understandably tends to emphasize relatively passive investment … "

Two commentators note:[36] "[T]he Restatement can be read for the proposition that passive asset management is generally a more prudent investment [strategy] than is active management. Because the Act draws so heavily upon the Restatement, this investment view may apply to the Act as well." In addition, trustees "must confront the apparent bias in the Restatement and the Act in favor of indexed funds versus actively managed funds." Furthermore, the trustee's duty to avoid inappropriate or unreasonable investment and management costs, "when read in conjunction with the Act's implicit assumption that markets are efficient, could lead a trustee to conclude that passive investing in index funds is superior to investing even in actively managed mutual funds."[37]

A commentator adds:[38] "While scrupulously avoiding any condemnation of active strategies, the overall tone of the Restatement comments leaves a firm impression that a primarily passive strategy which holds down costs is preferred.

Modern notions of prudent fiduciary investing may be fundamentally reshaped by the suggestion that passive investing is the standard for investing and managing trust portfolios.[39] Thoughtful trustees who use active investment strategies might be hard-pressed to justify their selection of many such strategies under the two-part test suggested by Restatement Commentary while rejecting low cost, low tax and broadly diversified passive investment strategies.[40] Such justifications, as noted, are problematic in many situations.[41] Two commentators characterize this as "rather disturbing, given the amount of trust funds that are actively managed."[42]

Trustees who do decide to engage in active investing should welcome the rigor of the two-part test suggested by Restatement Commentary. The test requires such trustees to identify more precisely, thereby forcing them to understand more clearly, their justifications for selecting particular active investment strategies.[43] This discipline may be helpful to their beneficiaries.

The "Wrong" Rationale For Passive Investing

Many trustees (as well as their advisors and agents) may not have a good understanding of passive investing.[44] Perhaps much of this has to do with the fact that the investment information system tends to place great emphasis on active investing.[45] Moreover, even when the case for passive investing is discussed, the treatment of the subject is often largely superficial. An example of this is the rationale often given for passive investing: "You should become a passive investor because over the last five years S&P 500 index funds outperformed 90% of all actively-managed funds."[46] This can be misleading to investors and is unfair to many active money managers. The reason is that the S&P 500, which measures the performance of U.S. large-company stocks, is used to measure the performance of many money managers who invest in U.S. small-company stocks. Thus, the primary rationale often given for passive investing in no way proves or disproves the inferiority or superiority of active or passive investing. All it means is that there was a mismatch between the performance in question and the benchmark used to measure it.[47]

It seems equally misleading (and unfair to passive money managers) to say—when small-company stocks outperform large-company stocks—that investors should adopt active strategies because 90% of actively- managed funds outperformed the S&P 500.

The "Right" Rationale For Passive Investing

At its core, the logic of passive investing rests on elemen-

tary arithmetic.[48] That is, the burden of the relatively high costs and taxes (as well as the negative compounding they generate against accumulating wealth) that characterize many actively-managed mutual funds (and other forms of active money management) grow larger over long time periods than the numbers representing the amount by which even most investment gurus beat a given financial market (or market segment).[49] This means not only that the chances of beating the market are very slim for such periods, but also that most active investors (whether professional or amateur) will likely substantially underperform the market and passive investors who earn the market return. Indeed, passive investors who earn "only" the market return actually achieve above average returns at lower levels of risk—in comparison to most active investors—without needing to beat the market.[50]

Passive investing can be a risk-, cost- and tax-efficient way of gaining broad exposure to different financial markets. It may be that, when implemented properly, passive investing is the best way to achieve simultaneously the two interrelated goals of many investors: (1) obtain the greatest possible portion of the returns offered by the asset classes in which they're invested, and (2) without exceeding some chosen level of risk. This is true of passive investing in both efficient and inefficient financial markets.

Myths Of Passive Investing

Given the suggestion that passive investing is the standard for investing and managing trust portfolios, it seems important that trustees become familiar with this approach to investing. A number of myths about passive investing have gained widespread acceptance. The discussion in the Appendix of the book this article is excerpted from, *The Prudent Investor Act: A Guide to Understanding,* carefully examines these myths.

7. Passive Investing: More Ethical Than Active Investing?

A commentator thinks that passive investing is a more "ethical" way to invest.[51] He decomposes expected return into two categories—ethical malfeasance and ethical misfeasance.

"Ethical malfeasance" occurs when an investment manager does something deliberately or conceals it (e.g., the manager knows that he's too drunk to drive, but drives anyway). For example, consider the manager who invests intentionally at a higher level of risk than the client chose without informing the client, and then subsequently generates a higher return than expected. The average return that's achieved over time exceeds that for investments at the client's selected risk level. The manager attributes the excess return to his superior investment skill.

"Ethical misfeasance" occurs when an investment manager does something by accident (e.g., the manager really believes that he's sober enough to drive). For example, consider the manager who can't manage cash properly or delays converting cash into investments. This incompetence causes the client's money to sit and forego expected return since it's exposed to a lower level of risk than the client selected. Thus, the manager doesn't know what he's doing and shouldn't be managing money.

The commentator notes that managing money in an efficient market without investing passively is investment malfeasance. He also notes that not knowing that such a market is efficient is investment misfeasance. In either case, such conduct may be imprudent per se (i.e., there's no excuse for the manager to be driving). A sober driver at the wheel of an index vehicle would seem to be the sensible solution, both from the manager and the client's perspective.

Because of the large volume of endnotes related to this article, and limitations of space in print, all endnotes can be viewed in their entirety on www.journalofindexes.com or www.indexuniverse.com/joi.

This article is an excerpt from the book The Prudent Investor Act: A Guide to Understanding, *by W. Scott Simon (Namborn Publishing Company, 2002). It is an excerpt from Chapter 7, which comprehensively reviews the effect the Act has on choosing active or passively-managed investment. This chapter also takes an in-depth look at the arguments, assumptions and facts relating to the active/index investment decision.*