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Special Interest Articles:

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"Never forget: the secret of creating riches for oneself is to create them for others."

-Sir John Templeton: Pioneer global investor and philanthropist

Passive versus Active Investment Management

By Christopher W. Beale, CFP®

The average person can't dunk the basketball. The average mutual fund manager can't beat their passive benchmark index.

Both of these statements are true. But this doesn't mean that no one can dunk a basketball or that no active manager can beat their index. Obviously some people can dunk a basketball but due to the mainstream media the statement about active managers being able to beat their passive benchmark is not as obvious.

To help you better understand what I'm talking about, a market index is a portfolio or combination of several financial securities or other investment vehicles with their value expressed as a total for purposes of tracking the entire market or at least a sector of the market. For example, large US company index may be expressed as either the Standard & Poor's 500 or the Dow Jones Industrial Average. An index of small US companies is represented by the Russell 2000. An index of bonds is represented by the Barclays Capital Aggregate Bond Index. $152.7 billion has left actively managed US stock funds from May 2014 through May 2015. At the same time passively managed funds have increased by $157.2 billion. The popularity of index funds can be traced to low costs and the difficulty of the average mutual fund manager to beat these benchmarks:

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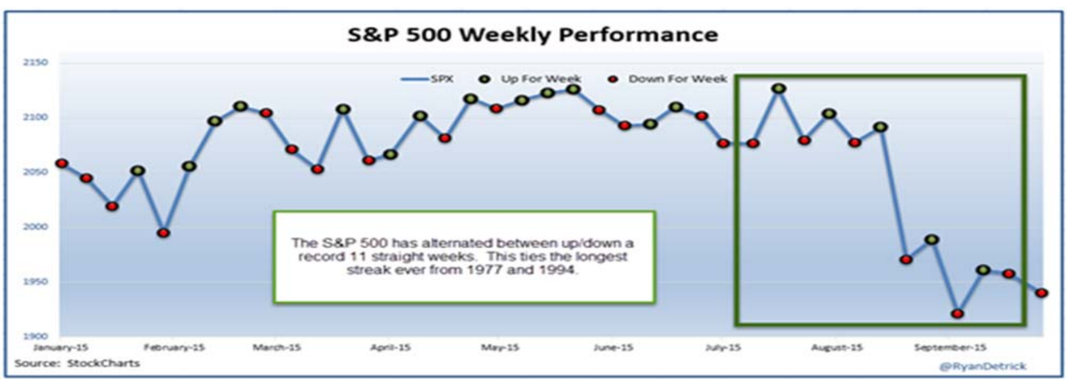
Observations about the Current Market Environment

By Christopher M. Lee, CFP®

As most of you have noticed, 2015 has been a bumpy ride (to say the least). We have seen quite a bit of market volatility (markets up and down) with the Dow even moving 1,000 points on August 24th, the largest intraday point decline on record. If you feel like 2015 has been a roller coaster (with a lot of *downs* lately) – it has, as seen in the graph below:



With the help of technology, it is easy to get reminded daily of what is going on in the markets along with your investment accounts, most of which at the touch of a button. With all of this uncertainty and volatility, please know that we are watching things very closely here at New England Capital. It is easy to let your emotions get the best of you (fear is a pretty powerful emotion), which is where we (your trusted advisors) come in to help be that voice of reason.

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only 47% of the time have active managers of US stock funds outpaced the S&P 500 during the 20 calendar years ending 12/31/2014.

What if we could screen or use criteria to determine which mutual fund managers might perform better than the benchmarks in the same way that we would screen the average person's probability to dunk a basketball?

I think it's obvious that we would look for tall people to determine the probability of being able to dunk a basketball. If we combine the first criteria of being tall with other criteria of having an above average vertical leaping ability, the probability of success would be even greater.

"If you always do what you've always done, you'll always get what you've always got."

-Henry Ford, Founder of Ford Motor Company

The research done by The Capital Group in the area of active verses passive investment management has identified three criteria shown to increase the probability of an active manager to beat their benchmark: low expenses, high manager ownership in their funds, and downside capture. Funds that have the lowest expense ratios tended to outpace their index. This obviously makes sense as funds with lower expenses have a lower bar to clear to beat their benchmarks. Managers and investment firms who have invested more dollars into their funds tend to outpace the benchmark more often. We believe it's helpful to have the people managing our money, manage their money side-by-side with us. Finally as to downside capture, mutual funds that most frequently were in the best quartile of downside protection tended to outpace the indexes more often.

The Capital Group's research took all US and international funds in the Morningstar database, then first, subdivided them into the lowest cost, and secondly, those that had the highest manager ownership (of at least $1 million) in their own funds. They then looked at the percentage of each group of funds that had outperformed their respective benchmark over a five and 10 year rolling period going back 20 years from January 1995 through December 2014. Based upon the total universe of funds, over a ten-year rolling timeframe fewer than 28% of the US and international funds outpaced their benchmark and fewer than 30% outperformed over five-year rolling periods. By selecting the 25% of the funds with the lowest cost, your odds of successfully beating the market index rose to just below 50%. If you look at the top quartile (top 25%) for the highest management ownership, roughly 70% of the higher-manager ownership funds beat the US Index and more than 60% of the similarly screened international equity funds top their indices over a ten-year period. For the five-year periods the numbers were 70% and slightly more than 50% respectively. Combining the two screens provided even better results; 100% of the US low-cost, high ownership funds outperform their benchmark over a ten-year period and roughly 90% of the comparable international funds did likewise. Over the five-year rolling periods, the odds of beating the benchmarks using these two selection criteria was over 75%. Adding in the third criteria of downside capture which means greater protection during declining markets, 100% of the top quartile managers using these three screens perform better than their benchmarks. This is especially important when we are in the distribution phase or retirement income payout phase of our lives.

Antti Petajisto did his research around the active/passive management debate when he was a professor at the Stern School of Business at New York University. He focused on "high active share funds", whose managers were active stock pickers with portfolios that did not look like the index due to their stock selection. His conclusion: active stock share funds in aggregate beat their benchmarks by 1.26% after fees and expenses. He also found that the size of the fund mattered too. The smallest quintile (smallest fifth) combined with the high active share management added 1.84% per year after fees.

Dr. Michael Phillips was a professor of finance at the University of Southern California before taking his current position as chair of the Center for Financial Planning and Investment at California State University at Northridge. He was also a former economist with the US Department of Commerce. His research showed that fiduciary screens helped in determining which active managers could beat their benchmark. He showed that managers and fund companies who put their interests secondary to that of their investors had better returns compared to the benchmarks.

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Stock market declines are a natural part of the investing cycle, but they're also the last things most investors want to experience. Declines have varied widely in intensity, length and frequency. While in the midst of one, it's been nearly impossible to tell if you're seeing a slight temporary dip in the market or the beginning of a more prolonged correction. One of our best pieces of advice for making it through volatile times in the market is to turn off the TV. After all, **media commentators are focused on the here and now, not on how to build wealth over the long term**. That said, periods of extreme market turbulence can be unnerving. With all of this market uneasiness and volatility – what can you expect going forward? I want to share with you what a portfolio manager at *American Funds* (Ted Samuels) recently offered up with some observations about the current market conditions [1]:

"In theory, there is no difference between theory and practice. But in practice, there is."

-Yogi Berra, MLB catcher, manager and coach

The world is not ending. Quite the opposite. In fact, corporate profitability is strong and recent volatility has been below what one would expect at this point in the bull market. U.S. stocks, as measured by the S&P 500, are down from their highs. This is not out of the realm of normal observations and can help to reduce some of the excesses that were building up. After all, we haven't had a 10% correction since 2011, which is unusual given the above average gains we've experienced during that time.

Neither a bear market nor a recession seems imminent. You might say that a perfect storm of uncertainty (China, concerns about the Federal Reserve raising rates, and falling oil prices) led to the global sell-off that has essentially affected all world stock markets. But overall, fundamentals seem solid and there are no indications that a global recession is around the corner, given the absence of any kind of liquidity contraction.

The banking system around the world — and certainly in the U.S. — seems much stronger than in 2007 and 2008. Regulators have been relentless in their focus on bolstering balance sheets and reducing systemic risks, including outsized leverage.

China is an issue, but an inflection point seems near. Many market observers have blamed China for causing this latest downdraft, which began with weakness in the local stock market and was exacerbated by the government's currency devaluation. The country's issues and challenges may be largely "priced in" at present levels.

Energy feels closer to the bottom. With oil prices continuing to plummet, some energy companies have started to cut dividends. But the precondition for oil prices to rise is ultimately lower prices and fear. We have plenty of that right now, which is why the energy sector may be looking attractive to purchase.

The Federal Reserve is more apt to hold off on raising rates now. The initial increase that was anticipated to occur in September did not come to fruition. The Fed has been overly political and kept rates low for too long. Still, given the perceived fragility of the system, I don't expect any immediate moves.

Other central banks will remain accommodative. Rates are near record lows around the world, and governments everywhere are doing all they can to prop up economic growth. If market turmoil persists, we will likely see additional easing measures, which should be positive for the market.

Balance is important. Despite all the talk about potentially higher rates hurting bonds, the major fixed income indexes have held up well and bonds have shown their value during this time of equity volatility. Bonds play an important role in adding stability during an otherwise bumpy ride.

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While past results are not predictive of future returns, the historic record shows that low cost, high ownership, active strategies where managers have shown fiduciary intent, have generally outpaced relevant market indices. At New England Capital we use these screens and more, when selecting the funds in your portfolios. We are continuing to do our own research to determine if there are times in market cycles where passive investing has the advantage over active management. If there is a benefit to passive investing we will continue to pursue it. We currently use a combination of passive and active strategies in certain portfolios now.

There is art as well as hard science in our process of building portfolios for both the accumulation and distribution phase of life. If it was easy, it would be a slam dunk for everyone!

Sources:
The Capital Group.
Bob Veres Inside information, Re-Assessing the Odds.

"The future aint what it used to be."

-Yogi Berra

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Turning off the TV will make it easier to get through these volatile periods. I'll end where I began, by reminding you to focus on the long term and not the scare tactics and shrill volume of the media. *Listening to dire predictions is what causes people to pull out of the market at exactly the wrong time.*

Please know that we are always here to talk to you. Please NEVER feel like you are bothering us if you have a question or a concern. We would rather have you understand what is going on, which should hopefully make you feel more comfortable. Also, if you just want to review your portfolio, your rate of return, and your present risk tolerance, or if there any changes in your investment objectives, please call us as well. We are here to help you and manage your expectations so that we are all on the same page. Over the past 2 years, asset allocation (one of our core beliefs here) may give the perception of diminished returns (compared to the S&P 500) but there is a "method to the madness" that we would be more than glad to share with you. As always, thank you for your continued trust with your hard earned money as we work with you to accomplish your life goals!

1 https://www.americanfunds.com/advisor/insights/market-commentary/trs-volatility-observations.html