WELLS FARGO ASSET MANAGEMENT

AdvantageVoice®

Investing

August 24, 2017

Is active vs. passive the right debate to be having?

By Melissa Duller and Jeremy Ryan

In the debate over active vs. passive investing, much of the attention is placed on explaining exactly what it is that active managers do. Active managers tout characteristics that they hope single them out—choices they make, assumptions they have, the philosophy and process that guide their decisions—helpfully listed in their factsheets in a sort of investment-industry dating profile. Passive indexes and the investment products that track them, however, are often assumed to have no guiding will at all beyond the market as a whole.

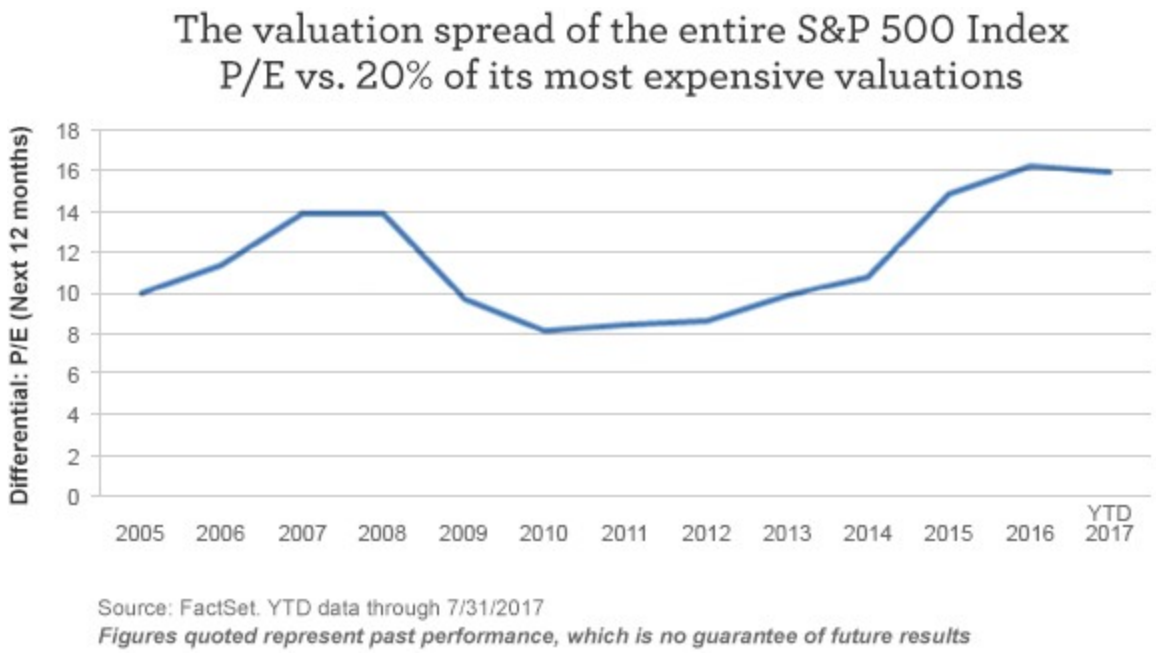
That passivity, however, can be misleading. Passive isn't really "passive" so much as it is "indexed," and these indexes can have quirky characteristics. It's not that the S&P 500 Index, for example, doesn't have any oversight or human influence – just less. The index is maintained by a committee of market professionals that has some discretion in selecting stocks or responding to market events.

According to S&P Global, the committee meets monthly to "review pending corporate actions that may affect index constituents, statistics comparing the composition of the indices to the market, companies that are being considered as candidates for addition to an index, and any significant market events. In addition, the Index Committee may revise index policy covering rules for selecting companies, treatment of dividends, share counts or other matters."

An index is like a yardstick that's used to measure performance. In the debate over passive vs. active, it sometimes seems like it's assumed the index is a characterless asset class, and what the investor is choosing to buy is a certain level of activity in relation to that class. But taking a closer look at the yardstick can show that it has plenty of character. This exercise isn't important because it's one more salvo in the war between active and passive. It's important because different benchmarks can have certain characteristics, and those characteristics can glom onto a portfolio like barnacles on a ship. At a certain point it's helpful to know if those barnacles are going to cause the ship to list to one side or the other.

The S&P 500: Pricey and pricier

If the S&P 500 could talk, it'd likely express a preference for pricey stocks, and the pricier the better. At least, it might do so in the current market environment. In any given period, the broader market is going to have expensive stocks and cheaper ones. However, the spread between the cheap and the expensive fluctuates over time. Currently, the valuation difference between the most expensive stocks and the average stock in the index is especially pronounced relative to the past 14 years. This is depicted in the chart below. Year-to date, the 20% (top quintile) of the S&P 500 Index with the highest valuations has an average price/earnings (P/E) multiple of 33 compared to the P/E of the entire S&P 500 Index of 17 – the highest valuation differential since 2003. Passive investors in this particular index should ask themselves if knew they were getting such pronounced exposure to expensive stocks.

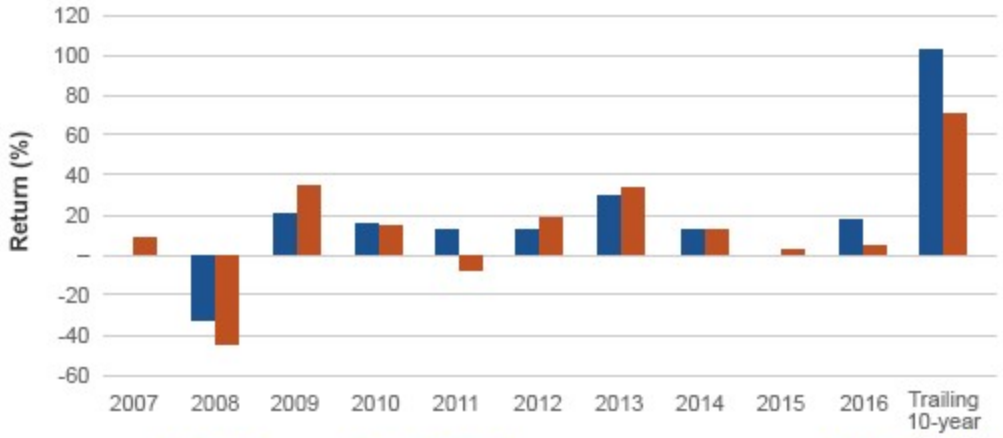


The S&P 500's investment philosophy today, should one be forced upon it, might be something like, "Buy winners and hold them." That philosophy might be a very sound one, especially in the roaring "a rising tide raises all boats" market of the past several years. Analysts who like to talk about factors—which are characteristics the market has rewarded over long periods of time—would say that momentum has been a dominant factor over the past few years. But it might not be the best one in the late stages of a bull market, or it might not make as much sense to include in a portfolio that already has large exposures or concentrated bets on expensive stocks. The point isn't that it's a good or bad tack to take; it's that it should be considered in light of a portfolio in particular and market circumstances in general.

The lure of dividends

Refining the S&P 500's hypothetically passive philosophy, it could be added that it's had a decided preference for dividend-payers relative to non-dividend payers. Much of the returns of the past 10 years have accumulated in large, dividend-paying stocks. Investors—especially Baby Boomers—sought income-generating investments in recent years. Higher-yielding stocks became especially attractive due to extremely low interest rates on bonds. The performance differential favoring high dividend payers over low dividend payers was apparent in 2008, 2010, 2011, and 2016. In 2011, high dividend payers within the S&P 500 Index appreciated approximately 12%, while low dividend payers declined 8%. Similarly in 2016, high dividend payers gained 18% while low yielding stocks rose a more muted 5%.

High dividend paying stocks within the S&P 500 Index contributed disproportionately to returns over the past 10 years



	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	Trailing 10-year
Dividend Yield > 2.0	-1.16	-33.08	20.92	16.28	12.43	12.36	29.88	13.40	-0.86	17.90	102.25
Dividend Yield < 2.0	8.86	-44.15	35.13	15.14	-8.08	19.38	33.80	13.68	3.17	4.85	70.80

Source: FactSet, trailing 10-year data is cumulative for the period 1/1/2007 to 12/31/2016
Figures quoted represent past performance, which is no guarantee of future results.

S&P 500 Index returns have enjoyed a relative tailwind due to its exposure to higher-dividend yielding stocks. However, the majority of actively managed funds – notably those in the Morningstar large-blend category – have had, on average, a lower dividend yield than the index. While interest rates may remain low for some time, they are likely to rise over the next five years. As they do, income from dividend-paying stocks may become less attractive, income investors may choose to sell stock holdings, and active managers focused more on total return than on income generation may have greater opportunities to outperform the S&P 500 Index. Maybe. It's always important to remember that current trends can persist for longer than many think. It's equally important to remember that current trends can change faster than many think.

Conclusion

As always, it helps for investors to know what they're getting. Choosing between different levels of activity in relation to an index might not be as helpful for a portfolio as a whole as knowing what factors the investor is getting with any particular investment. If an investor puts a considerable percentage of a portfolio into a set of what turned out to be relatively pricey dividend-payers, then it doesn't matter much whether the index's decision-making was passively driven. It's the investor who is actively choosing to get those characteristics. If an investor actively seeks such factors or believes they further a portfolio's goals, then it can help to know that these characteristics can be gotten relatively cheaply in a passive vehicle. If, by contrast, these factors aren't the top draw for a particular investor or they don't enhance a

portfolio's goals, then choosing the investment simply because it's passive wouldn't be as helpful. By learning the particular implications of various indexes, they can perhaps decide when that choice makes the most sense for them.

Price/Earnings is the price of a share of a stock divided by earnings per share, usually calculated using the latest year's earnings.

Additional resources:

- The link between active and passive: Human judgment
