

Indexing vs. Passive Asset Class Investing: Similar But Different

The first step for investors who are “graduating” to the world of passive investing is to recognize that a passive investment approach offers many benefits when compared to an active investment approach. Passive investing involves buying and holding market components, whereas an active investor or fund manager tries to pick the next winning stock or time where the market is headed next.

A passive approach offers these major benefits:

1. By holding entire market components, one maximizes the benefits of diversification
2. By “tilting” the portfolio to riskier or less risky components, the investor can expect to capture the highest market return given his or her risk tolerance
3. The investor maintains control over their own portfolio’s components (by avoiding active funds’ tendency to style drift without the investor’s knowledge)
4. Expenses can be minimized
5. Tax efficiency can be maximized

To implement a passive investment approach, investors can choose from:

1. Index mutual funds
2. Exchange traded funds (ETFs)
3. Passively managed asset class funds

Naturally, a question we frequently receive is, “Why shouldn’t I just buy index funds and/or ETFs instead of passively managed asset class funds? What is the benefit of passive asset class management versus ‘index’ investing?”

It is true that — whether an investor chooses to build his or her portfolio using index funds (or ETFs), or using passive asset class investing — we believe he or she has selected a strategy that is superior to investing in individual stocks or actively managed mutual funds. But building a portfolio of passive asset class funds expands upon the benefits of passive investing while minimizing some of its potential negatives.

First let's explore the differences between the two. To use an analogy, passive asset class funds relate to index funds (or ETFs) in the manner in which squares relate to rectangles. All squares are rectangles, but not all rectangles are squares. All index funds are passively managed, but not all passive asset class funds are index funds.

An asset class is a group of stocks with similar risk characteristics, including domestic, international, large-cap, small-cap, value, growth, real estate and emerging market stocks. An asset class also can be a combination of similar risk characteristics, such as "US small-cap value stocks" or "international large-cap growth stocks." An investment firm can create its own definition of an asset class, and then passively manage a fund based on that definition. In such cases, there may not always be any specific index (such as the S&P 500, Wilshire 5000 or Russell 2000) that represents or tracks that asset class.

Passive asset class funds retain all the benefits of indexing. They are relatively low-cost, low-turnover, and tax-efficient. However, they improve on the index model by implementing additional strategies that add even more value. Let's look at some of the ways a passive asset class fund can improve returns.

Creating Buy-and-Hold Ranges

Index funds by definition must sell any stock when it leaves the index. For example, if a small-cap stock increases in market capitalization so that it is no longer part of the small-cap index, the fund tracking that index must sell it. This creates turnover and tax inefficiency. In contrast, a passive asset class fund has the flexibility to create buy-and-hold ranges that enable the fund to hold a stock even if it falls out of the appropriate index. Properly implemented, buy-and-hold ranges help reduce turnover and increase tax efficiency while still enabling the fund to remain true to its stated asset class definitions. For example, a passive asset class small-cap fund might establish a range in which it *buys* all stocks that are in the smallest 8 percent of market cap. But the same fund might establish that it won't *sell* the stock unless it grows beyond the smallest 10 percent. Similar ranges also can be created for other asset class stocks, such as value, large-cap, etc.

Eliminating Certain Stock Types

Based upon academic evidence, some stock types have been demonstrated to result in historically poor returns, and passive asset class funds are able to establish screens that eliminate such types. For example, Initial Public Offering (IPO) stocks have demonstrated very poor historical returns in the initial years following the IPO. Based on this evidence, a passive asset class fund might eliminate all IPOs until they have seasoned a certain number of years, at which point they become eligible for purchase. The NASDAQ stock exchange has much less stringent listing requirements than does the New York Stock Exchange. As a result, the NASDAQ experiences far more stocks that eventually "delist" due to frauds and other financial weaknesses. By establishing a screen calling for greater financial requirements (such as those of the National Market System), a passive fund can reduce its exposure to stocks that eventually delist.

Establishing Additional Common-Sense Screens

Passive asset class funds are essentially free to establish additional screens that can be demonstrated to improve net returns. For example, because small-cap stocks experience lower levels of liquidity relative to large-cap stocks, their trading costs can be significantly higher. Therefore, a passive fund might establish a screen that no stock will be traded unless there are a certain minimum number of "market makers" (i.e., parties interested in trading the stock).

Taking Advantage of Block Trading Techniques

A small-cap passive asset class fund can also take advantage of its ability to remain flexible regarding its precise market cap weighting, whereas an index fund generally must maintain its specific defined weighting. By acting as a market maker in small-cap stocks, the passive asset class fund can earn not only the bid-offer spread, but it can also earn market impact costs.

We realize the preceding terminology can be daunting to even relatively sophisticated investors, so let's look at an example. Suppose that an actively managed fund has decided to sell a large block of a small-cap stock that is trading at 10 bid-10.5 asked (i.e., the broker/dealer is willing to buy at 10 and sell at 10.5.) The stock has typically been trading just 30,000 shares a day, but the active fund wants to immediately sell 100,000 shares. Perhaps the fund managers are predicting the stock is about to fall in price, and/or they want to buy a stock they feel is about to rise, so they conclude that they must sell quickly. They further understand that if they try to sell such a large number of shares relative to the stock's typical trading level, they will drive the price much lower ... even before they are done selling.

Before moving on with our illustration, it is important to understand that a passive asset class fund manager can conclude that, just because an active fund manager might be attempting to sell a stock, the information has no value in terms of whether the stock will actually move up or down. (Per the Efficient Markets Hypothesis, the stock's next move is random.) Therefore, a passive fund can benefit from what is more than likely a misplaced sense of urgency on the part of the active manager. For example, a passive asset class fund might establish a range of appropriate market-cap weightings it is willing to own — such as ranging from half to double its target holding.

Returning to our illustration, the passive asset class fund manager might check the fund's current holdings, determine it is holding 200,000 shares and conclude that it can hold up to 400,000, given the range it has established. Knowing the active fund is desperate to sell and knowing that they can — but do not have to — purchase the 100,000 shares, the passive fund managers might submit a bid of 9.5, or 5 percent below the market. If it wins the bid, the likelihood is that the stock will return to trading at 10 bid-10 ½ asked. The passive fund might then offer a small amount of stock at 10.375. It may even find a buyer who is looking to buy a large block and pay a premium for it. By earning the bid-ask spread and the market impact cost, the passive asset class fund has created the potential for negative trading costs.

Adding Tax Management Strategies

As we have seen, passive asset class funds have many advantages over index funds. However, passively managed funds that also engage in tax management strategies can do even better.

While passive asset class funds are already relatively tax efficient (compared to actively managed funds), there are additional strategies that can be employed to further improve their after-tax returns. These strategies include the following techniques:

- Fund managers avoid taking any intentional short-term capital gains. Stocks that should be sold because they have moved beyond their hold ranges are not sold if they are not yet eligible for long-term capital gains treatment. Once the required one-year holding period is reached, the stocks will then be sold. This lowers the tax rate on the capital gain from ordinary income tax rates to the lower long-term capital gains rate.

- Stocks that have significant losses are sold in order to harvest those losses. The stocks can then be repurchased following the 30-day waiting period required to avoid the wash sale rule (which would cause the loss to be ineligible for tax purposes).
- Specific lot accounting is used to minimize realized gains on sale. The stocks that are sold are the ones with the highest cost basis.

Fund managers avoid purchasing stocks just prior to the ex-dividend date (the day after the date of record). This reduces the amount of dividend income, which reduces the amount of taxes incurred. Combining the above strategies can be expected to generate significant improvements in after-tax returns (in taxable accounts, of course).

Adding Dividend Management

. While the recent reduction in tax rates applied to qualified dividends lessened the benefit of dividend management, it did not eliminate it. By focusing on minimizing dividends, fund managers can expect to improve upon after-tax returns. Let's explore how dividends can be managed in this manner. The Fama-French 3-Factor Model tells us that almost all of the variance of equity portfolio returns can be explained by the exposure to the risk factors of size (market cap) and value. Thus two portfolios with similar market caps and similar BtM (book-to-market) ratios have similar expected returns.

According to the same model, dividends are *not* a factor in expected returns. A fund that seeks to minimize dividend income can screen for stocks with high dividends. It can do so, and still own a portfolio with sensitivities to the small-cap and value factors that are very similar to a portfolio that includes the high-dividend-paying stocks. As such, it can enjoy the same expected pretax returns. The portfolio can be targeted to provide just enough yield to offset the fund's expense ratio, which can result in no net dividend income (and resulting tax burden) to shareholders.

Note that, investors who take advantage of funds that implement dividend management must be aware of and prepared to tolerate what is known as "tracking error." A fund that manages dividends has the same expected pretax returns as a fund that does not. But it will hold a significantly different portfolio in terms of specific stocks, so its returns can, and often do, deviate substantially from its relative benchmark. The tracking error should be random and thus short-term in nature. But, when it does occur, investors must be prepared to stay the course and ignore it, rather than panic and feel the approach is "not working."

In Summary

The academic world has provided investors with a road map to a prudent investment strategy based on passive investing. Building a globally diversified portfolio of passive asset class funds is most likely to allow all levels of investors to achieve their financial goals with the least amount of risk, particularly when they partner with an investment advisor who is experienced at implementing and maintaining a passive asset class portfolio.

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