July 2015

Active versus Passive Investing

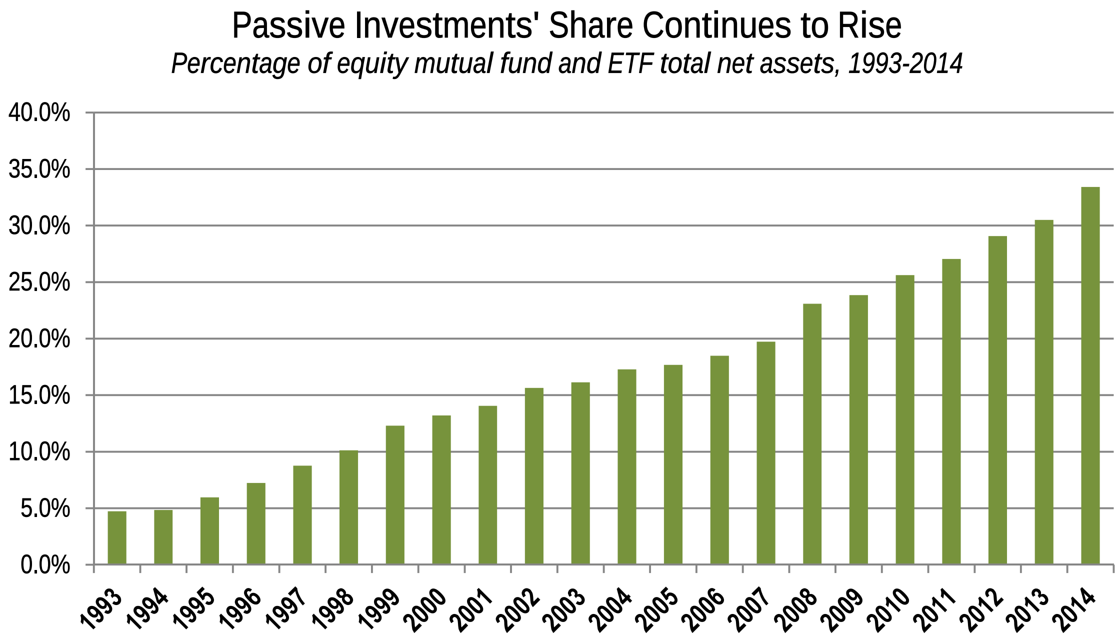
Recently, there has been a unique market environment that is challenging the discipline of some investors. Passive investing significantly outperformed active management in 2014, compelling many active investors to question their current investment philosophy. Unfortunately, active and passive investing are often portrayed as polarizing philosophies, but they do not need to be. Utilizing both active and passive strategies in the same portfolio is often beneficial, as both strategies have unique advantages and disadvantages. Media attention will likely continue to surround this topic as it continues to be a favorite issue to debate. However, investors should take a step back and consider the active versus passive debate objectively, as there are multiple factors to consider. This paper will provide background on active and passive investment strategies, as well as the performance debate, taxes, fees, and other unique considerations of each strategy. In addition, it will explain SilverOak's philosophy that both strategies can be used to meet a client's investment goal.

Passive Investing Overview

Passive investments track a specific market index and can be structured in the form of a mutual fund or ETF ("exchange traded fund"). Passive investments provide investors with cost-efficient exposure to certain segments of the market. There are a multitude of indices on which passive investments are based. The most popular passive investments track broad-based indices; however, country or sector specific funds are also popular. Many passive investments track an index with a market-cap weighted approach, such as the broad-based S&P 500 or the small and mid cap Russell indices. In a market-cap weighted index, companies with higher market capitalizations have a higher weighting. Recently, fundamental index funds have been gaining popularity. Fundamental indices weight companies based on valuation, utilizing measures such as Price/Earnings or Price/Book.

Passive investments within the same market segment can have meaningfully different performance due to their differing exposure to market-cap, valuation, sectors and regions, etc. For example, during 2014 the S&P 500 outperformed the Russell 1000 due to the S&P 500's higher weighting in mega and large caps stocks, which performed considerably better than mid and small cap stocks. Although both the S&P 500 and the Russell 1000 are used to measure the broad-based U.S. large cap stock market, the Russell 1000 has a higher weighting in mid and small cap stocks than the S&P 500. Regardless of the index that a passive investment follows, the performance of that passive investment should match the index, minus fees. Due to the multitude of index choices, passive investors still need to make decisions about which index to track and the appropriate investment to be utilized.

Passive investing has grown in popularity over the past decade as the efficient-market hypothesis has gained more traction with investors. This hypothesis states that an investor cannot consistently outperform the market; hence, active investing cannot consistently generate a better return than passive investments. As depicted in the graph below, over the past decade investors have continued to shift their money towards passive investments.



Source: Morningstar

Active Investing Overview

Despite passive management's increasing popularity, active management is still the predominant strategy used by investors. Active managers try to exploit market inefficiencies and select individual securities based on fundamentals and/or quantitative methods, in exchange for a management fee. Managers construct portfolios through bottom-up (company-specific) or top-down (macro-driven) research. These managers try to construct a portfolio that has a better risk/return ratio than a broad-based index. There are many different styles or methods of active investing, such as deep value, relative value, core, growth-at-a-reasonable-price ("GARP"), traditional growth and aggressive growth. Value managers select companies that are undervalued compared to their intrinsic value or relative value to similar companies, while growth managers invest in companies that have better long-term growth prospects. Regardless of style, active managers believe that their disciplined processes and skill will provide better long-term performance than an index.

In addition to the opportunity of outperforming certain market indices, some investors prefer active management because they are concerned with the construction of the indices. These concerns may stem from issues associated with the concentration an index may have in overvalued sectors, low-quality companies or exposures to certain sectors and/or companies considered contrary to the individual investor's personal beliefs (i.e. tobacco companies or deep water oil drilling companies), etc. Active management is a way for these investors to customize their portfolio to meet their specific needs and preferences.

The Performance Debate

Performance is often the focal point of the active versus passive debate. The general argument for passive investing is that markets are efficient ("efficient market hypothesis"), therefore active investors cannot consistently outperform the underlying index. Passive proponents point out that the average active manager has not outperformed the market in recent years and that it is difficult for active managers to overcome their higher management fees. As a result, passive investors choose the performance of the index tracked by the fund, less its corresponding fees, which tend to be lower than active management. Conversely, active management has the potential to outperform the underlying index. Active managers tend to have better relative performance in inefficient market segments with larger universes such as small cap and international. Active managers have also performed better during higher volatility periods around recessions, as higher quality companies tend to hold up better during periods of uncertainty. However, it has been more difficult recently for active managers to outperform in more efficient market segments with a smaller universe, such as U.S. large cap.

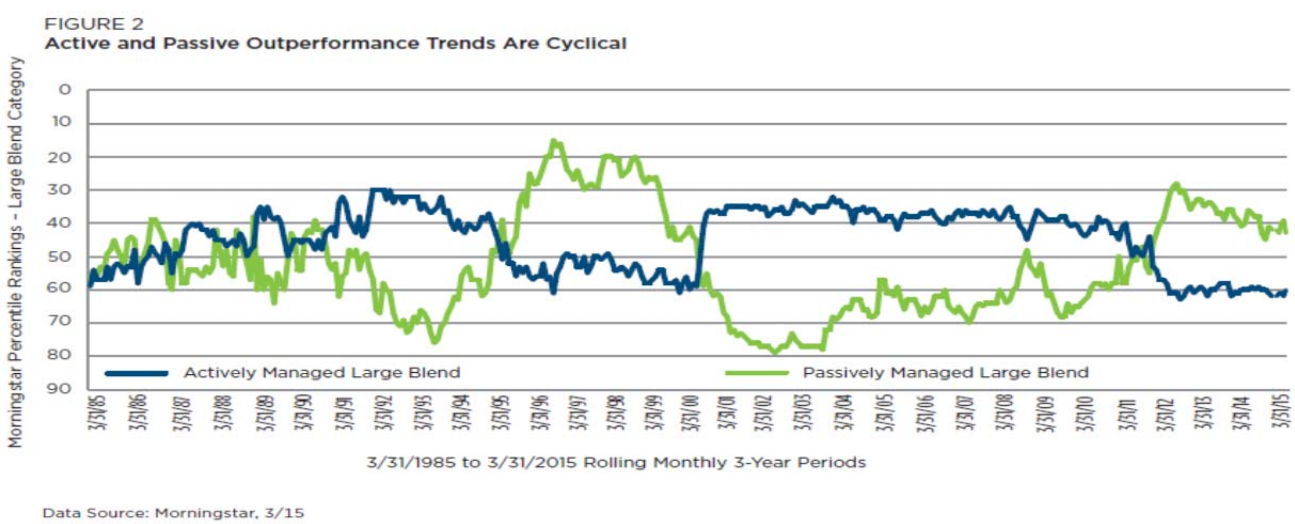
Financial institutions have an incentive to position the active versus passive debate in a polarizing fashion, as there are literally trillions of dollars at stake as they battle for fund flows. There are many studies produced by financial institutions and academics that favor one strategy over the other. In addition, technology has allowed the proliferation of indices, attribution analysis and new investment vehicles. This environment has elevated the active versus passive debate as relative returns across multiple time periods are readily available and investors are able to check their performance, relative to various indices, on a daily basis.

Relative performance reporting is a difficult exercise as strategies have different goals and their benchmarks (i.e. closest representative index) may not always be comparable. For instance, some active managers do not manage to a benchmark index because their goal is to provide capital appreciation and preservation. They may be "index aware" but in trying to provide long-term capital appreciation, there will be annual periods in which their performance can deviate meaningfully. Most active managers do not attempt to beat an index over any given year, but instead over a full market cycle, which can be 6-10 years. Comparisons can also be difficult because studies of active versus passive investments focus on absolute returns rather than risk-adjusted returns. Most active managers try to lower the risk to their portfolio through their stock selection process. After factoring in risk, active managers' relative performance improves considerably.

As previously mentioned, a comparison of active versus passive strategies is difficult. A significant portion of return difference can be explained by the performance of positions that are not held within both strategies. Active managers may elect to invest in companies that are not in their comparable index. Similarly, they can choose not to invest in companies that are in the index. Research by investment firm GMO, a well respected value-oriented investment management company, has shown that domestic large cap active managers' exposure to non-U.S. stocks, small caps and cash can explain the majority of return difference over time. For instance, when U.S. equities strongly outperform non-U.S. equities, many large cap active managers may underperform, as the index consists only of U.S. equities, while their portfolios may hold non-U.S. equities. Likewise, if large caps outperform small caps, many active managers may again underperform the index due to their higher weighting in mid and small cap equities.

Over the past six years, many of the factors noted above have benefitted passive investing as active managers have had a hard time beating their respective indices due to the difference in their holdings relative to the indices. In 2014, the majority of active managers underperformed passive indices as all three of those factors went against them: large caps significantly outperformed small caps (13.7% to 4.9%), U.S. equities significantly outperformed non-U.S. (13.7% to -4.9%) and cash was a major drag as many active managers have increased the portfolio's cash weighting due to high equity valuations.

Changes in market sentiment and the expansion and contraction of the economy cause cyclicality in market performance. Different market environments will favor certain investment strategies over others. The graph below shows over the past thirty years that active and passive investing is also cyclical. There have been multi-year periods in which active management outperformed and there have also been multi-year periods in which passive investing outperformed. If we review the past six years, passive investments have had a favorable environment. Low interest rates have benefitted highly leveraged, low quality companies and high growth speculative companies without earnings, including many small technology and biotechnology firms. As these companies have done better, their weighting has increased substantially in market-cap weighted indices. Active managers' typically underweight speculative or highly levered companies as they generally seek higher quality companies with sustainable competitive advantages and consistent earnings.



Source: Hartford Funds, Morningstar

In addition, low interest rates have encouraged risk taking by investors. Current fixed income rates are not meeting investor's income needs so they have sought higher yields in areas such as high-yield bonds, and in certain areas of the equity markets. Equity sectors that traditionally have the highest yields, such as consumer staples, REITs, and utilities, have experienced huge demand which has driven valuations to near their historical peak levels. These sectors are often underrepresented in active managers' portfolios because those companies have high valuations, poor balance sheets, lower ROIC ("return on invested capital") and weak earnings growth. The market environment will likely change as the economy continues to improve and as interest rates increase, providing a headwind for lower quality companies and a tailwind for active investing. The cyclical nature of performance in active and passive investing is one reason why, at SilverOak, we believe active and passive strategies can compliment each other in a client's portfolio.

Sector Concentration & Unique Risks

One advantage of investing in an index-based passive product is the diversification it offers. However, index investing does not come without risks or volatility. A major drawback to passive investing is that investors are required to accept the construction of the index. Market-cap weighted indices can be susceptible to concentration risk in sectors, geographies or in individual holdings. This typically occurs after sectors have outperformed for a multi-year period. For instance, energy grew to about thirty percent of the S&P 500 by the late 1970s. Other notable sector concentrations include technology in the late 1990's and financials in the mid to late 2000's. Currently in small and mid cap indices, industries such as biotechnology and REITs have larger than historical weightings as they have outperformed over the past five years. The risk is that these sectors are likely fully valued or even overvalued and could enter a period of underperformance. However, as compared to passive market-cap weighted indices, active managers typically underweight sectors they feel are overvalued while they overweight sectors they feel are undervalued or have stronger growth prospects.

Another risk of passive investing and market-cap weighted indices is the exposure to lower quality companies. Indices include many low quality companies with negative earnings which can range from 10 to 40 percent of the index. This exposure can help during periods of speculation or during the beginning of economic recoveries, when investors become less risk averse. This certainly has been the case over the past six years as low interest rates and the quantitative easing programs instituted by the Federal Reserve have benefited highly levered companies. However, a large exposure to low quality companies can be detrimental to returns, especially during volatile periods. Research by Royce & Associates, a highly respected small cap manager, has shown that during periods of higher volatility, active managers have outperformed. This is likely because they have favored higher quality companies with strong fundamentals. During the past 35 years, higher volatility periods have generally occurred in the years around recessions. This makes sense as active managers tend to be more risk averse. By contrast, passive strategies have outperformed during low volatility periods as investors have not been as concerned by quality and money continues to flow into overvalued companies; this momentum favors the market-cap weighting structure of passive indices. Below is a table that shows the past 35 years separated into quintiles. Quintile five is the most volatile period and quintile one is the least volatile period. Across rolling one, three, and five-year periods, the average active manager outperformed during the more volatile quintiles. This evidence reinforces that performance of active and passive management is cyclical.

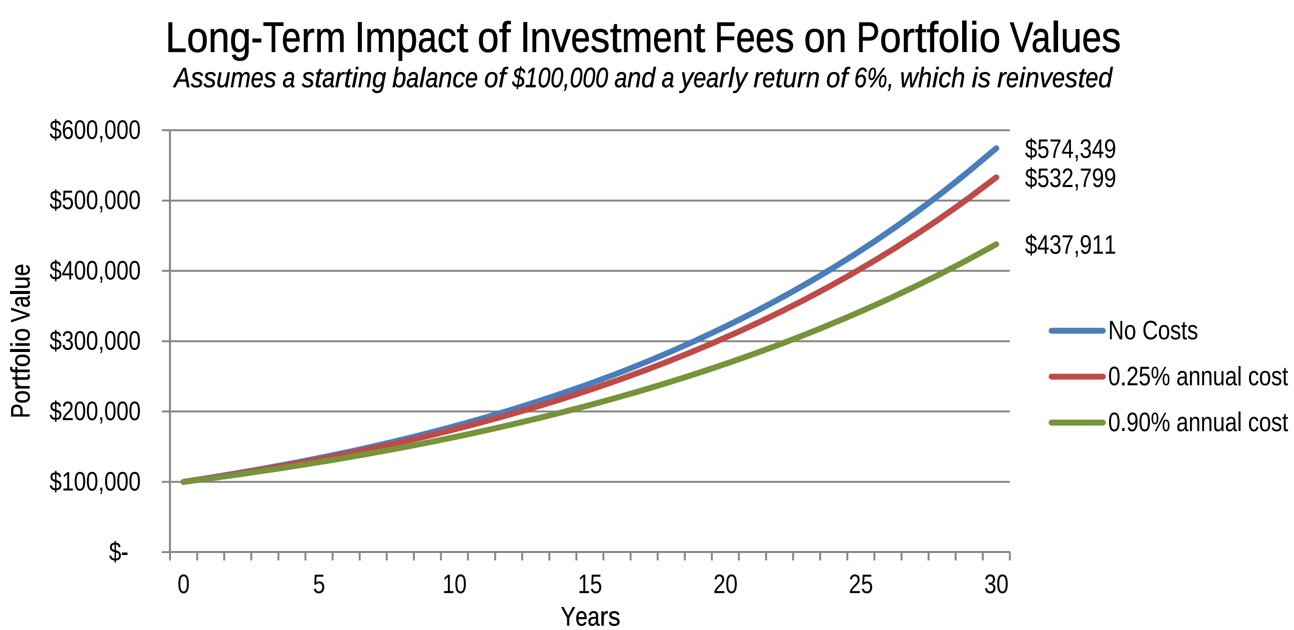
Volatility and Small Cap Performance Spreads (%)
From 12/31/78 through 9/30/14

	Quintile 1	Quintile 2	Quintile 3	Quintile 4	Quintile 5
Average of 12-Month Monthly Rolling Statistics					
Average Russell 2000 Standard Deviation	10.80	14.35	16.88	21.53	29.29
Average Russell 2000 Performance	18.37	19.99	17.13	12.43	-0.42
Average Morningstar Small Blend Category Performance	17.87	19.74	17.48	14.41	1.80
Average Morningstar Small Blend Category Performance Spread vs. Russell 2000	-0.50	-0.25	0.35	1.98	2.22
Average PMF Performance	15.26	20.77	18.47	16.38	2.49
Average PMF Spread vs. Russell 2000	-3.11	0.78	1.34	3.94	2.92
Average of 36-Month Monthly Rolling Statistics					
Average Russell 2000 Standard Deviation	12.65	16.90	19.39	22.33	25.25
Average Russell 2000 Performance	14.60	16.66	12.24	9.15	2.35
Average Morningstar Small Blend Category Performance	14.71	16.99	13.28	11.33	4.04
Average Morningstar Small Blend Category Performance Spread vs. Russell 2000	0.12	0.33	1.04	2.17	1.70
Average PMF Performance	12.52	18.29	14.64	12.36	6.90
Average PMF Spread vs. Russell 2000	-2.08	1.63	2.40	3.21	4.55
Average of 60-Month Monthly Rolling Statistics					
Average Russell 2000 Standard Deviation	14.16	17.49	20.15	21.91	23.56
Average Russell 2000 Performance	14.96	14.31	11.70	7.22	3.86
Average Morningstar Small Blend Category Performance	15.08	15.02	12.93	9.51	5.29
Average Morningstar Small Blend Category Performance Spread vs. Russell 2000	0.12	0.70	1.23	2.29	1.43
Average PMF Performance	12.91	15.88	14.81	12.30	7.21
Average PMF Spread vs. Russell 2000	-2.05	1.57	3.10	5.09	3.35

Source: Royce & Associates, Morningstar

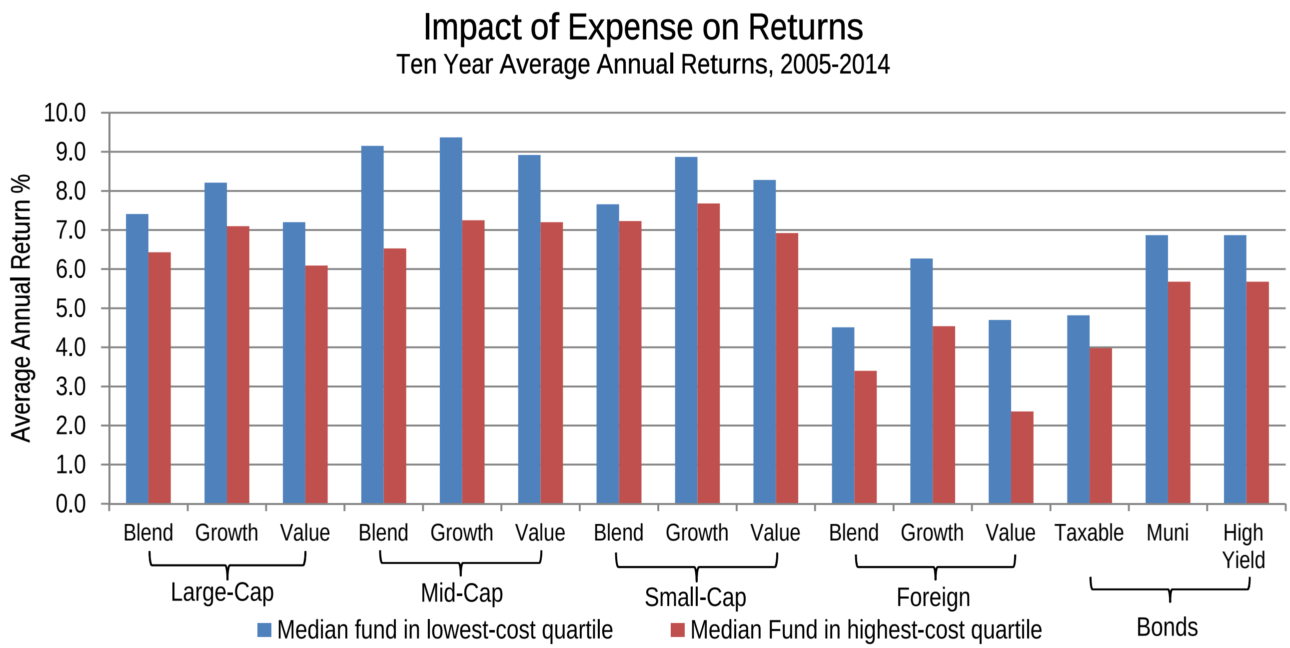
Investment Fee Impact

A major advantage for broad-based index investments is their lower fees versus actively managed mutual funds. Fees can be a significant drag on performance over a long-time horizon as returns compound. Below is a theoretical graph depicting an investment with an annual return of six percent and the impact that fees can have on capital appreciation.



Note: The graph above is a hypothetical portfolio and does not represent an investable asset.

SilverOak recognizes the impact fees have on the long-term performance of any investment and because of that, our IQSS[tm] (Investment Quality Scoring System[tm]) requires all recommended investments to have expense ratios that are below their respective category (i.e. peer) average. Actually, most are within the bottom quartile of their peers. The graph below shows that funds in the lowest cost quartile have historically outperformed funds in the highest cost quartile. In some investment categories, the difference in average annual returns is significant.



Notes: All mutual funds in each Morningstar category where ranked by their expense ratios as of December 31, 2014 and separated into quartiles. All funds with at least ten years of returns were included.
Source: Morningstar

After-Tax Returns

Taxes have always influenced the construction of portfolios and continue to be a concern for investors today as tax rates have continued to rise in recent years. Passive investments are generally more tax-efficient than active strategies due to their lower turnover (i.e. less trading activity) and market-cap weighted structure. While some actively managed mutual funds have low turnover, more similar to passive investments, they still tend to be slightly less tax-efficient.

There is a notable difference in the timing of capital gains tax payment between active and passive investments. Actively managed investments will pay taxes on capital gains throughout the holding period while passive investments will pay a majority of its capital gains taxes when the asset is sold. Taxes will ultimately be paid on capital gains with either strategy; however, some investors prefer to have the optionality of when taxes are paid and thus favor passive investments. Tax efficiency across active and passive investments varies greatly; consequently, SilverOak focuses on those with higher levels of tax efficiency versus their peers.

Some taxes are inevitable, but asset location can be very useful in minimizing taxes and increasing after-tax returns. By holding less tax-efficient active funds in tax-deferred accounts rather than in taxable accounts, the investor can avoid taxes on distributions. In general, it is most optimal to hold strategies that produce ordinary taxable income and/or high capital gain distributions in tax-deferred accounts. These strategies can include taxable bonds, REITs, commodities, emerging market debt, and high-yield debt as they have more distributions.

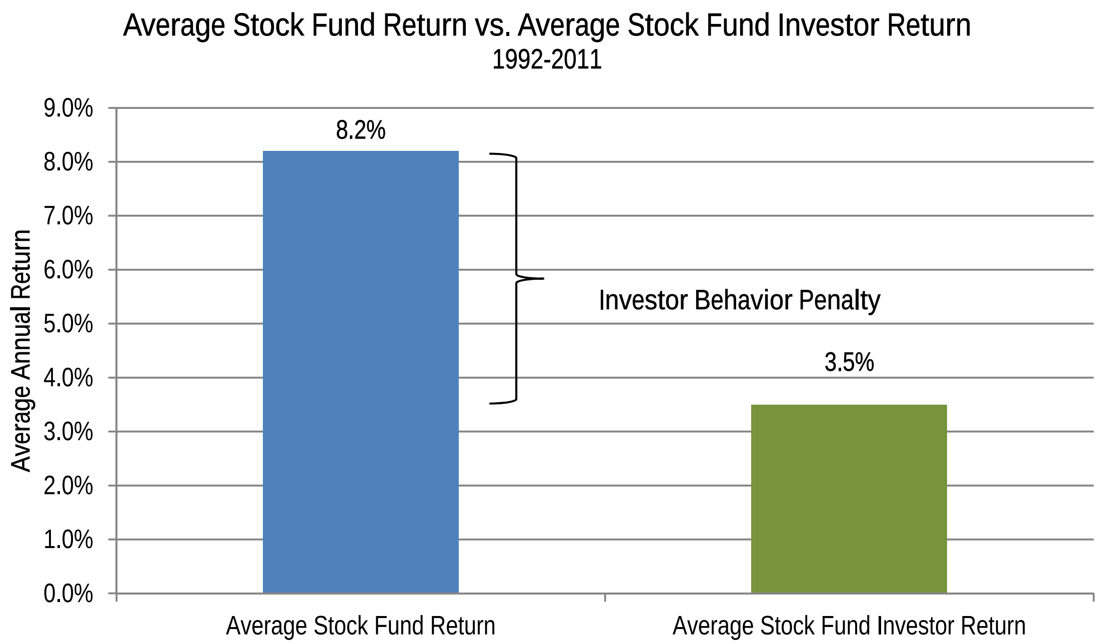
At SilverOak, we are cognizant of the impact taxes have on performance and we incorporate asset location into our portfolio construction and investment strategy process. Furthermore, most of the active investment strategies utilized by SilverOak have below category average turnover, which helps manage the tax consequences. Below is a table with asset classes and their generally preferred location due to expected income and returns.

	Expected Distributions	% of Income Expected to be Qualified	Expected Return	Preferred Location
U.S Large Cap Equities	Low	High	High	Taxable
U.S Small Cap Equities	Low	Moderate	High	Taxable
International Equities	Low	High	High	Taxable
U.S. Taxable Fixed Income	Moderate	Low	Low	Tax-Deferred
Municipal Fixed Income	Moderate	High	Low	Taxable
International Fixed Income	Moderate	Low	Low	Tax-Deferred
Emerging Market Debt	High	Low	Moderate	Tax-Deferred
Commodities	High	Low	Moderate	Tax-Deferred
High Yield Debt	High	Low	Moderate	Tax-Deferred
REITs	High	Low	High	Tax-Deferred

Investor Behavior

Setting the active versus passive debate aside, the most important goal of an investor is to have an effective long-term investment philosophy. One of the primary biases and risks for investors to overcome is called recency bias. This describes the behavior of putting too much emphasis on recent performance results when making investment decisions and expecting that performance to continue into the future. Recency bias can be detrimental to long-term financial success as markets are cyclical and often reverse when people are overly excited or pessimistic. Investors chase performance and switch into the best performing fund or index every few years. Investors who do this will realize lower returns than the overall market because today's winner many times becomes tomorrow's loser. Investment strategies and market factors such as growth, value, high quality or low quality will be rewarded at different times in the markets cycle. All managers with excellent long-term track records go through periods of outperformance and underperformance. Many of the active managers that are currently outperforming will likely go out of favor in subsequent years. While it is difficult to hold managers that underperform, the best time to invest may be during a period of underperformance.

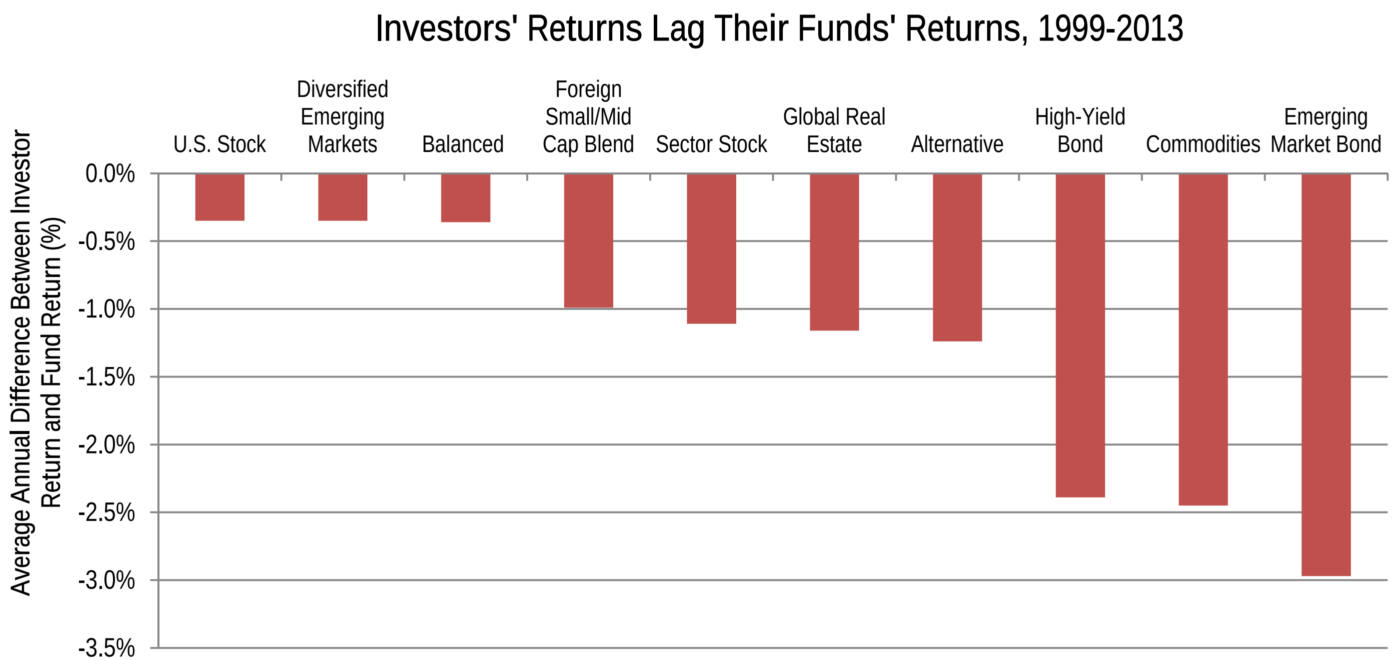
Studies have shown that investor returns are significantly lower than fund returns as they tend to "buy high and sell low". Below is a graph that shows the average stock fund return from 1992-2011 was 8.2%; however, the average stock fund investor only had a return of 3.5%. The difference in returns is due almost exclusively to poor behavior.



Note: Investor returns measure the return an investor receives over a period of time and incorporating purchases and sales of the fund.
Source: Quantitative Analysis of Investor Behavior by Dalbar (March 2012); Davis Advisors

Some investors cannot tolerate the variance between active manager returns and their respective indices. As a result, passive investing may be a great alternative for these investors. Passive returns will always be equal to the respective index, minus fees. Although this investor will never outperform the overall indices, they will not be exposed to the swings of active management being in favor or out of favor. To the extent that this allows the investor to stay full invested and not sell actively managed funds at the wrong time, the investor has a higher likelihood of meeting their long-term goals.

Trying to "time the markets" among asset classes can also be very detrimental to wealth accumulation and wealth preservation. After the S&P 500's return of almost 14% in 2014, many investors may want to abandon a diversified portfolio and instead own all U.S. large cap stocks. However, it would be a mistake to focus on recent short-term performance instead of long-term goals. As shown in the graph below, investor's realized returns are much lower in those asset classes that have greater variability in returns. The higher volatility causes investors to chase performance following good years, resulting in a larger behavioral penalty when performance reverses. Maintaining a disciplined investment approach will ultimately lead to a better outcome for the investor. At SilverOak, we invest in diversified portfolios with a long-term time horizon. We recognize that certain investment strategies or asset classes will go in and out of favor, but our disciplined approach remains constant and offers clients a smoother ride in meeting their goals.



Note: The average difference is calculated based on Morningstar data for investor returns and fund returns.
Source: Vanguard, Morningstar

Conclusion

The active versus passive investing debate will continue into the future just as it has in the past. It is important for investors to be objective and to choose an investment strategy that they are comfortable with and provides them the best opportunity to reach their goals. As we have shown, there are advantages and disadvantages to both strategies. Investors must understand and accept the variance in returns from their active managers, especially during times of underperformance. Demonstrated through the analysis provided, active management has added value over a full-market cycle, but investors must be patient throughout the ups and downs. Likewise, passive investing is a great way to get broad diversification at a low cost; however, investors must also accept the unique risks associated with passive investing. At SilverOak, we believe active and passive strategies can compliment each other and both can be used to meet a client's needs and goals. As a result, we believe that the majority of our clients' portfolios should hold some component of both active and passive investments.

The most important point to remember is that markets are cyclical and past results should not be extrapolated into the future. We are currently seven years into the U.S. recovery, which makes it one of the longest recovery periods in history. Returns from equities and fixed income investments will likely be lower over the next six years than they have been over the past six years as volatility returns to the markets and new leadership in the equity markets emerge. Investors must continue to remain prudent in their investment allocations and not be swayed by short-term results. A disciplined and diversified approach that is focused on long-term goals should keep investors from taking unnecessary risks or chasing performance.

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Investment decisions should be made based on an investor's specific circumstances taking into account items such as, risk tolerance, time horizon and goals and objectives. All investments have some level of risk associated with them and past performance is no guarantee of future success.