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Is the Debate Over?

by Stephen F. Trainer

The merits of active and passive management have been debated since 1975 when John Bogle started the first index fund at Vanguard. Advocates for active management believe that rigorous fundamental or technical analysis results in portfolio outperformance in relation to a selected benchmark. Passive investors believe that the market is smarter than any one person; as a result, prices for publicly traded securities incorporate all available information so analysis to discover dislocations in the market (and the associated marginal costs) is futile. Both sides assert their strategy is superior, making it difficult for investors when selecting managers. Unlike the Presidential Debates, we have objective measures that will help settle the issue.

S&P Dow Jones Indices, an independent third party, began producing a semiannual scorecard (SPIVA) in 2002 to measure the effectiveness of active management. The SPIVA Scorecard measures manager returns after-fees and compares those returns to the appropriate benchmark over various timeframes. The SPIVA Scorecard includes results for stocks and bonds from strategies all over the world.

The results tell us that over 91 percent of US Large Cap Stock Funds underperformed the S&P 500 over the last five-years[1]. In spite of this, many investors are willing to absorb active management's higher costs and disregard caveats on past performance to try find the precious few that outperform (for more on the topic, see: **7258 on Persistence**). The results are conclusive: the vast majority of equity investors would have been better off investing in index funds than with active managers.

Don't take our word for it – click the link below and review the extensive evidence yourself:

[1] *As of June 30, 2016.*

So, is the debate over? It sure seems like it but what about taxes? One limitation in the SPIVA Scorecard is it does not account for taxes; if less than 9% of managers outperformed on a *pre-tax* basis, how dismal must the picture be on an *after-tax* basis? While that data isn't readily available, we are comfortable concluding it's considerably less than 9% of the managers.

The link above only looks at the last five years but the conclusions are virtually the same when you see what has happened over the last ten and fifteen years: very few active equity managers have outperformed their benchmarks after taxes and fees are considered[2]. For 7258, the debate is over – active management in equities just doesn't work. Why subject our clients to higher costs when the results of active management have been this bleak? We use evidence like this to tilt the odds in our clients' favor by delivering lower-cost, more tax-efficient strategies.

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[2]*SPIVA Scorecard dated June 30, 2016 and CRSP Survivor-Bias-Free US Mutual Fund Database, provided by the Center for Research in Security Prices, University of Chicago, as of December 31, 2015.*