The Hazards of Passive Investments in Volatile Markets

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In the world of investing, there has been an argument brewing over the benefit of low-cost, *passive* investments versus higher-cost, *active* investments. Passive investments mimic the performance of an index, such as the S&P 500, and do not make decisions on which securities to buy or sell within that index (Vanguard, 2011). Active investments analyze economic and company specific factors and buy or sell securities in an attempt to beat a benchmark or index, such as the S&P 500 (Morningstar, 2011; Vanguard, 2011). Due to a trending view that the lower internal costs of *passive investments* will dominate actively managed mutual fund returns after accounting for their higher fees, there has been a significant shift of retail investments managed through financial advisors into exchange-traded funds (ETFs; investments that track a specific stock or bond index and trade intraday on the New York Stock Exchange/NYSE) (Vanguard, 2011). This shift has often entailed a replacement of mutual funds with ETFs in a traditional style-box asset allocation model with the objective of achieving more desirable risk-return characteristics.

A style-box allocation model is used to visually represent various categories of companies (smaller growth companies/small cap growth, larger value companies/large cap value, etc.) and investors can then fill each box according to their own risk tolerance and market outlook (Morningstar, 2011). Using various long-term, strategic risk profiles in an industry standard Morningstar Style Box representation matrix for equities, we overlaid specific investor recommendations onto their corresponding investment-style categories (value, blend, growth) and company-size (large, medium, small) (Morningstar, 2011). We then back-tested and compared ETF and mutual fund portfolios over a 10-year period from May 5, 2001 through October 31, 2011, after controlling for typical advisor annual fees of 1%. The back-tested data were calculated by “applying the ending period holding weights” (supplied by each investor's risk profile) to the corresponding individual holding's trailing annual returns (Morningstar, 2011, p. 19). The holdings are then rebalanced on an annual basis accordingly. Portfolio returns were not adjusted for taxes and the “calculations assume the reinvestment of dividends and capital gains” (Morningstar, 2011, p. 19).

The results showed that under volatile market conditions, as determined by the Chicago Board Options Exchange/CBOE Volatility Index, mutual fund portfolios had higher returns across all allocations except for the most conservative risk profile and that the beta (a measure of volatility or systematic risk) of every mutual fund portfolio tested was lower than its corresponding ETF portfolio (Morningstar, 2011). The results suggest that during periods of market volatility, investors with more than a conservative amount of risk-tolerance would be better suited utilizing mutual funds in a style-box asset allocation model after controlling for advisor fees. The research also suggests that ETF portfolios in a style-box allocation model often had worse risk-return characteristics and exposed investors to potentially greater amounts of downside risk.

As an investor, this research is crucial when comparing passive and active investments, especially for those investors who have a lower risk-tolerance or those approaching or entering retirement where poor portfolio performance in the initial years of retirement can have negative effects on retirement income for decades. Policy makers should also take note as this research indicates a need for increased education on not only the differences between passive and active investment strategies, but also the theory that lower internal costs will equal greater performance. Future research implications may include comparing active and passive style-box portfolios over bull-market conditions, the correlation of indices to one another in positive and negative market conditions, and the use of passive strategies by independent advisors versus those at investment firms.

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