Market Highlights

Confidence was high as reflected in both the consumer and purchasing manager surveys this past quarter and investors bet on continued growth in the US. Growth stocks outperformed value stocks 8.6% (Russell 3000 Growth TR) versus 3% (Russell 3000 Value TR). Investors did hedge their bet somewhat by favoring the generally less risky large cap stocks which returned 6% (Russell 1000 TR) over small cap stocks at 2.8% (Russell 2000 TR). In a further show of confidence, cyclical stocks outperformed defensive stocks 7.6% (MSCI Cyclical Sectors Index) versus 3.8% (MSCI Defensive Sectors Index).

Volatility continues to be low, further feeding the optimism seen in the market and making investing in an overvalued market more palatable. Also supporting equity investing is the prospect of loss in bonds that face the headwind of rising rates. However, a cautious Federal Reserve is hiking interest rates at a much slower pace than normal and the solid US economy, as well as a brighter outlook for global economies, are also supportive of continued equity investment.

International equities rebounded strongly as growth prospects improved and risks declined. A slight weakening of the dollar also helped international equities to outperform US equities, with emerging markets up 11.5% (MSCI EM) and developed markets up 7.4% YTD (MSCI EAFE) vs. the S&P 500 at 6%.

Several factors helped to drive this rebound. On the political front, the risk of a breakup of the European Union diminished after the Dutch election. The anticipated election of a pro/neutral EU French president also helped to calm markets. On the fiscal side, the previously large current account deficits of the "Fragile Five" (Brazil, India, Indonesia, South Africa and Turkey) shrunk over 50% since 2012, making them less vulnerable to capital outflows. Growth was also evidenced by international purchasing manager surveys, which indicated almost universal expansion with earnings accelerating particularly in Japan and the emerging markets.

The active vs. passive choice – some perspectives

Before we dive into the active vs passive debate, let's begin with a question? If you had $100,000 to invest over a complete market cycle, which portfolio profile below would you choose?

	Down Market Cumulative Return* 10/10/2007-3/9/2009	Up Market Cumulative Return* 3/9/2009-3/1/2017
Portfolio A – S&P 500 Index	-57%	254%
Portfolio B – More Aggressive	-65%	305%
Portfolio C – More Conservative	-45%	229%

*Price returns of the S&P 500 index.

Do you have more regret when your investment portfolio lags when the market is roaring ahead? Or, does regret kick in more strongly when the market is dropping and your portfolio is going down with it? Perhaps you are happy as long as you are close to the market benchmark.

Portfolio A above is the return of the S&P500 Index during the most recent market cycle which began on October 10, 2007, hit bottom on March 9, 2009 and reached its last peak on March 1, 2017. It represents a passive strategy (no fees included), staying close to the benchmark in both up and down markets. Portfolio B is the more aggressive – losing 15% more on the downside, but gaining 20% more on the upside. And Portfolio C is more conservative – losing 20% less on the downside, but not quite keeping up on the upside with underperfomance of 10%. Which one would you choose? We'll get back to your answer a little later.

Who aspires to be average?

A silly question, but with all the focus on passive investing these days you might have chosen Portfolio A, the passive strategy that closely tracks the index. Passive investing is all the rage. Not a day goes by without a famous personality or investment firm touting the benefits of passive investment strategies. The main reason is that passive investing is a simple way to diversify a portfolio and it's cheap. Another reason that passive investing has become so attractive recently is that passive tends to outperform active at the end of a bull market when the prices of securities tend to exceed most assessments of fundamental value. That is where the market is currently positioned – at least for US equities.

One might argue, as Warren Buffet does, that passive investing is a good strategy for the "average" investor who does not have the time, resources, expertise or patience – or a trusted investment advisor – to identify good investment opportunities and apply a disciplined approach to managing those investments. While there are ways to use passive vehicles to invest actively, for this discussion, we are referring to the use of passive index funds or ETFs to implement a long term asset allocation strategy.

Above average does exist

Numerous articles and academic research purport that the average active manager does not beat the benchmark for one simple reason – active management fees are high and average managers cannot consistently outperform their benchmarks by the amount of their fees. This is true. However, not all managers are average and not all fees are high, so why settle for average? With careful selection and attention to the costs, it is possible to find active managers who can win when it comes to building wealth. And doesn't it make sense to buy stocks not because they were good, but because they will be good in the future? We are not opposed to passive management; however, in most cases we believe that active is better.

Research tells us that active management is more likely to lose less during sharp downturns and may not keep up in less fundamentally driven environments. Recently, we have been in a period in which active management is less likely to outperform. The last few years have conditioned investors to measure their success in terms of their favorite index. We know from experience that this can mean trouble. Investor behavior that tends to push markets past their reasonable valuation can be exaggerated by the impact of passive investing, but the tendency to follow the herd over the peak is mitigated by employing a disciplined approach to investing that gives the opportunity for outperformance when it really counts – on the downside.

Beware of some consequences of passive investing

Despite all the research and media promoting passive investing, active investments in the US make up 64% of all investments according to Morningstar, $9.53 trillion active versus $5.41 trillion passive.

While the average active manager may not beat the index in some periods, passive investing means that one will always underperform the market due to fund fees and will always have the risk associated with market. This means that if you were invested in an S&P 500 index fund between October 2007 and March of 2009 you would have lost close to 57% of the value of your investment in the first 17 months, from which it would have taken 3 years to recover (April 2012). Imagine needing to withdraw 5% of your portfolio at the bottom of the market – doing so would have pushed out one's recovery period an additional 9 months for a total of 3 years and 9 months (January 2013).

Passive investing provides diversification that mitigates the risk of holding one company or sector, but it does not allow an investor to discriminate between two companies. Consider Under Armour (UAA) and Advanced Micro Devices (AMD), both members of the S&P500 Index. Investing in an S&P 500 index fund or ETF last year would not have permitted the investor to avoid the 63% decline in Under Armour's price nor take greater advantage of the 498% increase in the price of Advanced Micro Devices Inc (AMD).

Passive investing can also mean taking on more risk. The typical equity index fund is capitalization weighted. At the end of a bull market the index can be driven by overpriced stocks, which have grow in percent as their prices have gone up. This makes the index subject to greater decline when prices return to levels based more on company fundamentals. In summary, passive investing can provide diversification, but does not mitigate market volatility. The debate between active vs passive does not have to be about one versus the other. The real question is what makes sense for you? It could be either or both.

So, How Did You Do With the Portfolio You Chose?

	Initial Investment	Down Market Cumulative Return*	End Value Down Market	Up Market Cumulative Return*	**Complete Market Cycle End Value**	**Complete Market Cycle Cumulative Return***
Portfolio A	$100,000	-57%	$43,255	254%	**$153,031**	**53%**
Portfolio B	$100,000	-65%	$34,708	305%	**$149,331**	**49%**
Portfolio C	$100,000	-45%	$54,580	229%	**$179,367**	**79%**

*Price returns of the S&P 500 index.

You may be surprised to find that the most aggressive portfolio, Portfolio B, did not do as well as you may have expected, ending up with less wealth than the other two portfolios. And, maybe you were surprised to find that the more conservative Portfolio C had the greatest accumulated wealth at the end of the complete market cycle. Losing less when the market is in a downslide means you don't have as far to go to get out of the hole. This is the reason why Portfolio C does better over a full market cycle. In our view, combining managers in such a way as to give your portfolio the best risk/return profile customized for your risk tolerance is the best way to build wealth over the long term and make the ride more comfortable.