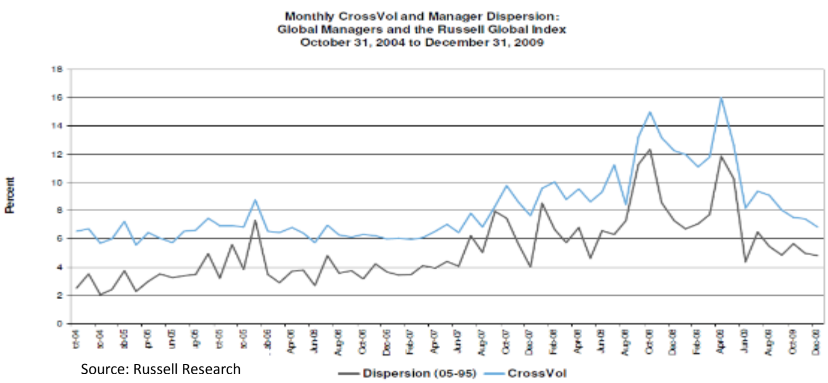
Lynx Investment Advisory

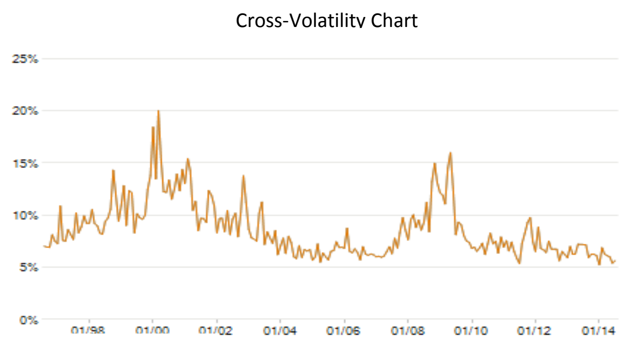
How Much is Too Much to Pay for Performance: Our Views on Active and Passive Investing

How much is too much to pay for performance? Since the early 1980s, investors have debated the merits of active investing and whether the additional performance justifies the higher fees. There exists extensive research and opinion on the virtues of active versus passive investing; we at Lynx Investments believe there is a place for active management in a portfolio as long as one is selective about the allocation. By utilizing the right tools and selection criteria to uncover competent managers, it is possible to add significant value net of fees from active management.

In 2012 Daniel Gardner of Russell Research performed a study, which concluded that skilled managers can be identified based off of their specific investment goals or thesis in order to meet client specific needs such as a yield requirement, an SRI focus, or a desire for lower volatility. Perhaps the most valuable takeaway from the study was the importance of cross-volatility. Cross-volatility is a measure designed to evaluate the relationship between stocks; low cross-volatility suggests that stocks are moving in tandem based on macroeconomic news or factors, while high cross-volatility indicated that stocks are moving based on company specific news. The study suggests that during periods of high cross-volatility active managers outperform, while passive managers outperform during times of low cross-volatility. Russell's research indicates that active managers will produce better returns when stocks are moving based off of stock specific risk and not overall market risk.



Source: Russell Research



Source: Russell Research

To demonstrate the effect cross-volatility has on active manager performance see the chart to the left, which plots market cross-volatility against the return of active managers over an index. This chart illustrates how active manager excess return closely follows periods of high cross-volatility. Cross-volatility is currently at one of the lowest points its been in almost 15 years (chart to the right), which may explain the recent underperformance of active managers. An explanation for today's low cross-volatility and strong market performance may lie in the actions of the Federal Reserve, while another explanation might be a simple reversion to the mean following the 2008 financial crisis.

A more comprehensive chart, from a Cambridge/GU Study, on page three provides further historical evidence to support the case for cross-volatility. The chart compares the performance of a passively allocated portfolio to a composite of endowments, which invest in a combination of active and passive funds. What is apparent is that though the passive-only allocation outperformed in years 1996-2001 and 2012-2014, from 2002-2010, nine consecutive years, the endowments or a combination of active/passive handily beat the passive-only alternative.

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What the Cambridge/GU Study does not highlight is the essential role of manager due diligence; without the sophisticated research teams these endowments employ, outperformance may not have been evident. The Journal of Indexes performed an “Active Vs. Passive” study, which found that outperformance was reduced to funds in certain asset classes, specifically small cap and large cap growth strategies. What this study demonstrates is that most managers do not outperform their respective benchmarks, furthering the argument for the importance of manager due diligence and selection.

At Lynx we agree with the findings from these studies and are of the opinion that a combination of passive and carefully selected active managers is the smartest way to construct a well balanced portfolio. We understand that active management will not always outperform its passive alternative, today’s environment being a perfect example, and remain cognizant of the cross-volatility environment. We also believe there is a subset of managers that, over time, are likely to provide the excess benefit necessary to justify the fees involved. With the knowledge and resources to find these active managers, an investor will likely achieve outperformance over time, which in turn should give justification for any associated higher fees.

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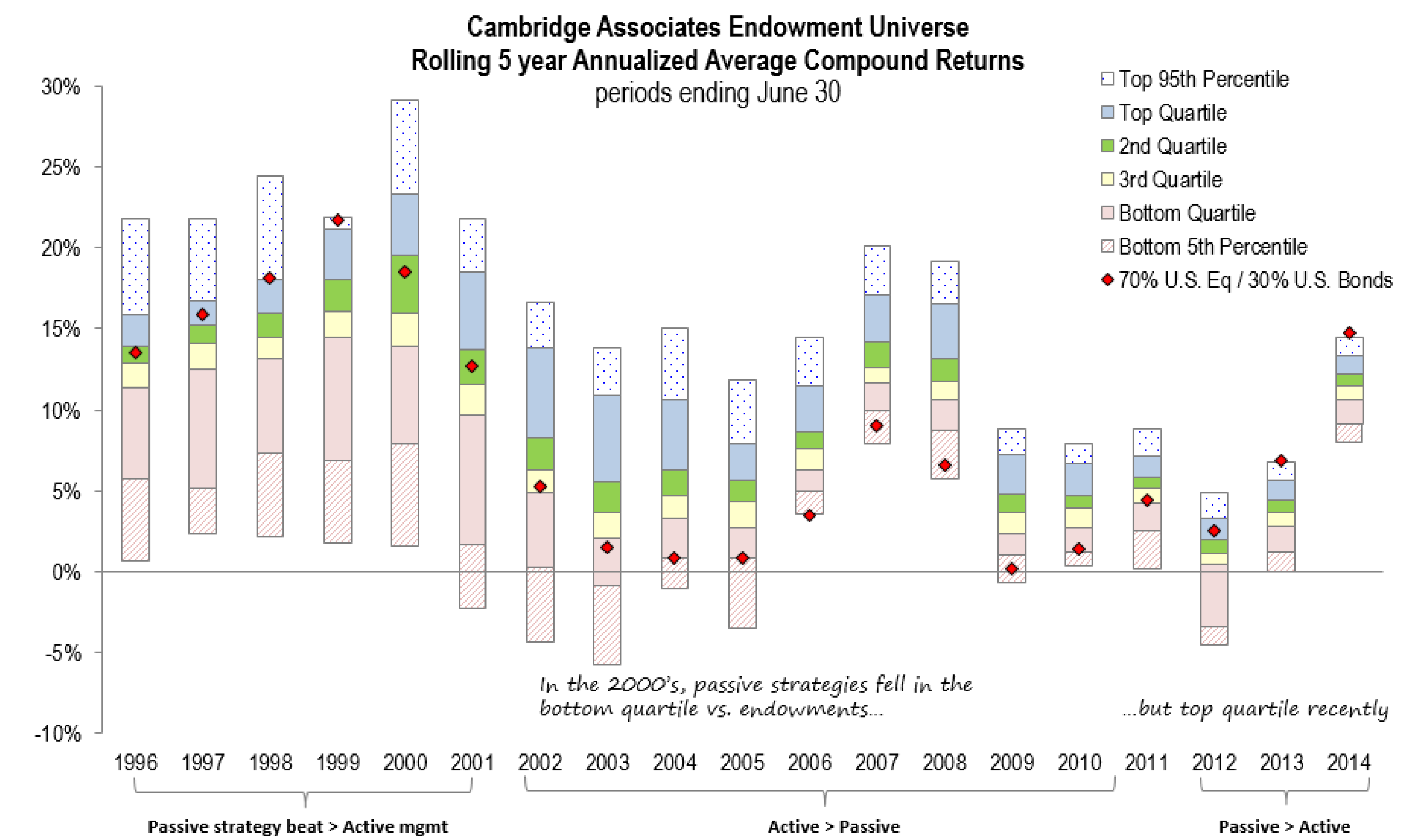
"Active Vs. Passive." *Journal of Indexes* 26 December 2008: n. pag. Web. 21 July 2014.

Gardner, Daniel. "Active or passive management in defined contribution plans?" *Russell Research* 2012 May: n. pag. Web. 21 July 2014.

Chart 3

Medium-term Comparative Endowment Performance

Most endowments underperformed passive strategies in the last several years, after several years of outperforming.
Will active management outperform going forward again?



Source: Data – Cambridge Associates/Chart – Georgetown University Endowment