Combining Active and Passive Management: A Portfolio Powerhouse

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"Where do you fall in the active vs. passive debate?" It's one of the most common questions in asset management. At TrueMark, we believe that framing the debate as a binary question is a significant oversimplification. The reality of the discussion is far more nuanced. In fact, why is it even a debate? Both passive and active management are tools investors can use. Sometimes passive makes more sense and sometimes active is preferred. Sometimes, the best approach is to actually deploy them together.

The Place for Passive Management

An investor looking for general U.S. market exposure might consider a widely available option such as a basic S&P 500 index ETF. The three largest passive ETFs in the market are designed to track the S&P 500*. SPY with $255 billion, IVV with $177 billion and VOO with $129 billion. The popularity of these funds is driven by their ability to deliver the desired general large cap market exposure at a relatively low cost of ownership.

More importantly, with regard to the U.S. mega-cap space, the winners and losers in the fight for market share have more or less been sorted out for most of the index, leaving a market that we would refer to as "efficient". The performance of an efficient market should be tied to the overall economic environment. In the long run, passive large-cap index ETFs are designed to deliver market returns for an investor looking for that type of exposure.

The Misconception

Many investors, and even some advisors, believe that the S&P 500 Index represents the largest companies in America. It is a common misinterpretation of the index. Even more surprising for some investors is that the index is put together by a committee. The S&P 500 does have rules for construction; however, many of them are subjective. Once the index is constructed by a committee, it is then rebalanced every quarter. While the turnover is low, the committee decides what companies are included and excluded from the index. When you look at the index from that perspective, "Passive" takes a little different meaning.

A notable aspect of the construction and rebalancing of the S&P 500 is the sizable group of names that are excluded from the index. At any given time, the S&P 500 includes about 500 companies, hence the name. However, the number of large companies that are ***excluded*** from that list is a much longer. The smallest S&P 500 company is Alliance Data Systems with a market cap of $1.6 billion.* There are 1,600 US domiciled companies with a market cap that size or larger, meaning that fewer than 1 in 3 of them are included in the S&P 500. Many of these are dynamic, growing companies with excellent prospects that just haven't made the cut yet for whatever reason.

If we focus on the Technology Sector, an area many investors believe holds the kind of dynamic, innovative businesses that you want to own in a growth portfolio, we can see the result of this exclusion. The S&P 500 has about 70 names that are classified as Technology, the smallest of which is Xerox at $3.9 billion. Yet there are 141 US domiciled Technology companies of that size or larger, including 23 Technology companies over $10 Billion in Market Capitalization, that are excluded.

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Let's not forget that the S&P 500 is designed to gauge large-cap US equities. In other words, it is supposed to capture the performance of the general large cap equity environment. In our opinion, it does this extremely well.

The Place for Active Management

Innovation offers a counterexample to efficient markets. Innovative companies, cutting edge businesses and new industries are not often adequately represented by passive indexing, which is designed to capture broader exposure. Almost everything we view today as a staple of modern life was at one point a cutting-edge technology. Now basic items ranging from canned foods, trains, refrigeration, cars and plastics to PCs and iPhones each dramatically changed our way of life and the way the economy operated at one time or another.

Initially, the companies involved in these innovative industries typically commanded high earnings multiples relative to the broader market, yet they have gradually become engrained in the landscape. This process of cutting-edge innovation progressing into a life staple has played out time and time again – it wouldn't be a stretch to say that today's most innovative businesses will likely follow the same, well-worn path.

In our opinion, active management excels in segments of the market where the winners and losers have not been determined yet, particularly in rapidly growing industries. These nascent industries are popping up all the time and they are the fertile ground from which new and innovative businesses develop in our economic system.

When a nascent industry emerges, it often results in hundreds of new companies vying to win market share. Fierce competition usually produces somewhere from three to five winners depending on the nature of the space. In time, this number will often be winnowed down to one or two as lesser winners are acquired by larger companies or merge to stay competitive. You hear about these winners because they become household names and may eventually join the S&P 500 Index, but you rarely hear about the hundreds of new companies in nascent industries that fail.

It is an active manager's job to understand a nascent industry, to work with experts in the field, and to identify which companies are believed to be legitimate contenders to take market share, and which are pretenders being swept along in the growth of a nascent industry. Winners may deliver extraordinary returns to investors over time, and losers will often go bankrupt. Unlike in established industries, this is a situation where diversification kills. Investors want to have exposure to the winners and avoid the losers at all costs. The broad brush of passive indices does not work here. In our opinion, only active management can realize the potential in these industries.

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Active management in this space has become especially important over the past 20 years as the private equity market has grown and evolved. Historically, conventional wisdom said that small and mid-cap indexes included companies that were growing and innovating. Companies would IPO small and bubble up to the larger ranks, but that really isn't the case anymore. Private equity in Silicon Valley has changed when the most dynamic and innovative companies move to IPO. When Intel issued its IPO in 1971, the total value was $8.2 million. Adjusting for inflation that would be about $53 million in today's dollars. Cisco's IPO in 1990 was based on a market cap of $224 million or $443 million in today's dollars.

There is no way that those innovative companies would have held their IPOs at such low valuations in today's financial markets. Private equity learned that keeping innovative companies private for longer is way more profitable in the long run. As a result, when Google's IPO happened in 2004, the company had a $23 billion valuation. Facebook's IPO set a $104 billion valuation in 2012. When Uber issued its IPO in 2019, the company was valued at $82.4 billion. These were already large-cap stocks by any definition. Today there are often fewer companies that IPO within nascent industries. Those that do are often farther along the process then they would have been in the past environments. Active managers can be well-positioned to focus on an industry in order to realize the potential over time.

A Dynamic Duo

Both active and passive management can serve important roles in investors' respective portfolios. Passive management like that of the S&P 500 is designed to deliver broad large cap equity exposure. Active management can key in on nascent, developing markets, where the winners and losers of the space are not yet clear. By blending passive and active investment management styles, investors may be well-positioned to harness the growth of established businesses as well as dynamic new industries at the same time.

Important Information

Source for data: Bloomberg, as of 2/9/2020. All rights reserved.