

the EDUCATED INVESTOR

FEATURE ARTICLE

Indexing Vs. Passive Asset Class Investing

Overview: Many investors may believe that passive investing means simply buying index funds. However, there are some key differences between index investing and passive asset class investing. The following discusses some of those differences.

Many investors realize that a passive investment approach offers many benefits when compared with an active investment approach. Passive investing involves buying and holding market components, whereas an active investor or fund manager tries to pick the next winning stock or time where the market is headed next. A passive approach offers these major benefits:

- σ By holding entire market components, one maximizes the benefits of diversification.
- σ By “tilting” the portfolio to riskier or less risky components, the investor can expect to capture the highest market return given his or her risk tolerance.
- σ The investor maintains control over his or her own portfolio’s components (by avoiding active funds’ tendency to style drift without the investor’s knowledge).
- σ Expenses can be minimized.
- σ Tax efficiency can be maximized.

To implement a passive investment approach, investors can choose from:

- σ Index mutual funds
- σ Exchange-traded funds (ETFs)
- σ Passively managed asset class funds

Investors may wonder, “Why shouldn’t I just buy index funds instead of passively managed asset class funds? What is the benefit of passive asset class management versus ‘index’ investing?”

The historical evidence has shown that index investing and passive asset class investing are superior strategies to investing in individual stocks or actively managed mutual funds. But building a portfolio of passive asset class funds expands upon the benefits of index investing while minimizing some of its potential negatives.

First, let’s explore the differences between the two. To use an analogy, passive asset class funds relate to index funds (or ETFs) as squares relate to rectangles:

- σ All squares are rectangles, but not all rectangles are squares.
- σ All index funds are passively managed, but not all passive asset class funds are index funds.

An asset class is a group of stocks with similar risk characteristics, such as domestic or international, large-cap or small-cap. An asset class also can be a combination of similar risk characteristics, such as “US small-cap value stocks” or “international large-cap growth stocks.” An investment firm can create its own definition of an asset class and then passively manage a fund based on that definition. In such cases, there may not always be a specific index that represents or tracks that asset class.

Passive asset class funds retain the benefits of indexing. They are relatively low cost, low turnover and tax efficient. However, they improve on the index model through additional strategies. Let’s look at some of the ways a passive asset class fund can improve returns.

Creating Buy-and-Hold Ranges

Index funds must sell a stock when it leaves the index. For example, if a small-cap stock increases in market capitalization so that it is no longer part of the small-cap index, the fund tracking that index must sell it. This creates turnover and tax inefficiency.

In contrast, a passive asset class fund has the flexibility to create buy-and-hold ranges that enable the fund to hold a stock even if it falls out of the appropriate index. Properly implemented, buy-and-hold ranges help reduce turnover and increase tax efficiency while still enabling the fund to remain true to its stated asset class definitions. For example, a passive asset class small-cap fund might establish a range in which it *buys* all stocks in the smallest 8 percent of market cap. But the same fund might establish that it won’t *sell* the stock unless it grows beyond the smallest 10 percent.

Eliminating Certain Stock Types

Based upon academic evidence, some stock types have been demonstrated to result in historically poor returns, and passive asset class funds can screen these stocks. For example, initial public offering (IPO) stocks have demonstrated poor historical returns in the initial years following the IPO. Based on this evidence, a passive asset class fund might eliminate all IPO stocks until they have seasoned a certain number of years, at which point they become eligible for purchase.

The Nasdaq stock exchange has much less stringent listing requirements than does the New York Stock Exchange. As a result, the Nasdaq experiences far more stocks that eventually “delist” due to frauds and other financial weaknesses. By establishing a screen calling for greater financial requirements (such as those of the National Market System), a passive fund can reduce its exposure to stocks that eventually delist.

Establishing Additional Common-Sense Screens

Passive asset class funds are essentially free to establish additional screens that can be demonstrated to improve net returns. For example, the trading costs of small-cap stocks can be significantly higher than those of large-cap stocks, as small-cap stocks typically experience lower levels of liquidity. Therefore, a passive fund might establish a screen that no stock will be traded unless there are a certain minimum number of “market makers” (i.e., parties interested in trading the stock).

Taking Advantage of Block Trading Techniques

A small-cap passive asset class fund can also take advantage of its ability to remain flexible regarding its precise market cap weighting, whereas an index fund generally must maintain its specific defined

weighting. By acting as a market maker in small-cap stocks, the passive asset class fund can earn not only the bid-offer spread, but it can also earn market impact costs.

The preceding terminology can be daunting to even relatively sophisticated investors, so let's look at an example. Suppose an actively managed fund is selling a large block of a small-cap stock that is trading at 10 bid-10.5 asked (which means the broker/dealer is willing to buy at 10 and sell at 10.5). The stock has typically been trading just 30,000 shares a day, but the active fund wants to immediately sell 100,000 shares. However, selling such a large number of shares relative to the stock's typical trading level will drive the price much lower ... even before they are done selling.

Before moving on with our illustration, it is important to understand that the stock's next move is random, per the Efficient Market Hypothesis. The fact that an active fund manager is attempting to sell a stock does not actually indicate whether the stock will move up or down. Therefore, a passive fund can benefit from what is more than likely a misplaced sense of urgency on the part of the active manager. For example, a passive asset class fund might establish a range of appropriate market-cap weightings it is willing to own — such as ranging from half to double its target holding.

Returning to our illustration, the passive asset class fund manager might check the fund's current holdings, determine it is holding 200,000 shares and conclude that it can hold up to 400,000, given the range it has established. Knowing that he or she can purchase the 100,000 shares and that the active fund is desperate to sell, the passive fund manager might submit a bid of 9.5. If the bid is won, the likelihood is that the stock will return to trading at 10 bid-10.5 asked. The passive fund might then offer a small amount of stock at 10.375. It may even find a buyer who is looking to buy a large block and pay a premium for it. By earning the bid-ask spread and the market impact cost, the passive asset class fund has created the potential to enhance returns through negative trading costs.

Adding Tax Management Strategies

As we have seen, passive asset class funds have many advantages over index funds. However, passively managed funds that also engage in tax management strategies can do even better.

While passive asset class funds are already relatively tax efficient (compared with actively managed funds), there are additional strategies that can be employed to further improve their after-tax returns. These strategies include the following techniques:

- σ Fund managers can avoid taking intentional short-term capital gains. Stocks that should be sold because they have moved beyond their hold ranges are not sold if they are not yet eligible for long-term capital gains treatment. Once the required one-year holding period is reached, the stocks will then be sold. This lowers the tax rate on the capital gain from ordinary income tax rates to the lower long-term capital gains rate.
- σ Stocks that have significant losses can be sold to harvest those losses. The stocks can then be repurchased following the 30-day waiting period required to avoid violating the wash sale rule.
- σ Specific lot accounting is used to minimize realized gains on sale. The stocks sold have the highest cost basis.
- σ Fund managers can avoid purchasing stocks just prior to the ex-dividend date. This reduces the amount of income that will be taxed at higher ordinary income tax rates.

Adding Dividend Management

Dividends are a tax-inefficient manner for investors to receive returns, because dividends are taxed at ordinary income rates. It is important to note that qualified dividends are currently taxed at capital

gains rates. However, current tax laws state that all dividends will be taxed at ordinary income rates starting in 2011. Thus, dividend management may grow in significance if current tax laws are not changed. Let's see why this is the case.

By focusing on minimizing dividends, fund managers can expect to improve upon after-tax returns. Let's explore how dividends can be managed in this manner. The Fama-French three-factor model tells us that almost all of the variance of equity portfolio returns can be explained by exposure to the risk factors of size (market cap) and value. Thus, two portfolios with similar market caps and similar book-to-market ratios have similar expected returns.

According to the same model, dividends are *not* a factor in expected returns. A fund that seeks to minimize dividend income can screen for stocks with high dividends, yet still own a portfolio with sensitivities to the small-cap and value factors that are very similar to a portfolio that includes the high-dividend-paying stocks. As such, it can enjoy the same expected pretax returns. The portfolio can be targeted to provide just enough yield to offset the fund's expense ratio, which can result in no net dividend income (and resulting tax burden) to shareholders.

Note that investors who take advantage of funds that implement dividend management must be aware of and prepared to tolerate "tracking error." A fund that manages dividends has the same expected pretax returns as a fund that does not. But it will hold a significantly different portfolio in terms of specific stocks, so its returns can (and often do) deviate substantially from its relative benchmark. The tracking error should be random and thus short term in nature. But, when it does occur, investors must be prepared to stay the course and ignore it, rather than panic and feel the approach is not working.

Summary

The academic world has provided investors with a road map to a prudent investment strategy based on passive investing. Building a globally diversified portfolio of passive asset class funds is most likely to allow all levels of investors to achieve their financial goals with the least amount of risk, particularly when they partner with an investment advisor who is experienced at implementing and maintaining a passive asset class portfolio.

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