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Managing Stock Portfolios - Active vs. Passive
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A long standing debate over the managing of stock portfolios has focused upon the question of whether to invest in a stock index or hire a manager to construct a portfolio. For more than 30 years, Vanguard has been a proponent of indexing, providing evidence that nearly two-thirds of money managers earn less than their index targets. But below the surface, investors should understand the risks associated with indexes.

What is an index? Companies like Morgan Stanley, Frank Russell and S&P create a variety of indexes or published lists of companies that reflect certain equity market classes - from large-cap to small-cap and developed foreign countries to frontier nations. For example, Russell publishes the Russell 1000 Growth Index, a domestic large-cap growth company index that includes 640 names from the Russell 1000 Index that have "growth" characteristics. The list is reconstituted once a year and is weighted based upon the market capitalization of each company. Apple, Exxon-Mobil and IBM have weightings of 5.9%, 4.8% and 3.4%, respectively, while Nike has only a 0.5% weighting. In fact, the top 10 holdings of this index represent nearly a third (28%) of its total weighting – showing the index to be top heavy. In 1999, 55% of the index was represented by technology stocks and the P/E ratio (price/earnings) was 35x (15x today) – revealing how concentrated and risky an index may become. In fact, this index suffered a 71% decline during the 1999-2002 period as technology stocks fell from grace, while the median active large-cap growth manager was down 40%. While there may be a place for index funds in a portfolio, it is important to understand that the index approach is not always the lowest risk alternative.

Why are index expense ratios so low? There are no fees being paid to portfolio managers and research analysts and the fact that no measurable trading is taking place, the annual cost to investors is typically much lower than active platforms and is one of the primary reasons many choose index products.

Why do so many portfolio managers under-perform their index benchmarks? You would think that beating an index is easy, since the manager knows the composition of the index and has the advantage of being able to trade in and out of positions as opportunities arise. Managers seeking alpha must be able to pick the right stocks (and weightings) and emphasize the winning industry sectors more often than not.

Major influences that impact a manager's relative performance include:

- Indexes may have style overlap – the Russell 1000 Growth Index had a 42% exposure to large-cap growth (on 1/5/12), along with 22% to mid-cap. Efficient market theory – price discovery is already backed into the price. Active stock portfolios hold far fewer names than the index. Not having similar weightings as the index impacts performance. Macro events influence investor behavior, but not the composition of the index. High frequency trading moves stock valuations and impacts performance over short periods - these events are unpredictable.

The proliferation of exchange traded funds (ETFs) has caused stock price change correlations to recently rise above 90%, thus a larger number stocks are moving together, despite significant fundamental differences in the companies. In periods of high correlation, quality companies often have no advantage.

Index products offer the path of least resistance to entering markets as no company specific research is required and the market itself will adjust the weightings. However, as pointed out above, even passive index investors need to be aware of the changes taking place in the market and the associated risk level of their portfolios.