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The Experts: When Does Active Management Make Sense?

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Under what circumstances should somebody use active money managers as opposed to index funds? The Wall Street Journal put this question to The Experts, an exclusive group of industry and thought leaders who engage in in-depth online discussions of topics from the print Report. This question relates to a **recent article** *on a new generation of investments that aren't nearly as passive—or as cheap—as readers might think and formed the basis of a discussion in The Experts stream on Monday, April 8.*

The Experts will discuss topics raised in this month's Investing in Funds & ETFs Report and other Wall Street Journal Reports. Find the finance Experts online at **WSJ.com/WealthReport.**

CARL WIENS

Also **be sure to watch** *three of The Experts— Christian Magoon (@ChristianMagoon) of Magoon Capital, Rick Ferri (@Rick_Ferri) of Portfolio Solutions and Matt Hougan (@Matt_Hougan) of IndexUniverse—speak about investing in index funds and ETFs in a video chat.*

Christian Magoon: Here Are Two Scenarios Favoring Active Managers

Active managers often have an edge in two scenarios. The first occurs in markets that aren't efficient. In general, traditional index funds need certain ingredients in underlying markets in order to best function. These ingredients include minimum levels of liquidity, market capitalization and cost efficiency. When those elements are not ideal, active management is a better choice because it is more flexible when dealing with inefficiencies. Why? Active managers aren't bound by the predetermined set of rules that traditional indexes follow. Thus market segments, including less-liquid fixed-income sectors and certain emerging equity markets, are often attractive candidates for active management.

The second area where active managers can be preferable is when implementing investment strategies that are complex or fast moving. These strategies are difficult to index due to the many contextual variables that can arise. In comparison, active managers are ideally able to make investment decisions quickly and based off countless variables. In comparison, contextualization and speed are not easy elements to "program" into index development.

Christian Magoon (@ChristianMagoon), chief executive of Magoon Capital, provides strategic advice to potential and existing ETF sponsors in areas of

product development, marketing and distribution.

George Papadopoulos : In the Long Term, Never

If we are talking about investing over the long term, never! If we are talking about short-term trading, perhaps you can try to identify an active money manager and hope to get lucky. If you go that route, you should try to pick an active fund with lower-than-average investment costs. You can't control investment performance, but you can control investment costs.

George Papadopoulos (@feeonlyplanner) is a fee-only wealth manager in Novi, Mich., serving affluent individuals and families.

Larry Zimpleman: Remember—It Takes Expert Knowledge to Pick the Right Index Fund, Too

In general, 75% to 80% of the population does not consider themselves investment "experts." While it might sound appropriate to ask if they should use index funds, the reality for this group is that using index funds assumes a person has enough investment expertise to be able to determine *which* index funds are appropriate for them, and what their overall asset allocation should look like.

The majority of the investing public really isn't in a position to answer that question. The best option for this group is: a) find an investment adviser that you're comfortable with or b) consider the use of "life cycle" funds (either risk-based or time-based) as a way to adopt a multi-asset-class portfolio that provides good diversification and adjusts the portfolio over time as horizons change.

If you consider yourself an investment expert, then the question of index funds vs. managed funds is more appropriate. But, again, this assumes you know what overall asset-allocation approach you want to use. In considering the use of active funds, be sure to look at the investment track record over an entire market cycle—not just for one or three years. Also, make sure the size of the fund is stable or growing and that the portfolio managers have been with the fund over that entire time.

Larry D. Zimpleman is chairman, president and chief executive of Principal Financial Group.

Charles Rotblut : An Argument for Both Active and Index

Though some of my fellow expert panelists may disagree with me, I think there is an argument to be made for combining both active and index funds.

Index funds work best when seeking broad exposure to stocks, particularly large-cap stocks. Given the low cost and the high propensity for active managers to underperform, start with index funds.

A good active manager, however, can take advantage of market anomalies such as value, size or liquidity. Sequoia (SEQUX), which I personally own, is a good

example. A manager who adheres to a rational asset-allocation strategy over the long term can also be beneficial. The Permanent Portfolio (PRPFX) and Vanguard Wellington (VWELX) are examples. In AAII's Model Fund portfolio, we combine actively managed mutual funds with index-tracking ETFs to profit from the advantages of both.

The big questions to ask are, what is the active manager bringing to the table, and is his strategy replicable year after year? A strategy that merely involves the manager selecting stocks he thinks are attractive isn't going to help investors. The approach has to exploit market anomalies or otherwise be truly unique, and there has to be long-term performance good enough to justify the higher expenses and risks associated with active management.

If you don't see consistently good long-term performance, stick with index. Considering that the average fund investor doesn't even match the returns of the funds they invest in, simply focusing on mimicking the performance of the broad indexes can offer a huge improvement in portfolio returns.

Charles Rotblut (@charlesrotblut) is a vice president with the American Association of Individual Investors.

Scott Adams : It's a Perfect Strategy for My Enemies

I can think of many cases in which I would recommend active money managers over index funds. For example, I might be giving the advice to someone I hate or—and this happens a lot—someone I expect to hate later. I would also recommend active money managers if I were accepting bribes to do so, if I were an active money manager myself, or if it were April Fools' Day. And let's also consider the possibility that I might be drunk, stupid or forced to say things at gunpoint. I've also heard good things about a German emotion called *schadenfreude*, so that could be a factor too.

Scott Adams is the creator of the "Dilbert" comic strip that appears in thousands of newspapers world-wide and www.dilbert.com.

Frank Holmes : Use an Active Manager for Specialized Equity Markets

I believe a portion of an investor's diversified portfolio should hold actively managed funds, especially for specialized equity markets that require specialized knowledge and expertise, as the pricing tends to be inefficient. These areas include emerging markets, small-cap stocks and companies involved in resources and metals mining. The key is in selecting an active manager who has extensive experience investing in these markets, as they understand the seasonal and historical patterns that help them navigate these complex areas.

Frank Holmes is chief executive and chief investment officer of U.S. Global Investors Inc.

Sheryl Garrett : Hope Says Active, Reason Says Passive

Although I follow the passive school of investment philosophy for most circumstances, there are times when active management has its place. Unfortunately, I don't know exactly when or if that place will occur. If buying the market is good, wouldn't it be even better to have a group of trained professional sort through and screen out the weakest companies/stocks or issuers/bonds and so on? Optimistic reasoning would tell us yes, but the academic evidence says otherwise.

Some of us don't want to settle for just what the market will bear, but rather hope that human beings (active money managers) have an ability to help mitigate risk and receive a higher return per unit of their risk taken in the less efficient segments of the investment marketplace, such as high-yield municipal bonds, international bonds, small-cap foreign equities and so on. I acknowledge that is wishful thinking and that there have only been a few dozen people in the history of the modern capital markets that really do add Alpha—consistently and over time. If we can only find the next Alpha managers! Meanwhile, take a load off and go passive.

Sheryl Garrett (@SherylGarrett) is founder of the Garrett Planning Network Inc.

Eleanor Blayney : Some Reasons for Active Managers (but Not Many)

If the person I was counseling was herself an active manager, I would definitely advise her to invest in her own fund: It sends a good message to other investors of her conviction and confidence in what she is doing!

For the most part, however, index funds trump actively managed funds when it comes to low information costs (you know what you are getting), low expenses and competitive returns over the long run. A case for active funds might be made for investments in areas that require highly specialized knowledge or expertise, such as a merger-and-acquisition fund or a fund focused on a very narrow segment of the market. Another possible argument for active funds: In a bear market, active managers can react defensively or opportunistically, whereas indexes must stay fully invested in their benchmarks.

Eleanor Blayney (@EleanorBlayney) is consumer advocate of the Certified Financial Planner Board of Standards.

Rick Ferri: High-Yield Corporate Bonds Are Better Suited for Active Management

Certain asset classes are better suited for active management than indexing. High-yield corporate bonds are a good example. An unrestrained high-yield bond index includes all bonds outstanding and weighs each security based on the amount issued by a company. This type of index would create problems for investors.

Before General Motors went bankrupt, their bonds were the largest segment of the high-yield bond market. GM paper dwarfed all other issuers. An investor wouldn't have wanted to own an index fund of high-yield bonds when the

company went under because they would have lost a bundle.

To reduce single-issuer risk, high-yield-bond-index providers created constrained indexes. The methodology held each company to a few percentage points of an index. It was a managed solution.

The second problem with high yield is liquidity. Many high-yield bonds trade infrequently, and that makes it impossible for an index-fund manager to track the index. To solve this issue, index providers added security screens to eliminate low-volume bonds. It was another managed solution.

There is nothing wrong with using an ETF or index fund that tracks a managed index, except that these products tend to hold fewer bonds and have higher expenses than some actively managed funds. The Vanguard High-Yield Corporate Fund Admiral Shares (VWEAX) holds more bonds and has lower expenses than any high-yield index fund or ETF. In my view, this makes VWEAX a better index fund than existing index funds and ETFs.

Rick Ferri is founder of Portfolio Solutions LLC and the author of six books on low-cost index fund and ETF investing. His blog is RickFerri.com.

Greg McBride : Small-Cap Stocks and Emerging Markets Present Opportunities for Good Active Managers

While I am a big proponent of index investing, investors can increase their odds of adding incremental return to their portfolios by seeking active managers that have a strong track record and consistent investment philosophy, particularly small-cap stocks and emerging markets.

Greg McBride (@BankrateGreg) is a senior financial analyst and vice president for Bankrate.com, providing analysis and advice on personal finance.

Matt Hougan: Active Management Might Work In Bonds

All of the data suggest that this is a terrible idea in nearly every corner of the market. We like to think that managers can have an edge in undiscovered corners of the market—small-cap emerging markets, illiquid credit—but the data suggest otherwise. Most active managers lose over the long haul, and it's impossible to find the ones that will outperform in advance. Anyone who debates this with you in the equity space is...confused.

In bonds, it's different. Broad-based bond indexes are so overloaded in U.S. government debt right now, and that debt is yielding so little and subject to so much interest-rate risk, that I worry about investors who "own the market" in the bond space. Even John Bogle, the father of index investing, has said that just buying the Barclays U.S. Aggregate Index is not such a good idea these days.

I think considering the services of successful fixed-income managers like Bill Gross or Jeff Gundlach is a legit idea. They've shown the ability to navigate tricky waters and have established remarkable long-term track records. Thanks to their

size, they also have a real advantage when it comes to accessing liquidity in the bond market.

Will it work out? I have no idea. But if you can get it for low costs— BOND costs 0.55% a year, for instance—it's a reasonable idea. (Run away screaming from anyone who wants to charge you 1% for investing.)

[Disclosure: Though I work for IndexUniverse, I own the actively managed BOND in my own portfolio.]

Matt Hougan (@Matt_Hougan) is president of ETF analytics and global head of editorial for IndexUniverse LLC.

Tom Brakke : Three Points to Consider When Pursuing an Active Strategy

Passive strategies like index funds should be the default approach for most people. They are cheaper, easier and have had better results over time than active managers.

Selecting active managers is difficult, and many of those who would give you advice on which manager to select base that advice primarily on past performance, which isn't a good predictor of future performance. (Those in the business of making the recommendations might say they do much more than that, but ask yourself this: When was the last time they proposed buying a fund with subpar recent performance or selling one that's been very good?)

Which is not to say that active strategies should never have a place in your portfolio. If you use them, do so carefully:

1) Choose managers that are truly active, not the "closet indexers" that are prevalent in the business. (Hint: You should want more "tracking error," not less.)

2) Focus on the least efficient parts of the market, where active managers have the best opportunity to outperform.

3) Discount the narrative you hear about the manager from those recommending the investment and seek out information from other sources.

Active managers offer the possibility of outperformance, while often delivering the reality of underperformance. If you really want to "outperform" your neighbor, save more than they do. It's as close as you'll ever come to a sure thing.

Tom Brakke (@researchpuzzler) is a consultant, writer and investment adviser who specializes in the analysis of investment decision making and the communication of investment ideas.

Michelle Perry Higgins : Active Mangers Can Help You Navigate Lesser-Followed Areas

Although certainly not in the majority, there are several actively managed funds available to investors that have done an outstanding job of outperforming their

benchmarks over time. The idea of an investor using funds like this in combination with some core index funds makes great sense. However, with so many funds in the universe today (per Morningstar, 29,432 as of Feb. 28, 2013), it takes a lot of time and effort to screen and identify funds that have past records of exceeding target levels. Even with appropriate due diligence, investors still have to keep in mind that past performance is no guarantee of future results. If I had one suggestion to offer the individual who was going to wade into this pool, it would probably be that they may have more success with active managed funds by going to lesser-followed areas such as small-cap stocks, emerging markets or even the high-yield bonds. In these sectors, there are more opportunities for a skilled manager to find undervalued opportunities as compared to a typical large-cap-fund manager.

Michelle Perry Higgins (@RetirementMPH) is a financial planner and principal at California Financial Advisors.

Rick Ferri to Frank Holmes and Greg McBride: The Myth of Inefficient Markets

Rick Ferri is responding to a post by Frank Holmes and another by Greg McBride.

Frank Holmes and Greg McBride advocated investing in actively managed funds that specialize in part of the equity markets that they believe require specialized knowledge and expertise. Their theory is that small-cap and emerging markets are inefficient and that active managers outperform indexing.

This theory doesn't pan out in the numbers. According to a newly compiled study by researchers at Vanguard, a significant majority of actively managed funds in so-called inefficient sectors such small-cap stocks and emerging markets have not delivered on the promise of outperformance, particularly after accounting for the large number of poor-performing funds that closed or merged over the years.

It's a myth that actively managed equity funds have a leg up in markets perceived as inefficient. Low-cost market-matching index funds outperform a majority of active managers in every style and sector and across every continent in the long run.

Rick Ferri is founder of Portfolio Solutions LLC and the author of six books on low-cost index fund and ETF investing. His blog is RickFerri.com.

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