SAVVY INVESTOR

Active strategies: Investing with conviction

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Active investing essentials

Gary Adams
Deputy Head of Investment Content
Savvy Investor

How does one begin to understand the functional differences between passive and active investing?

And once understood, what are the best ways of implementing this knowledge into an effective investment strategy?

These are the questions answered in Vanguard's new white paper, *"Considerations for active fund investing."* This comprehensive guide acts as a companion piece to Vanguard's *"Considerations for index fund investing."*

It explores what active investing entails and how success can be measured in granular yet accessible detail, touching on both the quantitative and qualitative aspects of the approach.

In our Ask the Expert section, James J. Rowley, Jr., CFA, Global Head of Investment Implementation Research, discusses some key considerations for investors looking at active strategies.

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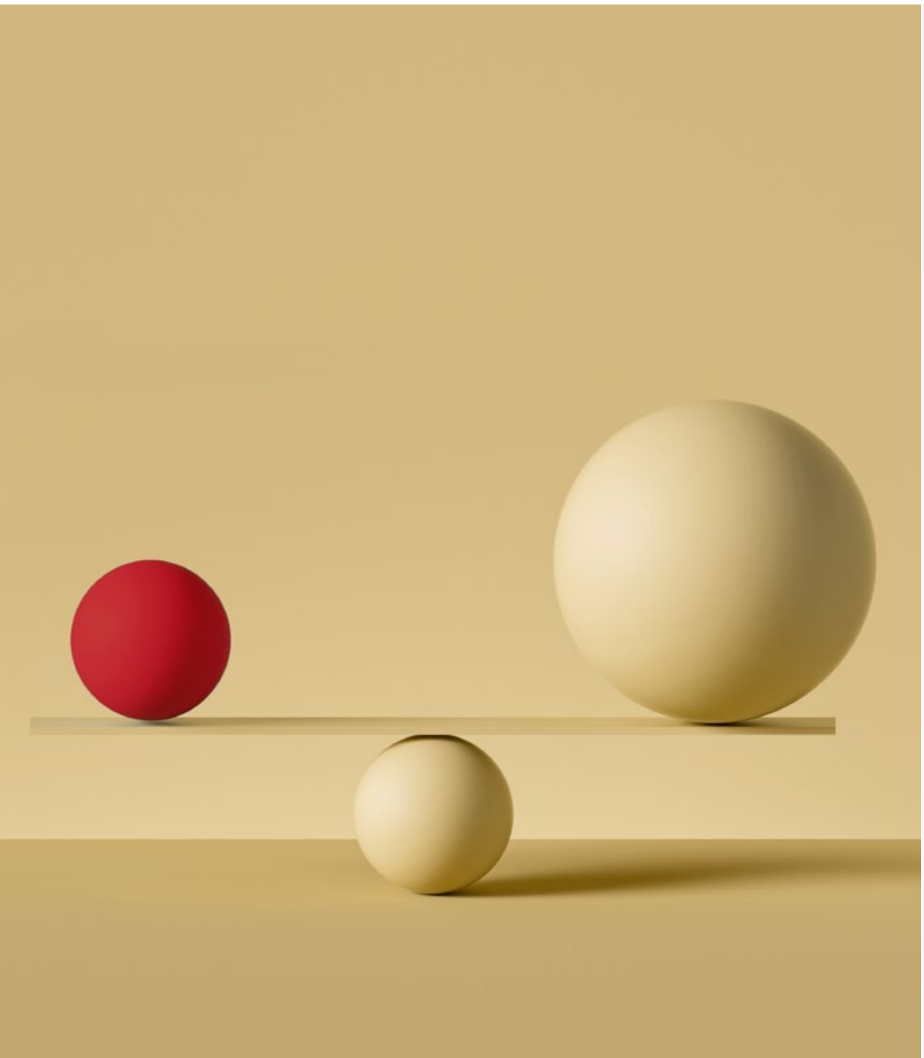

James J. Rowley, Jr., CFA
Global Head of Investment Implementation Research
Vanguard

James J. Rowley, Jr., is Vanguard's global head of investment implementation research and a member of the senior leadership team of the Investment Strategy Group. Among his areas of expertise are investment strategies, including indexing, active, and factor, as well as investment products, including mutual funds and exchange-traded funds (ETFs).

Jim and his team conduct research and provide thought leadership on issues related to indexing, ETFs, active management, alternatives, factor strategies, and ESG (environmental, social, and governance).

Jim joined Vanguard in 2005 and has held positions of increasing responsibility on the firm's ETF Product Management Team and in the Investment Strategy Group. Before joining Vanguard, Jim worked at Gartmore Global Investments, Lehman Brothers, and Merrill Lynch.

Jim's research has been published in The Journal of Portfolio Management and The Journal of Beta Investment Strategies (formerly The Journal of Index Investing), and he has presented to global regulators, policymakers, industry peers, and investors. He is also frequently interviewed by the financial media.

A CFA charterholder, Jim is a past president of the CFA Society of Philadelphia and is an advisory board member of The Journal of Beta Investment Strategies.

Jim earned a B.S. from Villanova University and an M.B.A. from New York University

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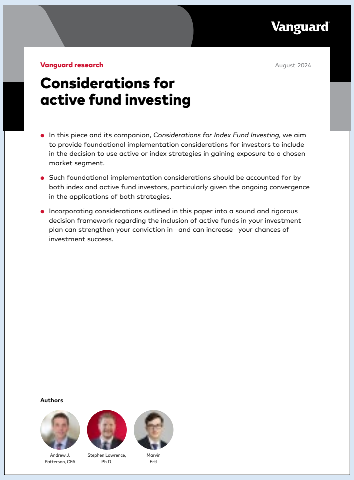


View the full paper

Although passive and active investing differ in some ways, Vanguard notes that successful active fund investing still follows Vanguard's four principles for investing success—goals, balance, cost, and discipline. Each of these is covered in more detail below.

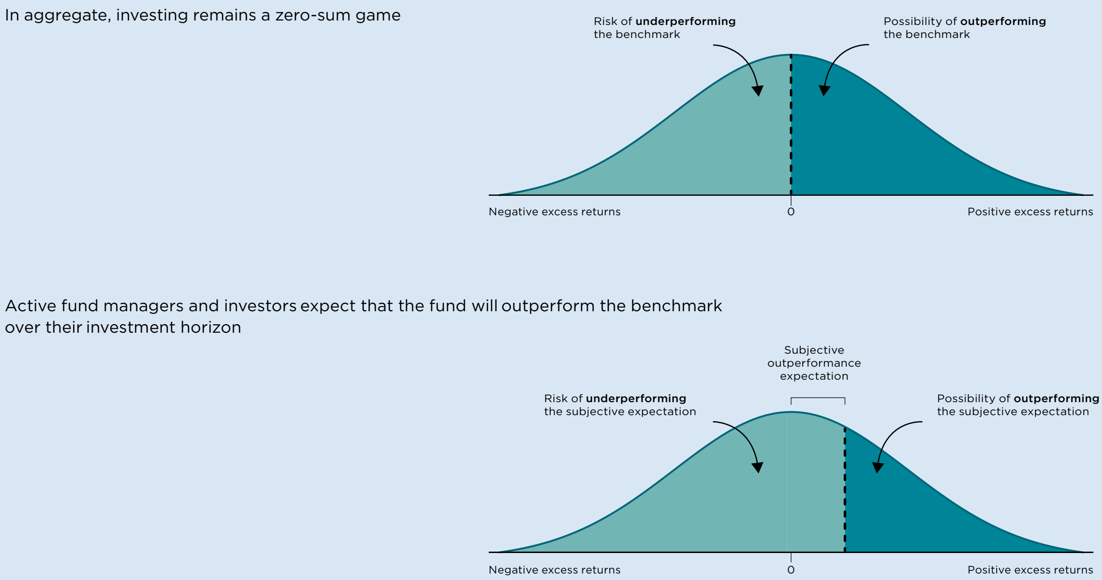
Goals: Outperformance and its definition

The core goal of active investing is outperformance—that is, achieving returns that exceed the fund's benchmark (e.g., domestic equity or fixed income) over time. To achieve this, fund managers construct portfolios that deviate in composition or weighting from the benchmark. This deviation introduces active risk, which encompasses different factors, such as tracking error, active share, and the manager's security selection decisions. Tracking error quantifies the variability in the fund's returns relative to its benchmark, while active share highlights how much the fund's holdings differ from those of the benchmark. Unlike index funds, which aim to mirror benchmark performance, active strategies embrace the potential for both outperformance and underperformance through having higher active risk.

When choosing between an index fund and an active fund, investors are essentially deciding between the predictability of returns and the possibility of higher returns.

The zero-sum nature of market returns indicates that for every investor who beats the market, another must fall short by an equivalent amount, leading to a net zero excess return before accounting for costs.

Figure 1: Conviction is key: Active fund investors expect to outperform a benchmark over time



Notes: The bell curve in each image consists of stylized data comparing the theoretical distribution of the excess returns of all invested assets in a market segment, an illustration of the concept of the zero-sum game, with net zero excess returns at the center. The figure images do not incorporate the impact of costs, which would shift each distribution to the left. Investors managing these assets include but are not limited to open-end-fund managers, closed-end-fund managers, individual investors, hedge funds, and other institutional investors who buy and sell assets that are included in the benchmark representing the market segment.

Source: Vanguard

Costs, which are covered later in this Special Report, push performance to the left of a performance bell curve (as seen in Figure 1). Active management aims to generate positive excess returns through outperformance of a benchmark over time, producing positive excess returns on the right-hand side of this curve.

Balance: Diversification and outperformance

Diversifying investments across multiple securities reduces the risk of significant underperformance relative to a fund's benchmark. However, investors must carefully balance diversification with the pursuit of outperformance—a delicate trade-off. While diversification mitigates the risk of underperformance by spreading exposure, active risk—the deliberate deviation from the benchmark mentioned earlier—creates opportunities for outperformance. Striking the right balance between these approaches is crucial for achieving long-term investment success.

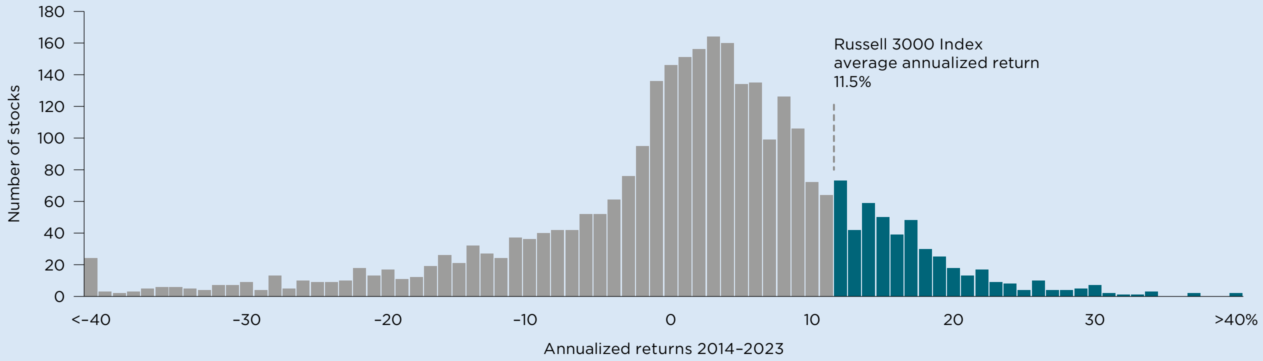
Figure 2 illustrates this tension between diversification and active risk. Over the 10 years to December 31, 2023, 80% of the stocks in the Russell 3000 Index underperformed the index, which itself posted an average annualized return of 11.5%. For a fund manager to beat their benchmark, they typically allocate capital to securities expected to outperform while avoiding or underweighting those anticipated to lag—its active share.

Investors assessing a fund manager must weigh this interplay between active risk and diversification. While quantitative metrics like active share and tracking error do provide insights into a manager's strategy, these should be considered alongside qualitative factors, such as the management firm's culture, investment philosophy, and decision-making processes. Additionally, investors cannot overlook a critical element that directly affects returns—cost.

Balancing the goal of outperformance with the benefits of diversification requires careful evaluation. A successful approach considers not only the numbers but also the people, practices, and prices behind them.

"Investors are essentially deciding between the predictability of returns and the possibility of higher returns."

Figure 2: A smaller pool of relative winners



Notes: The chart shows the distribution of annualized returns for stock constituents of the Russell 3000 Index in U.S. dollars as of January 31, 2014. The performance shown is for January 1, 2014, through December 31, 2023, with reinvestment of all dividends. Overlaid is the index's total return performance for the same period. Past performance is no guarantee of future results. The performance of an index is not an exact representation of any particular investment, as you cannot invest directly in an index.

Source: Vanguard.

Figure 3: Higher expense ratios introduce a higher hurdle to outperformance

Notes: The chart displays the distribution of the expense ratio (as of year-end 2023) and net returns in excess of a fund's prospectus benchmark in U.S. dollars for active and index equity and fixed income funds within the inclusion criteria specified in the Appendix over the period January 1, 2014, through December 31, 2023. The trend line results from a regression of excess returns on expense ratios, weighting the observations using net assets as of December 31, 2013. Basis points (bps) are one-hundredth of a percentage point. Past performance is no guarantee of future results. **Note: the inclusion criteria specified in the Appendix of the white paper**, *Considerations for active fund investing.*

Source: Vanguard calculations, based on data from Morningstar, Inc.

Costs: How this links to outperformance

The impact of costs on a fund's performance cannot be overstated. Expense ratios, transactions fees, and taxes all act as a drag on performance over time. Expense ratios are a key metric. Often associated with a manager acquiring better information and having skill, expense ratios nevertheless do not guarantee outperformance. In fact, lower expense ratios generally present a lower hurdle for a fund achieving positive net returns, as Figure 3 shows.

The rate at which securities are bought and sold (or turnover) further influences net returns, with higher turnover being linked to reduced after-tax retention. Minimizing both of these costs is vital for preserving returns. While funds with higher costs can still outperform, those with lower costs provide a clearer path to retaining more returns and boosting outperformance potential.

Discipline: The key to realizing benefits

Discipline in investing means sticking to an investment plan, even during periods of underperformance. It's easy for an investor to abandon a strategy. But doing so increases the risk of missing their financial goals. Even active managers who outperform their benchmark over long time horizons often endure extended periods of underperformance. In fact, Vanguard calculations show that a large majority of outperforming equity and fixed income funds underperformed for at least three out of 10 years analyzed, by up to 10% in many cases. To realize the benefits of outperformance, investors must be prepared to withstand periods of underperformance over their investment horizon. This requires dedication to a robust decision-making process, strong conviction, and discipline. This is a skill that should not be overlooked, because it increases the likelihood of achieving substantial investment success.

Read more about active management in our Ask the Expert section, where we talk with James J. Rowley, Jr. CFA, Global Head of Investment Implementation Research.

"Even active managers who outperform their benchmark over long time horizons often endure extended periods of under-performance."

Ask the Expert with Vanguard

Active investing

James J. Rowley, Jr. CFA, Global Head of Investment Implementation Research, discusses some of the key considerations investors looking at active management must ask themselves.

Interviewer
Gary Adams
Deputy Head of Investment Content
Savvy Investor

James J. Rowley, Jr., CFA
Global Head of Investment
Implementation Research
Vanguard

Gary: How might a potential investor effectively judge a management's culture and philosophy? What factors should they be on the lookout for, in both positive and negative terms?

Jim: This is where "personal investment philosophy meets trust in advertising." Any investor interested in active management should first consider the manager's personal investment philosophy. They should ask themselves if it aligns with their own philosophy. Both parties need to be on the same page. When I say, "truth in advertising," I mean, "if I sign up to invest with an active manager, do they deliver what we discussed in advance?" Or, if not discussed, do their stated objectives, philosophy, and processes hold true during your research? Do they consistently stick to this process? These are my first considerations when engaging with active management. The advantage is if they maintain their process even when performance or certain market segments turn against them. Changing their approach could be a warning sign.

Considering the level at which costs drag down performance, does it make sense for smaller investors, such as retail investors, to use active funds?

Everyone should focus on minimizing costs. This isn't about an institutional or retail framing; it's fundamental. Every basis point of expense ratio is a point of performance you don't receive. This awareness is relevant to any investor.

Are high cost, but high performing managers rare enough that efforts to identify them should be dismissed?

I prefer to discuss performance in past terms because current manager performance is historical, not ongoing. High costs can be compared to a race where someone starts 10 meters behind the line every time. At some point doing this becomes a disadvantage for any manager with relatively higher costs.

I don't think there's a magic number that says what cost level is suddenly high versus low or too high versus too low. It's relative. This is one of the arguments we make in our paper—that you can think of expensive ratios, say, as being on a continuum. Mathematically, every basis point of expense ratio reduces excess return by one basis point. From this standpoint, thinking of it as a running race, you have to ask: "How far back am I willing to start?"

Is active investment more suited to specific parts of market cycles?

I'd argue that it isn't because active management is not an asset class. And so there is no good or bad cycle for active investment. I don't think there are times when it is smarter or when it is dumber. Active management works off the principle of the zero-sum game. Somebody in the active management space producing a dollar means somebody else is losing a dollar through underperformance. In aggregate, outperformance is equalized by underperformance. This makes it an individual exercise in manager selection, not a collective asset class.

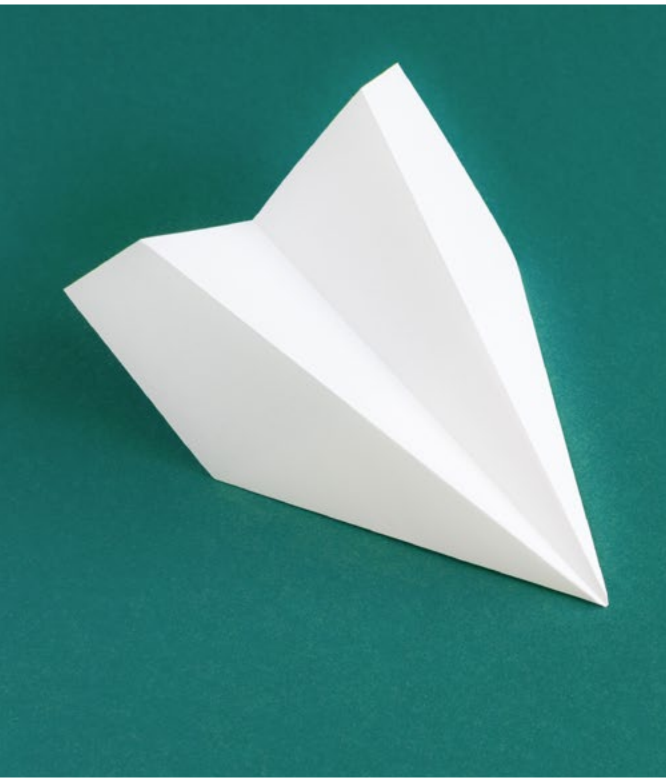
What is your recommended time interval for comparing an active fund's performance to its benchmark?

There are two ways I've thought about this although I can't tell you if they are necessarily the right approaches. One answer might be to ask how a manager endures through various different market cycles, be that during higher volatility versus lower volatility, shifts between value and growth or, as seen recently, when relatively larger cap stocks are doing better than relatively smaller cap stocks.

The second way I would think about this is referenced in our paper. In it, we replicate work completed by some Vanguard colleagues who wrote a different paper that looks specifically at managers who outperform over longer periods of time, asking how much underperformance they experienced intermittently through that time period. And it turns out that managers who outperformed their benchmark over 10 years on average, underperformed for around four years out of this 10. I think most people wouldn't believe this—it seems like a very large proportional amount of time for somebody who is an eventual outperformer. I don't know if there is a magical answer to that question other than to say that active management is really difficult, and investors really have to be patient in sticking through hard times to eventually reap the rewards of a successful manager.

How can an investor differentiate between temporary underperformance from more persistent issues with an active fund?

I'm not so sure that you can distinguish between the two, but I would point to a comment I made earlier about looking for changes in processes. After conducting due diligence and aligning with a manager's objectives, philosophy and process, any significant change to the latter would be a red flag.



"Active management is really difficult, and investors really have to be patient in sticking through hard times to eventually reap the rewards of a successful manager."

Is there a difference between refining a process or reacting to an unanticipated realty, and a wholesale change to a previously held conviction?

It could be either/or. There will be some qualitative elements you can keep an eye on, such as reading manager commentaries and staying on top of certain decisions they've made, typically with respect to buying or selling individual securities, or how a portfolio has been positioned. And quantitatively, there are some simple things to keep your eyes and ears open to, such as a concentrated portfolio shifting to something more diversified, or vice versa.

What practical strategies can an investor implement to strengthen their discipline?

Understanding your true risk tolerance is one of the best means of achieving the required discipline. Something we talk about in our paper is how active management, at its core, offers an opportunity to outperform at the risk of underperforming. And an easy metric to judge the magnitude of any potential underperformance is how concentrated or diversified a portfolio is. If an investor commits to such a fund and realizes they can't handle sizeable swings over short term periods, they may not have really understood their risk tolerance and would likely be happier with a more diversified manager. This isn't the investment manager's fault because they will be doing what they said they were going to do. It's about having a better understanding of risk tolerance and investors being true to themselves.

How should investors consider active funds with regards to changing investment time horizons?

Ironically, sometimes I believe that when we talk about active fund investing or index fund investing, we get too sucked into manager selections and what I call implementation within asset class issues. And I think we sometimes lose perspective on how important broader asset allocation is with respect to portfolio construction. When thinking about time horizons, my first reaction is to say that we should all be cognizant of the stock-bond mix, that both components are reasonably diversified.

If I'm thinking about my time horizon, meaning that I'm 50 years away from retirement versus five years, the more important issue becomes how much equity versus fixed income a portfolio contains rather than if it is actively managed or not.

Past performance is no guarantee of future results. The performance of an index is not an exact representation of any particular investment, as you cannot invest directly in an index.

All investments involve some risk. Be aware that fluctuations in the financial markets and other factors may cause declines in the value of your account. There is no guarantee that any particular asset allocation or mix of funds will meet your investment objectives or provide you with a given level of income. In a diversified portfolio, gains from some investments may help offset losses from others. However, diversification does not ensure a profit or protect against a loss.

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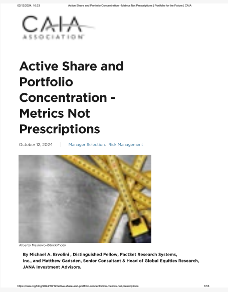

Active Share and Portfolio Concentration - Metrics Not Prescriptions

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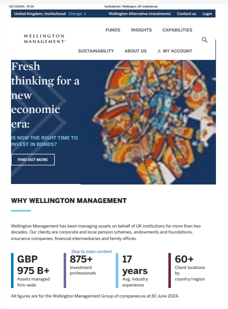

An Active Investor’s Guide to Growth Equities

25 September 2024 | Wellington Management

Investing in equities involves a degree of risk tolerance because equity prices inevitably go up and down.

Active vs. Passive Investing: Revisiting the Debate

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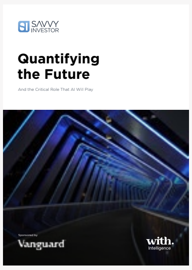

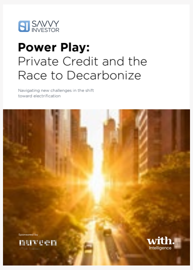

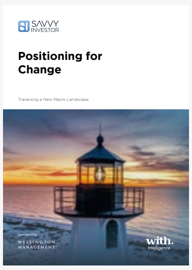

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