Why Active > Passive

February 2019

An Investing Legend:

We thought, with the recent passing of legendary investor Jack Bogle at age 89, that we would discuss (again) active management versus passive investing. Ironically, Bogle began his career in 1951 at asset manager Wellington as an active portfolio manager. Over the course of a wonderful career at Wellington, Bogle climbed the ranks from analyst to portfolio manager to CEO (by 1970). After spearheading a merger, which he later called "extremely unwise" and a "shameful and inexcusable" mistake, Bogle was fired.

In 1974, Bogle turned a negative into a positive and started Vanguard Investments. Over the next year, Bogle went on to launch one of first index mutual fund for individual investors. To summarize Bogle's main innovation, he wanted to create a cheap vehicle to simply mimic an index. Prior to this, most managers strived to exceed their benchmark and "beat the market."

In 1999, *Fortune* magazine named Bogle as "one of the four investment giants of the 20th century." Over the last four decades, it is easy to say that Jack Bogle transformed the world of investing. We couldn't agree more!

Active versus Passive:

It should not shock anyone to state that the biggest issue facing the asset management industry is the massive migration of assets from active to passive managers. In our "Active versus Passive" note, published in April of 2017, we addressed the "passive threat" to active managers from a somewhat differentiated point-of-view. To summarize that 12-page note, which can be read here, passive should continue to steal market share from active, but there are significant flaws to a market that entirely rests on index investing.

Obviously, as active managers ourselves, we feel there is an opportunity to add value through stock selection. In our case, the "secret sauce" lies in our unique process and investing philosophy. We feel superior stock selection can and does matter. For those with a differentiated point-of-view, an area of expertise and a long-term investment strategy, some managers can deliver returns in excess of the average market return. For us, there is only one true measuring stick: Are we generating alpha and outperformance for our clients?

Performance:

In a *Wall Street Journal* interview conducted in November of 2018, Bogle continued to emphasize how "nobody can reliably beat the market." He cited statistics that show that for the last 20 years, through August of 2018, 83% of actively managed funds in the US failed to beat the overall market (as defined by the S&P 500). While this is astonishing, it still means that 17% of actively managed funds were able to outperform. Sorry! We are always being chided for choosing a "glass half full" mindset.

Over the last two decades, the performance of active versus passive managers has changed dramatically. For example, active managers were delivering outperformance twenty years ago. In 2001, 2002 and 2004, active managers outperformed 68%, 66% and 55% respectively. However, within the last few years, this outperformance has flip-flopped. In 2014, 2015, 2016 and 2017, the percentage of active managers outperforming their benchmark has fallen to 25%, 28%, 32% and 38%. So, what changed?

Volatility:

Historically, volatility has been considered a positive condition for active managers. During the downturns of 2000 (dotcom era) and 2007 (financial crisis), 66% and 53% of actively managed funds outperformed.

In our April 2017 note "Active versus Passive", our conclusion stated:

> *Research has proven that active management does better in volatile and downward trending markets. If you believe we are headed in that direction, isn't it better to have an opportunity to at least adapt and change? Are you better off having an engaged and skilled active manager running your portfolio or blindly flying on autopilot? There will continue to be a place for passive management allowing for specific market exposures at low fees. Unfortunately, many investors have failed to ask the ultimate question of any asset manager. Are you adding value? Today, only index managers can easily answer that question.*

At the writing of that note, the market was relatively calm and devoid of any real volatility. The VIX was hitting all-time lows, and the market was marching higher. However, in 2018, the market finally experienced some heightened volatility. Active managers should have been cheering this unexpected volatility as an opportunity, in February and then again in the 4th quarter.

According to Morningstar, just 38% of actively managed US equity funds beat their benchmark last year. Over the last decade, the performance of stock pickers has been abysmal, with only 24% of funds outperforming their benchmark. This is clearly a disturbing and frequent trend for active managers and is precisely what Bogle constantly highlighted and preached to retail investors.

One obvious issue facing active managers is a lack of performance. However, we argue many fail to have argue "an edge." We liken this type of specialty to visiting a doctor. If you are having a problem with your knee, would you rather see an orthopedic knee specialist or a general practitioner? Medicine has become extremely specialized, with certain doctors focusing on one or two specific areas. Why hasn't the asset management industry followed suit?

We find the work of Princeton economist Burt Malkiel humorous. Malkiel is famous, in investing circles, for his research highlighting that "blindfolded monkeys could throw darts at a newspaper" and deliver returns similar, if not better, than "expert" money managers. How's that for demoralizing our entire profession?

Assigning Blame:

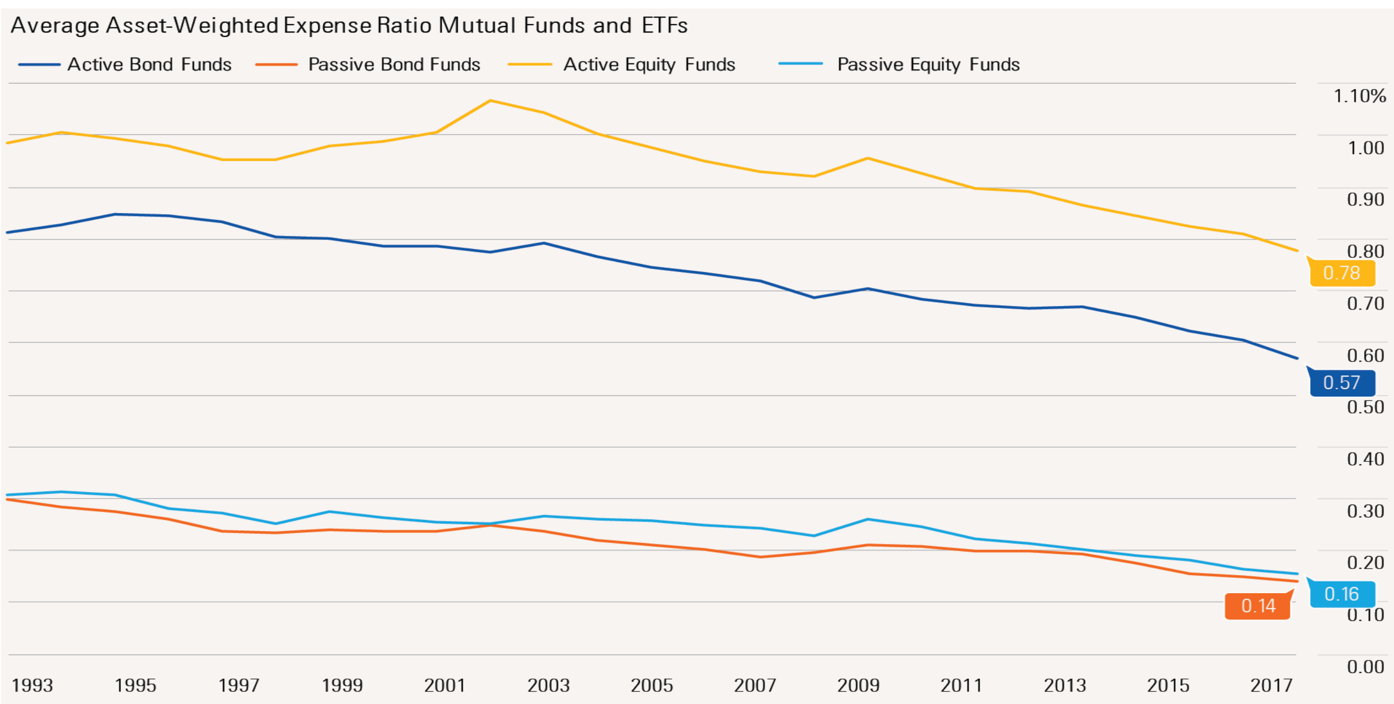
Money managers should not receive all the blame. The inherent laziness of certain retail investors is alarming. Loyal readers of ours know we are sports junkies. If a quarterback once completed 60% of his passes, but then fell to a dismal 20% of his attempts, he would likely be cut. Why are active managers given the luxury of holding sticky, long-term assets? Why don't investors hold their managers accountable?

In addition, some of the blame also should be assigned to financial advisors. Advisors should continuously conduct due diligence on their managers and question performance. Manole Capital is not a holistic money manager, building diversified portfolios across all market industries. Our opinion is that financial advisors should build diversified portfolios for their clients, with a proper understanding of each client's unique penchant for risk versus reward. Each client is different, but many financial advisors fail to customize their portfolios for a client's distinctive characteristics. In our opinion, one size does not fit all.

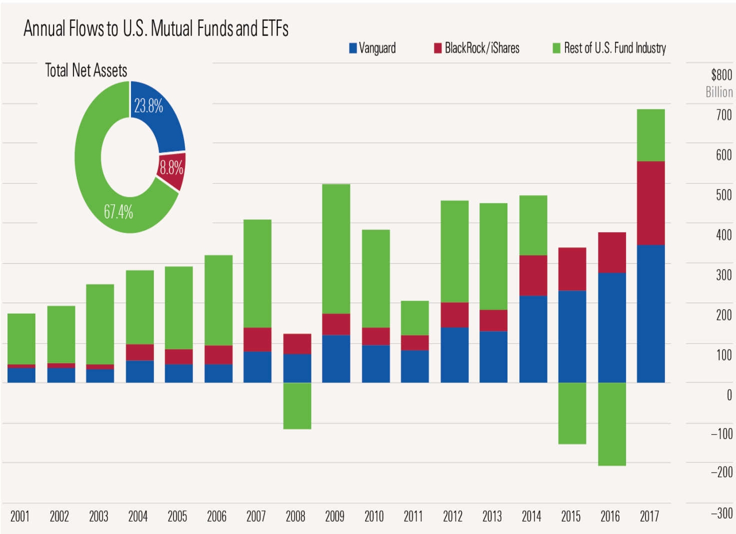
Fees:

Another item Bogle often discussed was the high fees charged by active managers. Due to John Bogle's wisdom, the overall market (if one uses the S&P 500) can be purchased for a fee of roughly 5 basis points (i.e. 0.0005).

With extremely low fees for index funds, Bloomberg Intelligence estimates that Bogle's passive style saved US investors close to $1 trillion in fees over his lifetime.



Market Share:



Only a few companies dominate passive investing. The "Big 3" of index investing are Blackrock's iShares, Vanguard and State Street's Spiders. Collectively, these three companies garner over 80% of the market.

According to a recent Morningstar study, BlackRock and Bogle's Vanguard garnered 57% of global net new inflows into long-term mutual funds in 2018. However, their dominance is fading. Last year, these inflows of $606 billion were down nearly 70% year-over-year from $2 trillion in 2017. A stock market that fell over 4% last year is clearly giving some investors pause.

Despite this market concentration, others are always trying to steal market share and capture this long-term opportunity. Just last year, Fidelity Investments launched the first "no fee" index fund, which perfectly reflects this "race to zero." Schwab offers a number of index offerings for less than 5 basis points. The index business is one of the most scalable models we know, but the race toward 1 basis point management fees (or even free) will likely hurt all participants. The lone beneficiary will ultimately be investors.

One Flaw:

It is estimated that 40% of the equity markets are now invested in various forms of passive vehicles. As more and more retail investors bypass stock picking, and invest passively, the trend continues to gain steam. Morningstar estimates that, at some point in 2019, US passive equity assets under management will finally surpass actively managed equity assets. Nothing in the tealeaves suggests this will not continue for years to come. We disagree with the entire market becoming passive. Why?

Investors have to recognize certain limitations of passive management. Purchases of passive equities are indiscriminate. What do we mean? If there is a redemption cycle, like the one just experienced in the 4th quarter of 2018, indiscriminate purchasing becomes indiscriminate selling. This shift ignores liquidity and works to the benefit of a rising equity tape. However, when redemptions arise, it can cause serious valuation gaps, especially for illiquid securities.

When Legg Mason reported its most recent quarter, Chairman and CEO Joseph Sullivan stated that $313 billion of active US mutual funds withdrew money during the quarter. He pointed out that this was the "biggest quarterly net outflow ever as measured (by dollars)." For additional perspective, Sullivan said that outflows during "the height of the financial crisis in 2008 were two-thirds of that number." We saw the effect of this during the large downdraft in the market in December of 2018.

Over the last decade, many have grown accustomed to a trending higher market. However, last year was a wake up call. For the first time in 9 years, 2018 was a down year for US equities. Investors in an index fund generated this market return, less a very modest management fee. We believe many passive investors failed to appreciate downside. If the market heads lower, the passive investor locks in all the market losses. An American Funds analysis stated that only half of all investors were aware that index funds expose them to 100% of the volatility and losses during a market downturn.

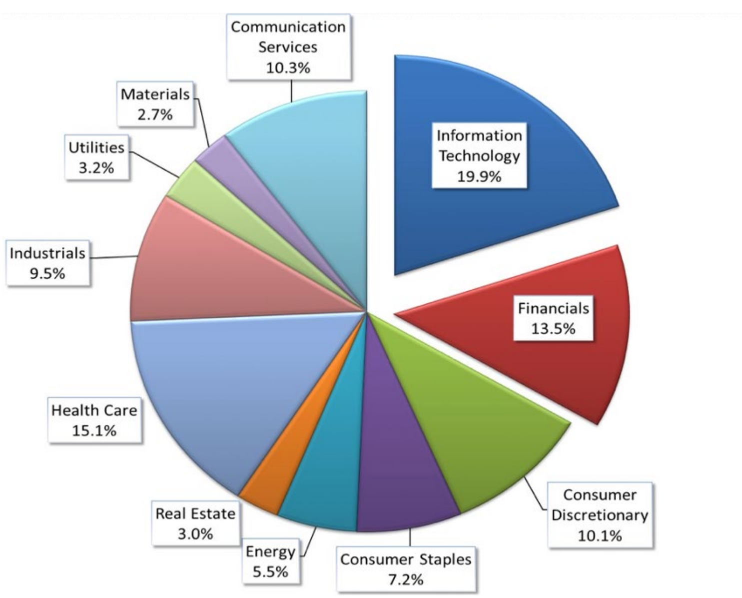
While the upside and downside (relative to the overall market) are essentially known with passive investments, the investor has limited his/her opportunities. Although it might not sound like much, we appreciate the value of being able to "lose less" than an index during market declines. If an investor chooses an active manager, he or she at least has the opportunity to outpace the index. Obviously, one always wishes to maximize returns when they are trending higher, but isn't it also valuable to control the damage on the way down?

Another Concern:

In the event passive dominates the US equity market, one has to question the unintended consequences and/or ramifications. Quite simply, passive managers do not conduct research on their investments. They do not perform any due diligence on the companies they own. There is no analysis of free cash flow statements, balance sheets or income statements. There is no modeling of past or current results and no analysis of future revenue prospects. The current business pipeline and industry dynamics are not studied, nor is any other underlying fundamental condition.

Passive investors receive the overall market return for an extremely low fee. Instead of results that beat the market average, index investors "get what they pay for." In the event one specific sector materially outperforms, that sector increases its weight in the index. As index managers simply follow along, and more money floods into passive funds, it can intensify this concern.

The Overall Market:



In our opinion, the S&P 500 is the US benchmark for equities. S&P Group (ticker SPGI) sets the weights and regularly re-balances this index. It is comprised of 11 various sectors, creating a diversified representation of the overall market.

The three largest segments of the benchmark are Technology at 19.9%, Healthcare at 15.1% and Financials at 13.5%. In addition, a passive investor gets a diversified portfolio with exposure to companies in Consumer Discretionary, Communication Services, Industrials, Consumer Staples, Energy, Utilities, Materials and Real Estate.

Sector Issues:

Just last year, many were worrying that Technology stocks were becoming too big of a component of the overall market. Amazon, Apple, Google and Microsoft were soaring higher. Apple and Amazon both eclipsed $1 trillion in market cap, and the technology sector weight in the S&P 500 was in the high 20's%. The S&P made some alterations to its index, putting Amazon and others into a new sector called Communication Services. This lowered the Technology weight, but it does not change our main point. Passive managers simply follow the committee at the S&P, that has the vast power to determine what companies are added to the index.

What is our biggest problem with certain benchmark weightings? What is our biggest problem with certain benchmark weightings? Choice, or more accurately, the lack of choice. Passive asset managers (and their investors) simply follow benchmark names and weights, whether or not they agree with current valuations or sentiments. Index managers do not choose what they own or have any say in portfolio composition.

To better appreciate this flaw in passive investing, just analyze sector weights back in the late 1990s. During the dotcom era, technology was rapidly changing our world and valuations for certain companies moved dramatically higher. By 1999, technology was the largest segment of the S&P 500, with a weight approaching 40%. When a sector or company is in favor, the index fund must buy even more of it, which may or may not be the wisest decision. Regardless of their opinion of these technology companies, passive managers were forced to keep their technology weight at the index level, to minimize drift.

If you were a passive investor, you essentially were agreeing with a massive overweight towards grossly overvalued technology companies. Unfortunately, within three months of 2000, the technology sector plunged and so too did those passive portfolios. With hindsight as our guide, that was the most opportune time to be getting out of technology stocks and avoiding that overvalued sector. Active managers could have made that decision.

Similarly, the financial sector weight at its peak in 2007 was nearly 25%. Right before the financial crisis occurred, passive managers were piling more money into this sector. Once again, active managers could have decided to bypass the sector and its unsustainably high results, while passive investors never have that choice.

Passive portfolio managers have absolutely no discretion in choosing between stocks and differentiating between winners and losers. These managers simply follow the names and weights set by the index, ensuring they do not veer too far from their assigned benchmark.

Enter ETFs & Smart Beta:

The US ETF market was only $793 billion in 2009 but has now ballooned to over $3.6 trillion in assets under management. According to the Index Industry Association, more than 3.7 million different indexes exist. Not all have index funds tracking them, but the market has clearly embraced passive management and flexibility.

Smart Beta funds have over $800 billion in assets under management and are a way for passive investors to take a slightly different, active approach. By first utilizing low-cost index funds, Smart Beta investors pick from a few different measures, such as sales, dividends, book value, etc. Smart Beta has the same goal of beating the overall market, but it attempts to reach that goal by exploiting certain factors and adding those into the process.

In our April 2017 “Active vs Passive” note, we stated, “*We believe that passive investments are best used when one is looking to replicate or mimic a certain sector or exposure. In addition, passive investments can be wonderful vehicles where the underlying manager has no inherent knowledge advantage. This can be especially helpful in cyclical sectors with unpredictable data points. For example, rather than forecast the price of WTI crude per barrel, one can simply choose to hug the benchmark weight in the energy sector and purchase the XLE.*”

The Case For Active:

Advocates of active management believe that markets are not always perfect at determining the right price for securities (stocks or bonds). Periodic financial bubbles and market corrections suggest that market inefficiencies exist. If you have ever purchased an individual stock, you also believe that the market is not perfectly efficient and market-beating bargains can be found.

Active portfolio managers attempt to identify market inefficiencies to deliver attractive returns for investors. They can hold investments in different proportions than the index, “overweighting” investments they think will do better than the rest and “underweighting” those they think have less appealing prospects. Active managers believe that in-depth analysis of a company, along with its products, industry, competitors and other factors can identify mispriced investments. Also, active managers can choose to hold investments that are not in the benchmark index itself or avoid owning securities in the benchmark altogether.

They also believe that markets tend to overreact or underreact to certain short-term information or sentiment, which means active managers with a longer time horizon can take advantage of temporary price fluctuations. In other words, active managers can attempt to "buy low, sell high."

Not Found in an ETF:

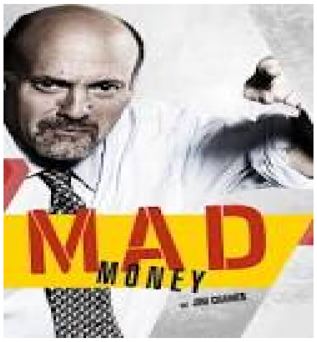
Each of the 11 sectors of the S&P 500 can be individually purchased as ETFs. For a modest fee of roughly 25 basis points (i.e. 0.0025), investors can customize which sectors they wish to gain exposure to. Our issue is not with the market benchmark, nor its composition. Our issue is choice and this passive mentality.

Within the Financial sector, Manole Capital does not own traditional banks and insurance companies. We choose to avoid credit sensitivity and cyclical businesses. Passive investors can purchase the XLF (Financial ETF), and easily get access to these “old school” financials. This isn’t a good benchmark for our Fintech portfolio, as we only own one company in the XLFs Top 10 holidngs.

Within the Technology sector, Manole Capital chooses to bypass one-time sales and hardware companies. If you wanted to purchase the XLK (Technology ETF), you would only see two overlapping positions in the XLKs Top 10 list.

Specialize, not Generalize:

Manole Capital focuses on the two largest sectors: Technology and Financials. These two areas account for roughly 1/3rd of the overall market. We do not believe that a small team (or even a large team) of analysts and portfolio managers can have a market advantage or knowledge that covers the entire spectrum of global equities.



We have a tremendous amount of respect for someone like Jim Cramer of CNBC. He has the remarkable skill of being able to mention one to two bullets on hundreds of companies. He is the definition of a "generalist" portfolio manager, and he would probably admit that he is "a mile wide, but only an inch deep.".

Manole Capital does not focus on Energy, Healthcare, Consumer Discretionary, Staples, Telecom, Materials, Industrials, etc. We have spent over 20 years analyzing companies in the specific Fintech industry.

Our definition of Fintech is "anything utilizing technology to improve an established process." You could argue that this is a broad and wide-ranging definition that leaves open for discussion what is and what isn't Fintech. We totally agree!

Instead of focusing on one particular sector of S&P 500 classification, we identify and invest in companies that possess certain characteristics that we believe lead to outperformance.

Our Secret Sauce:

The core of Manole Capital's investment strategy, philosophy and process makes us special. We find and buy wonderful companies that meet certain desired characteristics. We do not believe market timing can be successfully accomplished. We are long-term investors, not short-term traders.

Our Strategy:

- We are business buyers and investors, not short-term traders
- Our focus is to conduct in-depth research on strong, durable franchises
- We strive to buy great companies at reasonable prices
- We have a core belief that value is driven by time, not timing
- Our process seeks to identify growth businesses with key attributes
- Adhering to these investment strategies leads to positive stock selection

Desired Characteristics:

- High barriers to entry and a "moat" around the franchise
- Market share leaders with durable competitive advantages
- Pricing power and flexibility to withstand market volatility
- Recurring revenues and sustainable business models
- Strong balance sheets with predictable free cash flow
- Excellent management teams properly allocating capital

Timing:

- In the short run, the equity markets are a VOTING machine
- Fickle opinions about prospects determine popularity or lack thereof
- In the long run, the equity markets are a WEIGHING machine
- One needs to assess underlying trends to determine intrinsic worth
- A company's valuation is determined by its long-term performance
- Companies that execute well will see their stock prices trend higher

Conclusion:

At Manole Capital, we focus on the ability to generate predictable growth, regardless of the current environment. Our companies must deliver revenue growth, because tax savings cannot be expected to boost earnings every year. Many companies that benefited from the reduction in taxes in 2018 will fail to grow this year. Without growth, their stock prices will stagnate. In our opinion, real and sustainable growth is more important than ever. From our perspective, active decision-making and company specific decisions are more critical than ever. Passive investors will make no such judgment and assessment.

As index investor is bound by arbitrary rules set by a benchmark committee. If the index owns 2% of XYZ Company, you continue to own 2% of this company, regardless of whether its valuation is highly attractive or grossly overvalued. While some stocks are overvalued on traditional metrics, we prefer to analyze companies differently. Using various metrics, we conduct deep fundamental analysis and look at underlying intrinsic value to properly frame valuations. We continue to find attractive companies that sell at a discount to our calculation of intrinsic value, all while satisfying our rigorous criteria of desirable company characteristics. With many companies failing to generate organic growth, we have built a concentrated portfolio of FinTech holdings that continues to grow sustainably and predictably. We spend our days researching and identifying wonderful secular growth companies, with targeted characteristics.

Manole Capital only focuses on the Fintech industry, an emerging category in which we have two decades of experience. We have no problem swimming against the strong current of passive investing. We only invest in the areas in which we have an edge and expertise. We strongly believe we can beat a "blindfolded monkey," but only time will tell.

We look forward to your comments.

Warren Fisher, CFA
Manole Capital Management

Disclaimer: