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# Passive Equity Strategies Are Still Valid

By Editor Test *Tue, Dec 13, 2011*

*A true passive strategy, history shows, was never meant to be limited to the S&P 500 or to any other single asset class, writes the owner of Strategic Distribution Institute LLC.*

The great debate goes on… and on and on. "Active management wins!" "No—passive management wins!" The market behavior of the past two decades could support either argument. Or perhaps we need to redefine our terms. 3D Asset Management of East Hartford, Conn., for instance, has created a hybrid strategy that poses an interesting twist on the definitions of both passive and active. (More about 3D in a moment.)

Once upon a time, active equity investing meant trading stocks and passive investing meant buying and holding stocks. Starting in the 1990's, when S&P 500 Index funds returned 17% or more a year, active and passive management came to mean trading or holding an entire asset class or index. An investment of $100,000 in the S&P 500 Index on January 1, 1990 would have grown to nearly $500,000 by December 31, 1999. Financial publications touted S&P 500 index funds as the only investment anyone could ever need.

Unfortunately, this type of passive strategy failed during the following decade, producing a 1% annual compounded loss. An investment of $100,000 in the S&P 500 Index on January 1, 2000 would have been worth just $90,000 at the end of the decade. Retirees who were drawing income from that type of account were devastated. By early 2010, passive strategies were being called "old school" methods that were obsolete in the "New Normal."

Did this poor performance invalidate passive equity investing? Not at all. We have been so focused on the rise and fall of the S&P 500 that we have forgotten the true definition of passive investing. A true passive strategy, history shows, was never meant to be limited to the S&P 500 or to any other single asset class.

The roots of today's investing strategies can be traced to Harry Markowitz' work. Prior to his development of Modern Portfolio Theory in the 1950s, successful investment strategies were attributed to the ability to select and hold a handful of the "right" individual stocks. Markowitz' "Theory of Portfolio Choice" showed that diversification could reduce risk without sacrificing yield and that investors could construct optimal portfolios that maximized return for given levels of risk. This work led to a Nobel Prize in economics for Markowitz, William Sharpe and Merton Miller in 1990.

Twenty years later, at the University of Chicago, Eugene Fama and Kenneth French redefined passive investing. In the mid-1970s, Fama's "Market Efficiency" white paper argued that, because equity markets were priced efficiently and because of the drag of active management fees, picking a few companies out of an asset class would offer no better returns than buying the whole asset class.

Fama/ French modeling recommends taking positions in *all* equity asset classes worldwide and weighting them according to each investor's appetite for risk. Instead of holding just a few investments, passive portfolios of this type might hold shares in 8,000 to 10,000 companies. (The two men had the benefit of the Center for Research in Security Prices (CRSP) at the University of Chicago's Graduate School of Business (now the Booth School). Created in 1960, CRSP remains one of the world's largest database of historical investment returns.

Such portfolios could control costs and volatility while outperforming actively managed portfolios with similar risk exposure, Fama and French demonstrated. Sure enough, during the so-called "lost decade" of 2000 to 2009, diversified portfolios that followed their model delivered compound annual returns of 6% to 8% (with 8% coming from all-equity passive portfolios) Of the stock pickers and asset class "rotators" who called passive management a lost cause, few outperformed the Fama/French strategy.

Does that mean that active management is dead? No, it simply needs to be redefined. 3D Asset Management follows the Fama/French mathematical weightings and uses exchange traded funds instead of index funds because they cost even less. But Wayne Connors, the 3D Asset Management principal who sets the firm's allocations, also uses "active overlay"—a hybrid of active and passive strategies that involves actively managing the weights of asset classes in a diversified portfolio.

Based on studies of investment behavior, 3D has observed that the movement of institutional money in and out of equities has short-term (over a period of 18 to 24 months) impact on the returns of certain asset classes and consequently adds to the volatility of a traditional passive portfolio. The firm subsequently demonstrated that yield can be increased and volatility reduced by tracking this behavior and adjusting the "weighting" of the indexes periodically—while remaining fully invested in all of them and adhering to the Fama/French model.

For advisors who design income strategies for retired clients—whether you use a systematic withdrawal plan or a time-segmentation (bucket) strategy—this hybrid strategy is worth considering.  As the originator of the time-segmented Income for Life Model (IFLM) strategy now marketed by Wealth2K, I recommend this hybrid approach to my retired clients for the long-term segments of the model.

The volatility of the last few years has led the public to believe that all investment theory is obsolete and that only two options remain: to manage money very actively or to buy indexed annuities with income riders and shift all market risk to an insurer. Too many advisors have allowed themselves to get swept along by this same wave of emotion, when it's our job to stay on the intellectual side of advice. If Markowitz, Fama and French are right, there is no rationale to "shift" long-term market risk. The lost opportunity-cost is too great.  Even in the worst of times, passive diversified portfolio design serves our clients well.

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