Enhanced practice management: Client risk and the case for active/passive combinations

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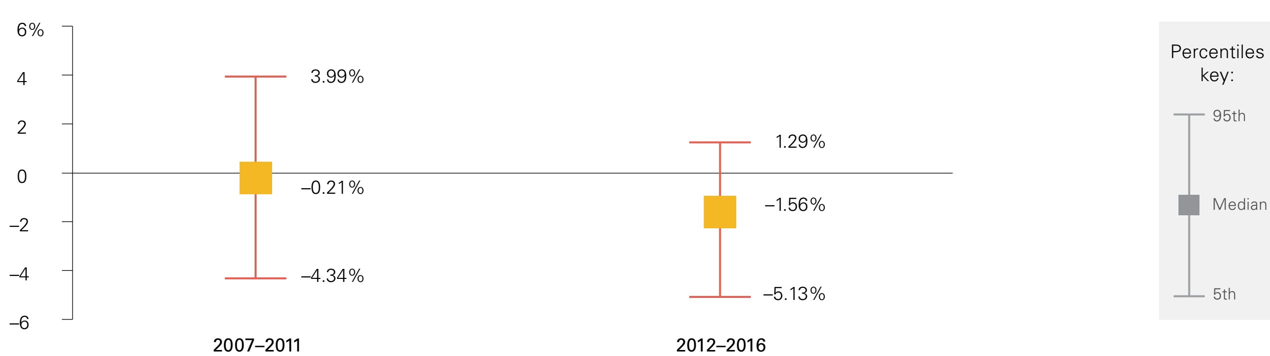
- One implication of the transition toward a fee-based practice model is that "client risk" (for an advisor's practice) may increase if clients decide to pull assets or terminate a relationship because of a mutual fund's underperformance of common market indexes.
- This client risk exists because it is often short- to intermediate-term performance that can make or break an account, even if the client is positioned as a long-term investor.
- Mitigation of such client risk is a frequently overlooked benefit of adding broad-based passively managed investments—that is, index funds or exchange-traded funds (ETFs)—to a portfolio primarily comprising actively managed funds.[1]

For advisors who have elected to use active management, either on their own via security selection or through professionally managed funds, one hurdle is that outperformance is difficult to achieve (Harbron et al., 2017).

Figure 1 demonstrates two challenges of picking actively managed funds. First, in each of the two successive five-year periods that we evaluated, the median fund underperformed its prospectus benchmark. Looked at a different way, in each period more than 50% of the funds failed to deliver on their objective of outperformance. Between 2007 and 2011, the median fund underperformed its prospectus benchmark by 21 basis points (bps) annually—and between 2012 and 2016, the median fund underperformed its prospectus benchmark by more than 155 basis points (bps) annually. Second, the performance spread between the top 5% and bottom 5% of funds was more than 6 percentage points annually. This degree of dispersion can lead to client risk, as we discuss on the next page.

Figure 1. Advisors and their clients face a wide distribution of potential outcomes when using active management



Notes: Chart includes all diversified active U.S. equity funds, covering the periods January 1, 2007, through December 31, 2011, and January 1, 2012, through December 31, 2016. Excess returns are measured relative to a fund's stated costless benchmark. Results for each period reflect only those funds that survived the full five years covered.

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

1 For additional information on combining active and passive, see Wallick et al. (2017).

Complicating this is that over the ten-year period, nearly 58% of all funds that were alive on January 1, 2007, were liquidated or merged at some point before December 31, 2016.

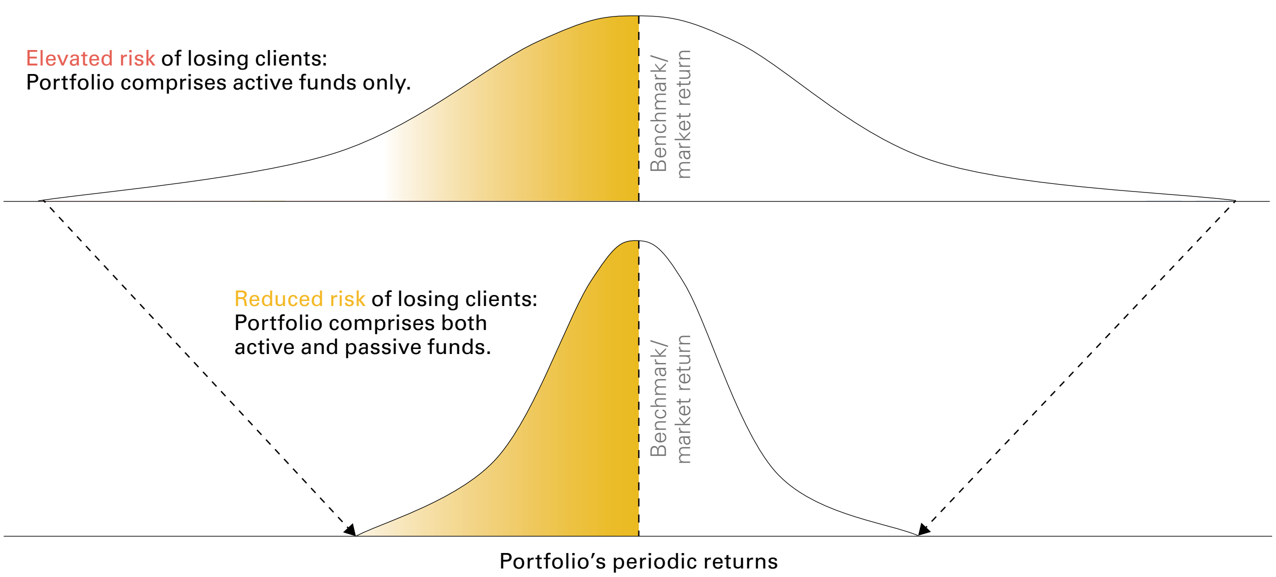
As **Figure 2** shows, the risk to an advisor's practice when using active funds exclusively is that in volatile markets and uncertain times, underperformance can heighten the risk that clients will leave an advisor's practice. We submit that this risk is larger than can be offset by positive client referrals during the good times.

Although the upside of outperformance may be a marginally greater share of wallet or more referrals, underperformance can lead to a client's questioning strategy or withdrawing assets—and to a lack of referrals.

Indexing can help alleviate this asymmetry by truncating the risk of unwise investor behavior and negative feedback loops for the advisor's practice.

Moreover, adding a slice of passively managed funds or ETFs can help free up resources typically spent on manager research and oversight. These resources can then be redirected toward improving relationships with existing clients or attracting new ones.

Figure 2. Adding passive funds to a portfolio can shrink performance distribution around the market, reducing flight risk: A theoretical example



Source: Vanguard.

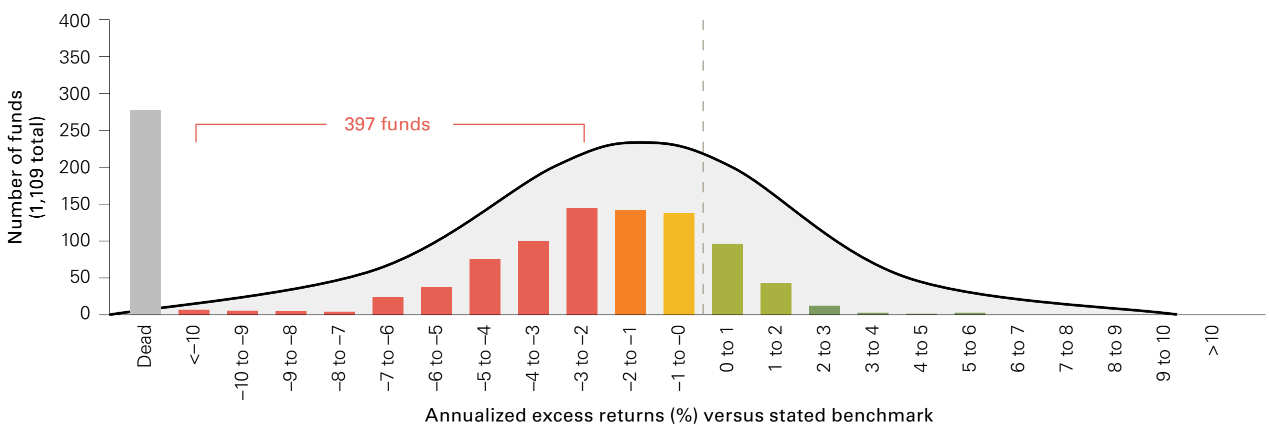
Figure 3 demonstrates the implications of dispersion among fund performance and the cyclical nature of outperformance. For this example, we ranked all funds over the first five-year period shown in Figure 1, then selected the top 20% of funds. We then tracked the performance of those top funds over the second five-year period. Figure 3a shows the results of that tracking. It is interesting that although these funds were the top performers over the first period, their performance did not persist; instead, it formed a distribution similar to the top part of our theoretical example in Figure 2.

Moreover, only 14.0% (155) of the funds that were top performers over five years ended 2011 even managed to outperform over the five years ended 2016, while a sparse 1.5% (17) turned in what we would call "significant" results of more than 2% annual outperformance.

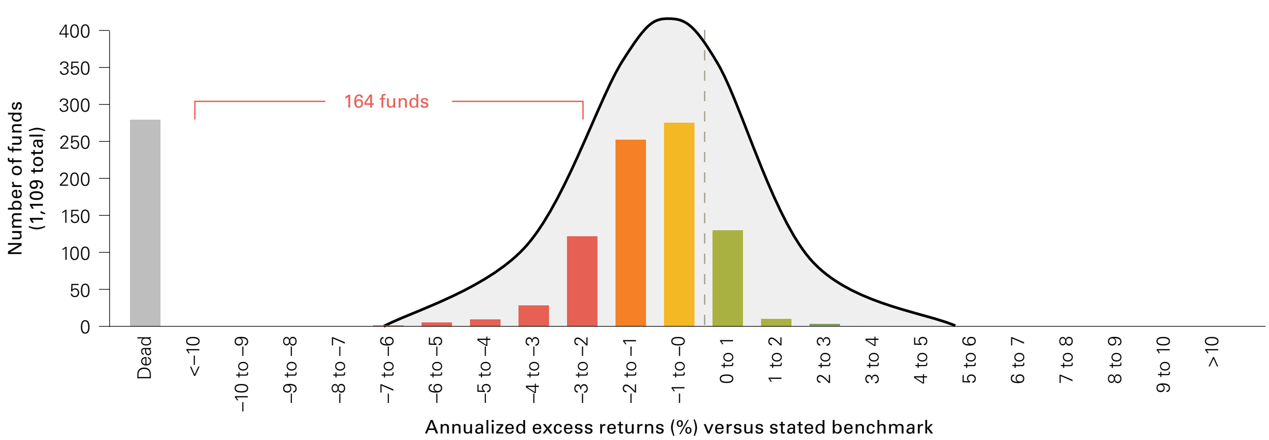
On the other hand, 35.7% (397 funds; see Figure 3a) achieved "significant" underperformance of –2% or more annually, while 278 other funds were liquidated or merged at some point between 2012 and 2016.[2]

Figure 3. From theory to practice

a. Distribution of excess returns over the five years ended 2016 for funds that ranked in the top quintile as of 2011



b. Same as above, but adding a 50% allocation to each fund's style benchmark (10-bp annual haircut to benchmark returns)



Notes: Figure 3a includes all diversified U.S. equity funds that ranked in the top quintile for the five years ended 2011. Figure 3b includes the same funds as Figure 3a, but combines each fund with a passive index matching the fund's investment style in a 50/50 ratio. To reflect implementation expenses, the index returns are reduced by 10 bps annually. Excess returns are measured relative to a fund's stated benchmark. Data reflect excess returns over the period 2012–2016 for the 1,109 funds in the top quintile from 2007 through 2011.

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

2 For more on the performance of funds that were merged or liquidated, see Schlanger and Philips (2013).

The impact on a portfolio of adding a diversified passive index fund or ETF is notable. Figure 3b uses the same funds as Figure 3a but adds a 50% allocation to a benchmark matching the funds' investment style. To reflect implementation expenses, we reduced the benchmark returns by 10 bps annually. In effect, we take the original 1,109 active funds and create 1,109 "new" funds–each half index and half active. Practically speaking, similar results can be achieved by using a broad market index fund to help control relative risk in the aggregate portfolio.

First, as would be expected, the active/passive portfolio produced lower positive excess returns (12.8% of funds, or 142 funds, continued to outperform).

Perhaps more important, though, the active/passive portfolio also reduced relative downside risk. The number of significant underperformers was reduced to 164 funds, or 14.8% of the available funds (versus 397, or 35.8%, for the primarily active portfolio shown in Figure 3a).

Mitigating such significant underperformance can be critical to successful long-term client relationships. The advisor who uses a combination of active and passively managed products may be better able to shift client conversations from the sometimes difficult topic of investment performance to estate and family wealth planning, neither of which are subject to the risks of the market. These services can be a more reliable base upon which to build an enduring practice.

References

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