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Active investment strategies outperform passive ones in the long run: Dalbar

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By Jade Hemeon | March 16, 2017 16:50

Although there's a growing amount of data showing the investment returns of index funds, known as passive investments, exceed those of managed funds, known as active investments, the returns investors actually achieve in these strategies show that investors who adopt an active strategy do better than those who adopt a passive one over the long term.

According to new research from Boston-based Dalbar Inc., covering the 15-year period between Jan. 1, 2001 and Dec. 31, 2016, the average active investor outperformed the passive investor for periods of more than five years. The difference was as a result of investors' behavioural patterns, particularly the timing of their purchases and redemptions.

"While the historical performance statistics of active investments are generally lower than the passive counterparts, the passive investments are more vulnerable to the behavioural influences that are costly to investor returns," the Dalbar report says. "Investment results are more dependent on investor behaviour than fund performance."

Specifically, active investors achieved an average annual return of 4.04%, an advantage of 119 basis points (bps) over the 2.85% return passive investors achieved for the 15-year period ending Dec. 31, 2016, according to the Dalbar study, which used data on mutual fund flows from the Investment Co. Institute to determine when investors bought and sold funds.

Although both active and passive investors achieved a 4.37% return for the 10 years ended Dec. 31, 2016, for the five-year period ended Dec. 31, 2016, active investors earned 8.51%, 39 basis points higher than the 8.12% return passive investors achieved.

For shorter time periods, passive investors did better. Case in point: active investors earned an average return of 3.66% for the three-year period ended Dec. 31, 2016, 174 bps lower than the 5.4% return passive investors showed.

For the one-year ended Dec. 31, 2016, active investors earned 6.73%, or 265 bps lower than the 9.38% return passive investors reaped.

"The shorter time frames [one and three years] reflect the unexpected post-election boom that disproportionately benefited passive investments," the Dalbar report says.

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In contrast, the longer time frames are more reflective of both boom and bust market cycles that typically take place in the market over time, the Dalbar report says. For the 10 individual months when passive investors had the greatest advantage relative to active investors, market returns were positive in eight of those months. During the 10 months when active investors had the biggest advantage, all had negative market returns.

"The evidence shows that passive investments provide greater capital appreciation while active investments offer greater preservation," the report says.

The advantages of actively managed funds include managers' ability to use capital preservation tactics and specific strategies that can be adapted to align with various goals. Temporary market changes are less visible in active funds than index-based strategies that mimic every zig and zag of the market. And investors are less likely to withdraw from a down market if they know the manager has a capital preservation strategy in place, the report reveals.

As passive investments typically track major stock market indices, new reports of passive investments are inescapable, the Dalbar report says. Investors are inundated with the activity of the stock market through television and Internet exposure, as well as through newspapers and magazines.

"The barrage of information eventually will include a nugget or pattern that creates concern for one investor or another," the report says. "With no filter other than to fill a news cycle, there is little context for careful evaluation."

There are indications of imprudent investing in response to excessive exuberance in the news, and untimely cashing out when claims of catastrophes are made, the report says. These activities often result in buying at market highs and selling at low points, particularly on the part of passive investors.

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