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Active Management vs. Index Funds: Just the Facts

By Chris Greco: Partner, Sawgrass Asset Management

Over the past few years as plan sponsors and pension fund boards have seen their annual contribution requirements rise, there has been an increased focus on plan costs and how to lower them. In addition to a quest for lower costs, there has also been increased pressure to find better investment return solutions. These two factors have recently supported a renewed interest in index funds that we have not seen since the late 1990's when the market was led by internet stocks. As always, it is important to make such decisions for the long run. It is crucial for investors to recognize that index funds are an investment choice just like active management and that an index's relative performance can change from good to bad over market cycles.

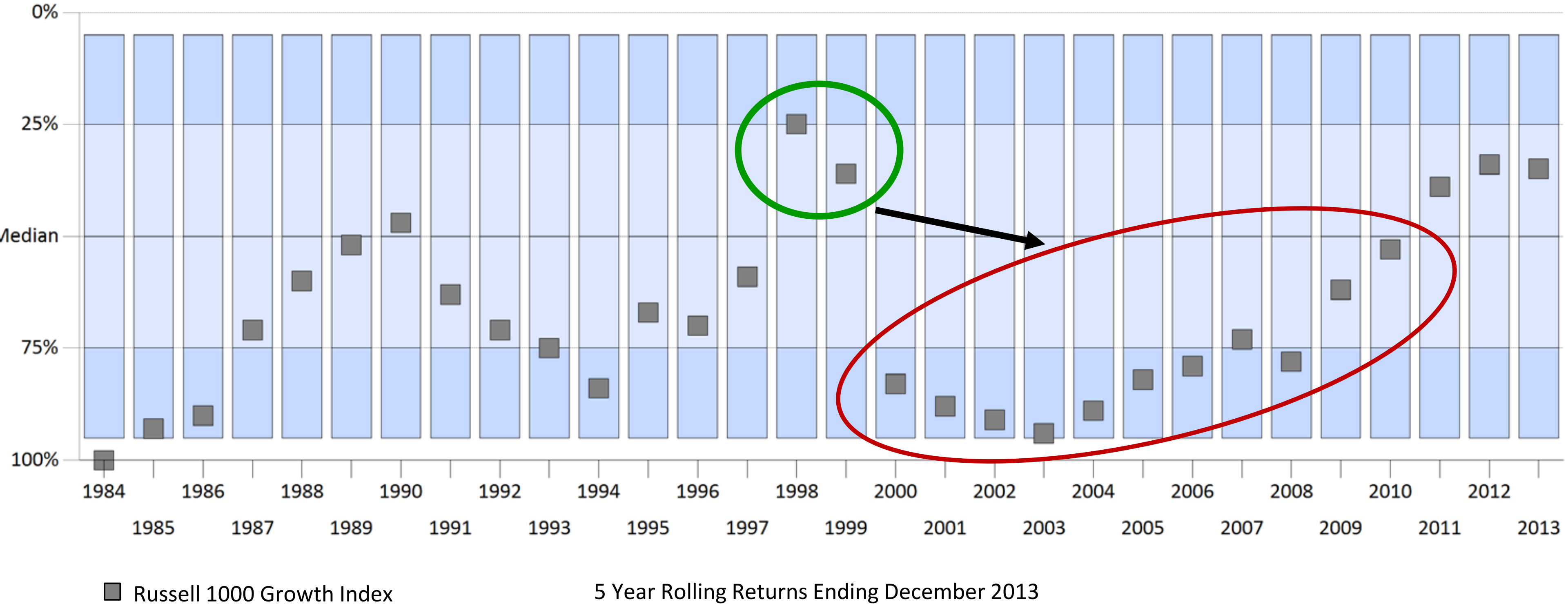
Fact: Using the Large Cap Growth Index as an example, prior to 2011, the last time the trailing 5 year performance of Russell 1000 Growth Index was ranked above median was in 1999 (eVestment US Large Cap Growth Universe). After 1999, the rolling 5 year index returns ranked below median for the following 11 straight years, 8 of which were bottom quartile! These are the type of returns that pension funds cannot afford for the next 11 years. While we sit here today, the trailing 5 year return of the Russell 1000 Growth index ranking is again better than 65% of the Large Cap Growth Universe, however, it is worth recalling a famous Mark Twain quote, "History may not repeat itself, but it does rhyme." The stock market is cyclical, and we are currently in an environment that ***has*** favored the Russell 1000 Growth index over the past 5 years. However, it is important to remember that you can't buy past performance, and any decision that board members make today will be impacted by the ***next*** market cycle that we experience.

There are key differences in how active management and index funds function within the market that must be fully understood. Active investment managers invest in stocks with an eye toward future earnings and growth, while the Russell 1000 Growth index contains the largest stocks and is backward-looking with a momentum flavor. In 2012 Apple grew to become the largest stock held in the index at 8% and experienced a 30% decline but the index was unable to sell any of its shares to mitigate its exposure. This information is explained by the fact that the index only changes its composition one time per year in June, in contrast to an active investment manager who implements purchase and sell strategies throughout the year and can react to current market conditions. The significance of these differences was also highlighted in 2003 when the trailing 5 year Russell 1000 Growth Index was ranked among the bottom 6% of managers due to the index's inability to sell out of the same internet technology names that made it look so good in 1998 and 1999.

Looking ahead, active managers have a more favorable investing environment as compared to index funds because equity multiples have returned closer to long term averages, volatility has declined, and as stock correlations decrease active managers can apply their stock picking skills based upon company specific information. Evaluating investment performance is not easy, and as we have seen over the years, there are notable differences between past and future results for any investment option. While the index may have provided strong relative performance over the past 5 years, history has shown that the index is not always guaranteed to perform well over the subsequent market cycles. Going forward can you afford the index providing below median returns for an extended period of time, as it did over a majority of the past decade?

Large Cap Growth Index Performance Ranking Over Time –

Below Median Returns 80% of the Time!



The last time the Index ranked this strongly, it was followed by 11 consecutive years of below median 5 year returns.

Source/Universe: eVestment, US Large Cap Growth Equity