BNY Mellon Investor Solutions
Active or Passive Investing: Why Not Both?

The decades-long debate between active and passive investing strategies has strong support on both sides. But does it have to be an either/or situation?

We believe asset owners should identify the best opportunities across both active and passive investment options. However, when considering factors like fees, risk and time in the market, some asset classes may warrant an active approach.

The difficulty lies in knowing what parts of equity and fixed income markets justify an active approach versus a passive one. BNY Mellon Investor Solutions has developed an approach to help guide decision-making around this topic, called Fee Productivity. It's a framework asset owners can use to evaluate the effectiveness of active investment strategies, after fees, risk and available passive options are taken into account.

How Fee Productivity Works

Our Fee Productivity methodology has five key components:

1. Investment Database

We examine the performance data of separate accounts, collective funds, ETFs and institutional mutual funds reported in Nasdaq's eVestment database. An important distinction of our approach is that we include both active and inactive investment strategies in our analysis, because simply evaluating currently active investment approaches could skew results: Managers with unattractive performance, for instance, may stop contributing their results to the database.

2. Fees

We evaluate active investment performance on a net-of-fees rather than the typical gross-of-fees basis, because investors cannot take home gross-of-fees results. Net-of-fees returns provide a much better indication of true investment performance of an active investment strategy, in our view. For example, if the median manager in any given asset class outperformed the benchmark by 75 basis points (bps) on a gross-of-fees basis over a given time period, and the median fee for active management in that asset class was 100 bps, then the net-of-fees result is 25 bps underperformance versus the benchmark.

3. Benchmarks

Much research on the merits of active investing focuses on manager performance in relation to a general benchmark for the asset class in question. This presents several problems. First, applying a general benchmark to all strategies within an asset class ignores the potential sub-styles of strategies within that asset class. This includes the delineation of core, growth, and value styles on the equity spectrum – or even more granular sub-styles, such as low volatility, environmental, social and governance (ESG) integration, and so forth.

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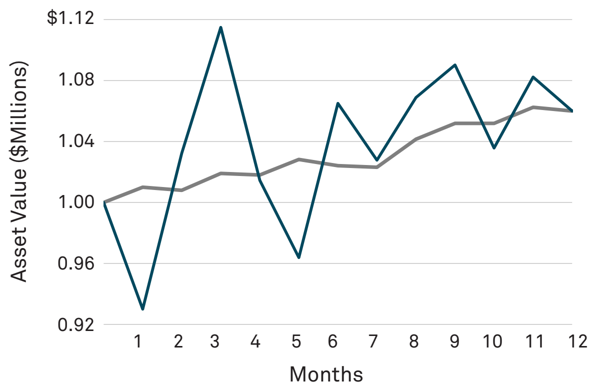
Also, a benchmark is often not investable. For U.S. equities, the ability to closely represent the benchmark in question is present, but as you move to fixed income and other less liquid asset classes, benchmarks often don't represent an appropriate comparison. For our analysis, we compare the universe of active strategies for each given asset class against the suite of available passive options. This includes passive mutual funds, ETFs, collective funds and separate accounts. By doing so, we can account for the fees as well as varying degrees of performance which passive options may present in each individual asset class.

4. Risk

Most research on this topic reviews the relative returns of active management. But returns are only half of the equation. Prudent investors should consider the level of risk taken to achieve these returns. Consider the following example, which illustrates how two investments may produce the same return over a given time, but with meaningful differences in risk profile. The investment with substantially higher levels of risk would likely be deemed the less attractive option by most investors.

Exhibit 1: The Importance of Accounting for Risk



Note: For illustrative purposes only. The two sample investments are hypothetical and not representative of any actual investments available in the marketplace. Hypothetical monthly return streams were created with varying volatility levels and final return values equated to provide the hypothetical example.

Defining risk is another highly debated and analyzed topic. Arguably the most popular risk-adjusted return measure is the Sharpe ratio. But like any metric, there are several well-documented drawbacks with this approach. For example, the traditional Sharpe ratio doesn't account for returns that are non-normally distributed, nor does it properly rank investment options when returns are negative for a period of time.

Our Fee Productivity analysis incorporates a modified Sharpe ratio to compensate for these drawbacks.[1]

$$\text{Modified Sharpe Ratio} = \frac{\left(\text{Investment Return} - \text{Risk Free Rate of Return}\right)}{\text{Standard Deviation}\left(\frac{\text{ER}}{\text{abs ER}}\right)}$$

5. Time Period

We evaluated investment fund performance results using rolling three-year periods over the past 20 years of available data. For certain asset classes, such as U.S. Large Cap Equity, a variety of both active and passive investment options were available over the entire time period. However, other asset classes provided a more limited scope of analysis due to a lack of active and/or passive investment options representing the space.

[1]This modified Sharpe Ratio was introduced by Craig L. Israelsen in Journal of Asset Management (2005) and correctly ranks investment options even when investment returns are negative.

Fee Productivity Analysis

Here's a summary of the fee productivity research for several major asset classes. Our analysis is also available for dozens of additional asset and sub-asset classes.

Exhibit 2: Annual Fee Productivity Analysis through December 31, 2020

Asset Class	# Products	Avg % > Passive
Equity		
U.S. Large Cap Core Equity	907	43%
U.S. Mid Cap Core Equity	205	46%
U.S. Small Cap Core Equity	412	49%
ACWI ex-US Large Cap Equity	201	55%
ACWI ex-US Small Cap Equity	74	73%
Global Emerging Mkts Large Cap Equity	147	68%
Global REIT	108	84%
Fixed Income		
U.S. Core Plus Fixed Income	241	76%
U.S. High Yield Fixed Income	395	97%
U.S. TIPS / Inflation Fixed Income	88	60%
Global Emerging Mkts Fixed Income - Local Currency	92	73%
Other		
Infrastructure	62	70%
U.S. Private Real Estate	Passive/index benchmarks are not available	
U.S. Private Equity		
Hedge Funds		

Interpreting the Data

 # Products includes all products in the database (both active and inactive) for the given asset class with at least a three-year return history.

Avg % > Passive reflects the percentage of active strategies over the past 20 years that have outperformed the median passive investment for the given asset class, after fees and risk are considered.

Sources: BNY Mellon and eVestment. Three Year Rolling Net of Fee Returns, Trailing 20 Years as of December 31, 2020

Past performance is not a guide to future performance.

Note: Number of managers includes both active and inactive products. Product Sharpe Ratios were calculated using net of fee returns. Fees are calculated as average fee available across all fee tiers for each product. In the instance where a product does not disclose a standard fee schedule, the universe median fee was used. The Citigroup 3-Month T-Bill was used as the risk-free rate for Sharpe Ratio calculations.

The Value of Fee Productivity

Our research has helped provide a framework for objectively evaluating the most attractive areas to apply active or passive investment management. It's especially useful as a guide for organizations with an active risk budget that they can employ when developing investment portfolios, because it can target where they should spend resources. Asset classes with the highest likelihood of success can often yield positive results from active management, even if a sub-par investment manager is chosen.

Looking to utilize an asset class that has shown less attractive results in the past? The effectiveness of active management in this space may now rest with the ability to identify a consistent top-tier manager, with less opportunity for error.

The Value of Manager Research

In our view, strategy and category-level active manager performance is cyclical and end-point specific; manager research and selection is invaluable in helping to identify top-performing managers. Every quarter, the Manager Research team at BNY Mellon Investor Solutions analyzes data on approximately 15,000 mutual funds from across the major asset classes and regions to understand factors influencing the performance of active management. This research offers insights on areas of opportunities for active management and how to position investment manager strategies in a well-diversified portfolio.

Regardless of the asset class, we believe manager selection across active and passive investments is best accomplished through a regimented and proven manager research framework. We strive to provide an institutional-quality manager research function, executed by a large team of seasoned manager research professionals who cover all asset classes. Our manager research process identifies managers who can consistently provide the intended exposure and results, as well as those who may have the best opportunity to provide excess returns after fees.

We welcome the opportunity to discuss how the Fee Productivity framework and manager selection framework can fit into your organization's investment decision-making process.

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