Madison
EXCELLENCE IN INVESTMENT MANAGEMENT

THE ADVANTAGES OF ACTIVE MANAGEMENT

While the discussion may start with performance, it should end with meeting your investment needs.

The debate over active versus passive (or indexed) market strategies is not only unending, it tends to invoke passionate responses. This can lead to the impression that passive and active investing are somehow at odds. The fact is, understanding the advantages and disadvantages of all investment choices is the best way to achieve a balanced, sensible and investor-appropriate asset allocation. At Madison, we practice a disciplined active management strategy which we believe can add value over time. We believe it is particularly appropriate for investors who want to participate in up markets, but prefer a manager who has a history of showing relative strength in down markets.

Advantage 1: Risk Management and Maintenance of Asset Allocation

The long-term returns of any investment strategy are contingent on one important factor: the investor remain invested in the strategy for the period in which performance is being assessed. Whether the approach is indexed or active, real returns will vary tremendously if investors trade in and out of the market or switch managers in response to short-term market trends. We've seen this happen over and over during our investment lives, and the results can be punishing. The most pronounced example was the flood of investment dollars during the tech boom that left conservative, actively managed equity strategies and went into aggressive growth strategies – including passive ones linked to the NASDAQ Index. In the year 2000 aggressive investors took tremendous hits during the tech bust, even as many managers focused on fundamentals produced solid positive returns. In a more recent example, during the financial crisis in 2008 and early 2009 many stock investors lost heart, sold stocks and stock funds near the bottom, and missed out on the rapid recovery that followed.

An active manager with a history of mitigating losses in downturns may promote investment discipline and the maintenance of an appropriate asset allocation. The ability to keep investors on course may turn out to be a much more important factor in their real returns than whether a given manager or investment vehicle was a percent above or below an index over a particular period.

Advantage 2: The Opportunity for Outperformance

Investors in indexed stock funds and ETFs expect results to be close to the index their manager mirrors minus expenses. One of the arguments for indexing is that the stock market is a no sum game – for every buyer there is a seller. As a result the aggregate return of all investors will equal the market's return, minus trading and operational expenses. While some managers may have the skill to outperform their unmanaged benchmarks, the argument goes, it is difficult to identify these managers who do so consistently, so why not simply go for the lowest expense option?

One of the first things to consider is whether the benchmarks or indices are worthy of emulation. Passive strategies that mimic popular indices have to, by their very nature, take on whatever shortcomings the index contains. As we saw in the tech boom, market cap-weighted indices which give the largest, most highly valued companies the biggest impact (such as the S&P 500) can become very much "followers of the herd," when they hold large allocations in popular, but overpriced and speculative securities. Indices also have an active management component, as companies are added and subtracted, often at times that are not ideal, as when a company is held until bankruptcy.

At Madison, our core stock investment strategy is to find companies with outstanding business models, management and fundamentals and purchase these when the valuation is attractive. We believe this is the key to solid, long-term risk-moderated performance. On the bond side, it is our experience that investors expect this part of their asset allocation to provide stability and help with capital preservation. Our active bond management allows us the flexibility to shorten bond maturities when interest rates appear likely to rise. Since bonds typically lose value in rising rate environments, and longer bonds are more susceptible to this effect, shortening portfolio maturities has the potential to mitigate losses. We believe these stock and bond strategies give us the best opportunity to provide superior risk-moderated returns.

Advantage 3: Finding the Best Match

While investors may be pleased to see their equity portfolios rise in tandem with the market, they may be less pleased to capture all of the market's downsides, as we saw in 2008. This aversion to loss is one of the tenets of the science of behavioral economics. Selecting active managers is a way for investors to find a match with their risk profile, since historical results suggest the philosophy and discipline of a manager can be linked to the overall volatility and risk of a mutual fund.

Advantage 4: The Special Issues with Passive Fixed Income Strategies

While you can't invest directly in an index, an investor whose main objective is to match an index's performance will be drawn to a passive strategy linked to the index of choice. This works remarkably well in the world of stocks. Managers of passive stock products have shown the ability to consistently produce results close to the index of choice. It's our observation this is much less true in the bond world, where passive strategies have shown considerable variance from their index. This could be a major disappointment to investors whose expectations may not be matched by their passive bond fund or bond ETF.

Conclusion

In short, we are firm believers in the opportunity for outperformance and believe active oversight of stock portfolios is an essential tool in engineering appropriate risk management. In bond portfolios we believe most investors favor risk moderation. Although we prefer active management, we would never argue that indexing is universally inappropriate. The pairing of passive and active stock strategies strikes us a sensible approach for many investors. We are less impressed with the results of passive investing in bonds, where dispersion from the index is a serious hindrance to achieving desired results.

The returns of all indices and Morningstar categories are used for illustrative purposes only and do not reflect the performance of any Madison portfolio or product.