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Actively Managed or Index Funds? Why Not Both?

Five Smart Strategies for Pairing the Two Approaches

By
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Some investors swear by actively managed mutual funds. Others are just as single-minded about only owning funds that simply follow an index.

- ## Index Funds, Active Funds or Both?

But does it have to be an either/or decision?

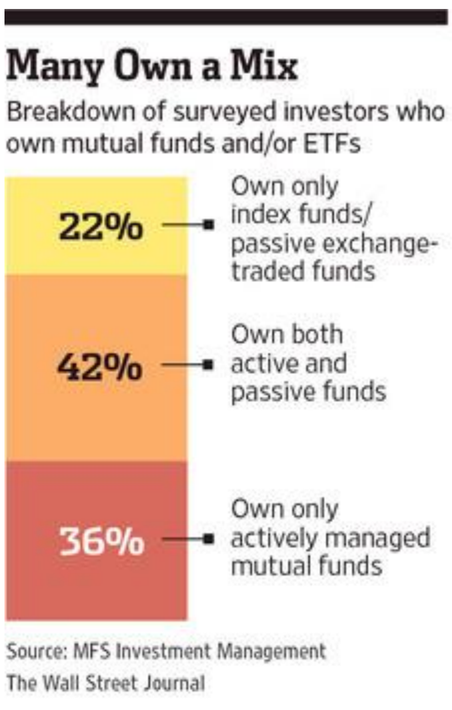
No. In fact, there are a lot of people who own both active and passive funds. Sometimes, the reasons can be smart financially; other times, they are to satisfy an emotional need. Whatever the impetus, here are five strategies that combine the two types of funds to achieve specific purposes:

1. Use indexes for efficient markets, active funds for others

Advocates of indexing argue that it's impossible for active managers to beat broad market returns over long periods. But some investors believe a skilled manager is more likely to do that in certain less-efficient market areas—those that don't trade as actively and are slower to react to new information.

Over the past 15 years, sectors where active managers have tended to beat indexes the most are those such as international stocks and stocks of small U.S. companies, an analysis by Robert W. Baird & Co., Milwaukee, found.

Aaron Reynolds, associate director of asset-manager research at Baird, notes, though, that markets can evolve over time. For example, emerging-markets stocks and high-yield U.S. bonds, which used to be less-efficient areas and thus better suited to active management, have grown more efficient in the past five years as global markets have become more interconnected and more investors have flocked to those sectors, he says.



Marc Vorchheimer, a planner in Spring Valley, N.Y., may use a passive fund that tracks the S&P 500 index for exposure to the broad stock market. But for small-cap stocks, he sometimes uses Janus Triton, which recently held about 100 securities and ranks in the top 30% of Morningstar Inc.'s small-growth group for five years. In small-cap, especially, "a talented manager can often find attractively priced securities," he says.

2. Keep a door open for beating the market

Index mutual funds and exchange-traded funds offer a low-cost, tax-efficient way of matching broad market returns—which a large percentage of active managers can't seem to do.

Still, there's an emotional element: Many investors continue to believe they can beat the market or select funds that will, says Meir Statman, finance professor at the Leavey School of Business at Santa Clara University. And they aren't willing to lock in average returns, even though average can be huge in a boom. Many think illogically that "if you only own index funds, you may do well, but you are never going to hit it really big," he says.

Holding a mix of index and active funds is a way to get the advantages of index funds along with the satisfaction and potentially the financial upside of active management. Sunit Bhalla, a financial planner in Fort Collins, Colo., pairs a broad index fund such as Vanguard Total Stock Market Index with narrowly focused active funds, such as Longleaf Partners, which recently held just 17 stocks. Longleaf Partners doesn't always beat the S&P 500, but it has done so often enough to generate an annualized 2.9 percentage points of excess return over the 15 years through January, according to Morningstar. On a $100,000 initial investment, that would have meant an extra $94,000, before taxes, compared with investing in an S&P 500 index fund.

Mr. Bhalla says he is very selective about which active managers he uses. First and foremost, he says, such funds have to have reasonable expenses and value-focused strategies—including the flexibility to keep a higher cash balance when there aren't any stocks worth buying from a value standpoint.

3. Add an active manager to fine-tune the volatility of your portfolio

If this year's dramatic market swings make you queasy, you might add a defensively minded active fund to your index holdings to dial back overall volatility. That likely will mean settling for less upside in rallies, but losing less during corrections—an approach some financial professionals think can yield better long-term results.

Among U.S.-stock funds, either First Eagle U.S. Value or Weitz Partners Value could be a good choice in such a strategy, says Kevin McDevitt, senior fund analyst at fund tracker Morningstar. "Their managers look at valuation in absolute terms [rather than just looking for stocks that are cheaper than others], and if they can't find things at attractive prices, they will let their cash balances grow," Mr. McDevitt says. "That creates a bit of a risk buffer."

Over 10 years, First Eagle's returns have topped the S&P 500 by about one percentage point a year on average, while the Weitz fund has beaten that index by an annual average of more than three percentage points over 15 years.

Conversely, adding index funds might tamp down volatility for some investors heavy in stock-picking funds. That's because some active funds that are long-term winners have big ups and downs along the way. A 2012 Vanguard Group analysis found that a portfolio equally split between 20 top active and four index funds produced smaller excess returns, but more moderate losses during corrections, compared with a portfolio of only those top active funds.

4. Use a mix of funds to hedge against market crosscurrents

Passive and active funds tend to perform better in different environments, says Michael Ricca, a managing director at Morgan Stanley Wealth Management. Broad equity index funds performed well in the momentum-driven rebound in 2009. But when momentum ebbs, Mr. Ricca says, it can be better to own an active manager who can scout for attractively valued securities or shift to sectors that might hold up better in a correction.

To hedge against swings in sentiment, Exencial Wealth Advisors likes to own a mix of passive and active funds, says Tim Courtney, chief investment officer in the firm's Oklahoma City office. Along with a broad stock index fund, it holds an actively managed institutional value fund from Dimensional Fund Advisors along with Fidelity Contrafund, a strong performer in Morningstar's large-growth category.

5. Use an active-passive blend to bring down overall expenses

Many active funds charge 1% or much more in annual expenses, while index funds may charge as little as 0.05%. Even if you generally favor active funds, you might use a blend to lower your overall portfolio expense ratio to perhaps around 0.5%, says Mr. Courtney of Exencial.

In holding a mix of active and passive funds, you need to pay close attention to the expense ratios charged by active funds that focus on small-cap U.S. or foreign stocks, cautions Michael Iachini, managing director for ETF research at the Charles Schwab Investment Advisory unit of Charles Schwab Corp.

He notes that such funds sometimes charge 1.5% or more a year for management and administrative expenses, which can pull your overall portfolio expenses up significantly.

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