Chilton Trust

The Great Debate: Active vs. Passive Investing

How does one measure the true impact active managers have on portfolios?

Throughout the last decade, an unavoidable topic of discussion has been the flow of assets out of actively managed funds into passively managed ones. As a result, there have been countless discussions, articles, and opinions weighing the benefits of either active or passive investing over the other. Either party will have hoards of analysis to support their approach, which makes asking an active manager to weigh in on the conversation somewhat like asking Santa Claus to choose a favorite holiday. While we at Chilton Trust, are active managers ourselves, we do not believe the battle for assets has to be a zero-sum game. The solution for robust and holistic investment management can include passive strategies while being rooted in a strong active management approach.

What is Passive Investing?

Passive investing refers to the attempt to match the performance of a particular benchmark by replicating the underlying investments in the benchmark using pre-set rules that control the investments. Passive funds can follow broad indices, like the S&P 500 or a global index, or be much more targeted and niche-focused, like an energy or cannabis ETF, for example. Passive funds typically own the same or similar securities of a particular index with little or no qualitative or quantitative analysis of the underlying holdings. As a result, investors in passive funds own securities regardless of quality, profitability or risk profile, a dynamic that could prove problematic in more challenging markets.

What is Active Investing?

Active investing, on the other hand, is the endeavor to outperform one's relative benchmark by selecting securities/investments that result in superior investment returns over time — also known as alpha. Active managers employ rigorous quantitative and qualitative analysis to come to investment decisions, and often are poised to take advantage of market inefficiencies or periods of volatility. Security selection can differ meaningfully from a benchmark, as can the sizing of positions. Importantly, active managers seek to produce risk-adjusted returns and can be proactive in advance of looming risk, avoid underperforming or riskier sectors and securities, and select specific positions or exposures.

We find that taking an "either-or" approach fundamentally misses the bigger picture. Furthermore, amidst the proliferate opinions on this topic many have ignored the nuance that it is not just about choosing active over passive investing

but choosing the right active manager over a passive management fund. In this paper, we will discuss the definitive methods and skill set a strong active manager uses to add value to a portfolio that passive investment simply cannot achieve.

The Great Debate: Active or Passive?

Within this debate, the crown jewel of the argument for passive investment has been the strategy's low-fee structure. Since passive investing is controlled automatically and uses a rules-based approach rather than a fund manager and a team of analysts; therefore, costs and management fees are generally lower. However, low cost does not mean low risk. By definition, passive investing vehicles are only designed to keep pace with the market and are not able to outperform or provide alpha. During bull markets, investors are typically all too happy to keep pace with the markets, at low cost, but what happens when volatility comes into play? Keeping pace with the market ultimately means that passive investing will capture 100% of the downside, leaving investors exposed in more turbulent market conditions. By contrast, active investors know the companies they're invested in and hold long-term conviction in their individual security selections. Fees collected by an active manager enable them to devote intense research and due diligence to the companies they're invested in and supports strategic portfolio positioning within the ever-changing investment landscape. While we do not doubt the effectiveness of a passive management strategy, for some clients, we do not feel it should replace active management in totality. When choppy conditions prevail, management teams are required to be wise allocators of capital in order to achieve continued growth and price appreciation. At the same time, an investment team will need to demonstrate an astute ability to identity the winners and take advantage of pockets of volatility. These strategic decisions can greatly impact performance during difficult market periods but are not achievable in a passive fund, where you simply own the market versus having fractional ownership (shares) of a company.

At Chilton, we find that many clients find value in investing through Separately Managed Accounts, or SMAs, allowing for greater flexibility, transparency, and control as portfolio positioning can be specifically tailored to its owner. Particularly, amid shifting volatility, this is attractive to investors who want to adjust their risk profile, tailor positioning, and take advantage of various tax management strategies, such as off-setting capital gains with tax-loss harvesting. SMAs offer advantages that aren't found in index funds or ETFs. The customization, especially at a boutique firm not beholden to specific asset allocation models, allows for a reduction of exposure to certain stocks or sectors while giving the investor the power to choose from an array of strategies and diversifications that suit his/her needs. In a down year, a manager can implement techniques like tax-loss harvesting to ensure that the investor's after-tax performance is more favorable than if they simply "owned the market". Similarly, we strongly believe that having a relationship with the manager of these separately managed accounts, allows for increased fortitude when the market is suffering losses. Particularly, in times of volatility, fear can set in for inexperienced investors, which in turn can lead to poor decision-making. To invest for the long-term, an investor must enter the market with certain expectations; the market will not be up every year, a manager will not outperform every year, and invested capital will not always garner positive returns. Of course, these are not palatable outcomes but a trusted manager and team can help ease concerns when the fears of unfavorable day-to-day trading headlines creep in.

When solely invested in a passive strategy, such as an ETF or mutual fund, one can feel at the mercy of market whiplash and view the only solution as selling because they own "too much of the market". Inopportune selling, such as this, can cost the investor dearly in unforced errors and missed opportunities. Strong active fund management can help manage risk, provide a solid source of alpha and enhance overall portfolios.

At Chilton, we don't attempt to be market timers. We believe selling at the wrong time prevents one from being invested on the market's best days, which can have a costly effect on portfolios. Instead of a knee-jerk decision, we use challenging market conditions to dig deeper into our research, re-new our convictions and identify undervalued opportunities.

In support of our thesis, active management has seen an increase in sophisticated capital recently, with the November 2022 Global Asset Owner Survey reporting 20% of investors expecting to 'shift towards active' in the next 18 months. The shift occurs as 2022 was the seventh worst year for the S&P 500 on record since 1929, according to FactSet data. Further supporting the notion that well-versed investors recognize the challenge of a volatile market and believe these conditions require the skills and specificity of an active manager. The value of an active manager lies in knowing which companies they own, analyzing and evaluating their business models and, exuding the proper temperament to keep clients on course – even when markets come under pressure. At Chilton, we are able to capitalize on opportunities that arise during market downdrafts by investing in companies that demonstrate "quality value."

Pockets of volatility can create huge opportunities to upgrade portfolios with higher quality names at attractive entry points. These are names that may be trading below their historic P/E Multiple or are significantly undervalued on the street but nonetheless demonstrate high-quality business models, free cash flow generation, or other characteristics that significantly de-risk the stock. . It is only through the devotion of time, analysis, and research of an active manager that these pockets of opportunity can be identified, and it can play a critical role in a portfolio's long-term positioning and ability to create meaningful long-term alpha. Passive investing forfeits an investor's right to make the kind of strategic investment decisions that can have a tremendous impact on performance. While active managers may not beat the benchmark every month, every quarter or even every year, the potential for upside is greater when one can apply skill and experience to create and manage for strategic outperformance.

Choosing whether to invest with an active manager or passive fund (or ETF) is a decision that must be made by each investor for his/her specific needs. At Chilton Trust, we take great pride in our research and diligence processes that are at the root of the creation of high caliber, actively managed investment portfolios, each tailored to and reflective of a client's needs and goals, striving to preserve and grow capital over the long-term. This approach truly demonstrates the intrinsic value of active management, which we believe cannot be fully captured when investing solely in passive strategies.

CHILTON TRUST

For further insight on transfer planning and strategy, contact one of our experienced wealth advisors or explore our content library here.

Chilton Trust

300 Park Avenue, 19th Floor
New York, New York 10022
(212) 843-6882

Chilton Trust Company, a private, independent Trust Company, advises and provides wealth management services including fiduciary service and investment solutions to high-net-worth individuals, families and foundations.

NOTE: This document was prepared by Chilton Trust. Any use of "Chilton Trust" herein refers to Chilton Trust Company, NA and its affiliates, including but not limited to Chilton Investment Services, LLC, and their owners, employees, and agents. Fiduciary services are provided to clients by Chilton Trust Company, NA. Investment advisory and portfolio management services are provided to clients, by delegation, by Chilton Investment Services, LLC and other affiliates. This material is or general informational purposes and does not take into account the particular investment objective, financial situation, or individual need for the recipient. Any information provided herein is based on third party sources which Chilton Trust believed to be reliable. Chilton Trust makes no representations as to the accuracy or completeness thereof. Views expressed herein are based on information as of the date indicated and are subject to change without notice. The mention or focus of a particular security, sector or asset class is not intended to represent a specific recommendation and all comments provided are subject to change at any time.