Investing Lessons from Baseball's Active Managers

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As the popularity of passive investing continues to gain momentum, take pause to think about a lesson from baseball. The question is: what kind of equity lineup creates a winning team?

Nobody can deny the increasing shift of equity investors toward index strategies. Net flows to passive US equity funds have reached $21.7 billion this year through June, while investors have pulled $83.7 billion out of actively managed portfolios, according to Morningstar. In this environment, active managers are increasingly challenged to prove their worth and justify their fees.

Building a Winning Lineup

Baseball provides an interesting analogy for the active equity manager. Across all players in Major League Baseball,the batting average this season is .253, as of August 6. Yet even in today's statistics-driven environment, you won't find a single team manager who would choose to put together a lineup of nine players who all bat .253—even if it were possible.

The reason is clear and intuitive. For a baseball team to be successful, you need to have at least a few hitters who are likely to get hits more often than their peers. And to create a really robust lineup, a manager wants a couple of power hitters who pose a more potent threat. Of course, some hitters will trend toward the average and slumping players will hit well below the pack. That's why you need a diverse bunch. A team comprised solely of .253 hitters is unlikely to have the energy or the momentum needed to win those crucial games and make the playoffs.

False Security in Average Performance

So what does this have to do with investing? When an investor allocates funds exclusively to passive portfolios, it's like putting together an equity lineup that is uniformly composed of .253 hitters. This lineup might provide a sense of security because returns will always be in synch with the benchmark.

But it's little consolation if the benchmark slumps. A passive equity lineup won't be able to rely on any higher-octane performers to pull it through challenging periods of lower, or negative, returns.

Still, many investors fear getting stuck with a lineup of .200 hitting active managers. We believe the best strategy to combat that risk is to focus on investing with high conviction managers, who have a strong track record of beating the market, according to our research.

Passive and Active: The Best of Both Worlds

Passive investing has its merits. Investors have legitimate concerns about fees as well as the ability of active managers to deliver consistent outperformance. The appeal of passive is understandable.

Yet we believe that putting an entire equity allocation in passive vehicles is flawed. It leaves investors exposed to potential concentration risks and bubbles that often infect the broader equity market. And with equity returns likely to be subdued in the coming years, beating the benchmark by even a percentage point or two will be increasingly important for investors seeking to benefit from compounding returns and meet their long-term goals.

There is another way. By combining passive strategies with high-conviction equity portfolios, investors can enjoy the benefits of an index along with the diversity of performance from an active approach, in our view. Baseball managers don't settle for average performance. Why should you?

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