

## About the Firm

Lancaster Pollard Investment Advisory Group, an SEC-registered investment advisor, helps nonprofit organizations create the financial means to last the life of their missions by managing *total* financial risk rather than just investment-associated risk. Lancaster Pollard Investment Advisory Group shares common ownership with Lancaster Pollard, a leading provider of investment banking and mortgage banking services for the senior living, health care, affordable housing and private education sectors.

## Comparing Active vs. Passive Management

Manager selection is an important part of constructing an institutional investment portfolio; however, before deciding on a specific investment manager, institutional investors must first decide whether to use active management or passive management. Given the proliferation of index strategies over the last 35 years, institutional investors have a number of passive investment strategies that are less costly than active management and cover nearly every market or asset class imaginable. Ideally, institutional investors should focus on using active management in those asset classes where active managers have consistently outperformed the index, while using passive management to gain cost effective exposure to asset classes in which active management has proved to be ineffective.

### Research Parameters

To identify those asset classes in which active management is preferred over passive management, Lancaster Pollard Investment Advisory Group conducted a study of the historical performance of actively managed mutual funds within seven different asset classes. The use of mutual fund return data addresses two potential issues related to the analysis of manager performance, specifically fees and selection bias.

Mutual fund returns are reported net of fees, while separate account returns are typically reported to various databases gross of fees. Further, separate account investors pay different fees based on the size of their accounts, while every

investor in a mutual fund pays the same fee, as defined by the fund's expense ratio. Therefore, it is difficult to generate net of fee performance for separate account managers. The cost associated with active management is an important consideration when analyzing the performance of active managers relative to the appropriate benchmark.

Selection bias occurs when a manager stops reporting performance to a database. This is most prevalent within separate account manager databases, to which reporting is voluntary, and typically happens after the investment manager has experienced a period of bad performance. Selection bias results in the worst performing managers being eliminated from the universe when they stop reporting performance, which artificially inflates the returns of that universe. Therefore, selection bias can cause active management to appear more effective relative to the index than is actually the case. Conversely, mutual funds are publicly traded vehicles, so managers cannot choose when to report performance. As a result, mutual fund universes typically have less selection bias relative to separate account databases.

The final issue addressed in designing the study was endpoint sensitivity, which is the risk that performance during the period is impacted by the beginning and ending points chosen for the analysis. For example, analyzing a single five-year period may show that a mutual fund outperformed the index; however, this perfor-

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mance might be largely attributable to a single quarter or year within that period when the mutual fund significantly outperformed. A better way to analyze performance is to utilize rolling periods, which allows for analysis over a number of periods and market environments, thereby reducing the impact of endpoint sensitivity.

The study used quarterly rolling five-year periods ending between June 30, 2000 and June 30, 2009. This period is believed to be sufficiently long enough to capture a manager's ability to generate alpha (returns over those expected from an index-tracking portfolio or other appropriate benchmark) while lessening the impact from a bad quarter or even bad year, both of which are bound to happen for all active investment managers. The first quarterly rolling five-year period was for the period ending June 30, 2000.

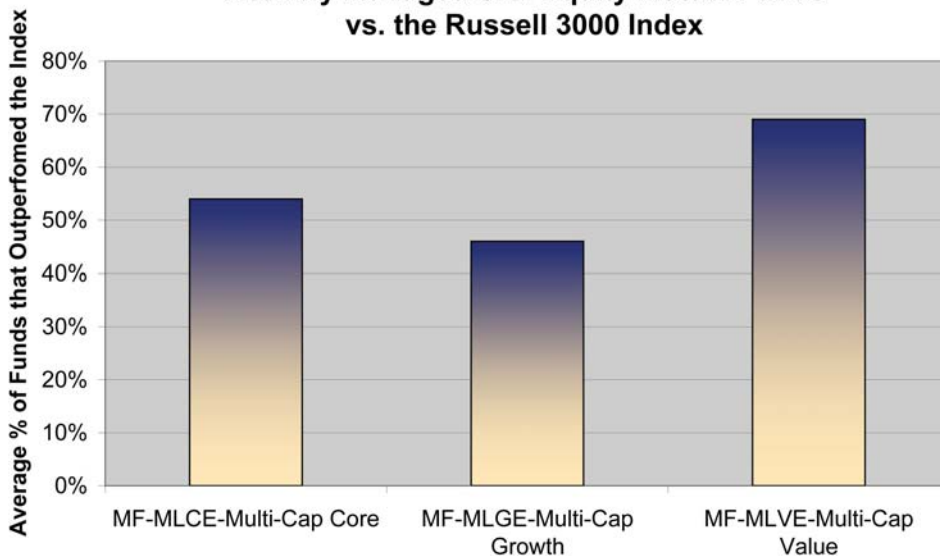
### Active vs. Passive

Although active manager performance was analyzed in each of seven different asset classes, the most focus was placed on actively managed U.S. equity mutual funds due to the considerable active / passive debate within this asset class. Lancaster Pollard Investment Advisory Group compared the performance of actively managed U.S. equity mutual funds classified as multi cap core, growth, and value by Lipper to the performance of the Russell 3000 Index, which measures the performance of the largest 3,000 stocks in the U.S. Over the 37 quarterly rolling five-year periods ending June 30, 2000 to June 30, 2009, the study found that multi cap value mutual funds performed the best versus the Russell 3000 Index, with 69% of the funds outperforming the index on average during the 37 rolling five-year periods (see chart below).

Said another way, using historical data, there was almost a 70% chance of randomly selecting a multi cap value mutual fund that outperformed the Russell 3000 Index over any given five-year period between June 30, 2000 and June 30, 2009. Conversely, only about half of multi cap core and multi cap growth mutual funds outperformed the Russell 3000 Index on average during this period. Therefore, investors had no better than a 50% chance of randomly selecting a mutual fund in either one of these categories that outperformed the Russell 3000 Index over any given five-year period between June 30, 2000 and June 30, 2009.

Based on this analysis, Lancaster Pollard Investment Advisory Group believes a more efficient solution to constructing a U.S. equity portfolio would be to combine active management with passive management. For example, institutions could utilize an index fund that tracks the performance of the Russell 3000 Index, which would provide broad exposure to U.S. equities, including large cap and small cap stocks as well as growth and value stocks. This index fund could then be complemented with a multi cap value manager that has the freedom to select stocks without regard to market capitalization, while using its own definition of value rather than the definition of value according to Russell, Standard & Poor's, or some other index provider that constructs separate growth and value indices. The resulting U.S. equity portfolio, which would be more heavily weighted toward the index fund than the active fund, should reduce fees and should lead to a greater chance that the combined portfolio will outperform a broad-based U.S. equity index such as the Russell 3000 Index.

**Actively Managed U.S. Equity Mutual Funds vs. the Russell 3000 Index**



Source: Lipper eVestment Alliance quarterly rolling 5-year periods ending June 30, 2000 to June 30, 2009

### Conclusion

When it comes to manager selection, the decision to utilize active management or passive management is an important one, but these approaches need not be mutually exclusive. Rather, the use of active management or passive management is dependent upon the asset class as well as the institution's unique situation. This research has shown that active management is the most effective in certain asset classes, while passive management is more effective in other asset classes. A combination of active and passive management provides many investors with the best chance of outperforming their market benchmarks at the lowest cost possible.