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7 REASONS TO CHOOSE ACTIVE NOW

While index investments have their place, it's important to recognize what actively managed strategies can do for investors — especially in the current environment, where the risks embedded in passive strategies loom large.

Industry averages don't tell the whole story. Statistics about the performance of active funds overall have reached differing conclusions through the years. But what matters to investors is the performance of the active funds they actually own — which can vary greatly. The key for investors is to focus on managers whose approach is truly distinct from the indexes — and be wary of so-called "index huggers" which are not different enough to truly outperform.

Investor needs may demand outperformance. Many investors have aggressive goals and/or imminent priorities that may only be realized with returns greater than passive strategies can provide. In many cases, the outperformance possible through active strategies may be the only way to meet these goals without formally reallocating money into higher-risk sectors.

Indexes may pose real risks. Indexes are not averages of the whole universe of securities in an asset class. Instead, they are models constructed around assumptions — many of them arbitrary — about what to include and how to weight it. Unfortunately, over time, those assumptions can introduce unanticipated risks. Example: the huge increase in Treasuries as a component of the popular Bloomberg Barclays US Aggregate Bond Index that's taken place since the financial crisis exposes passive investors to unwanted duration and interest-rate risk. Another example: the concentration risk inherent in a cap-weighted index like the S&P 500, with the top 10 stocks accounting for over 18% of its value. But do those stocks represent the best chance for future gains?

Some sectors are naturally suited to active. In specialized markets, where information is harder to come by — think small-cap stocks, emerging markets stocks, global high yield — active managers can add value by using their expertise to identify securities that are underpriced relative to their fundamentals.

Active can preserve as well as grow assets. After fees, a passive index strategy will gain all that its benchmark gains — but also lose everything its benchmark loses. In contrast, active strategies have the option to adjust holdings in response to adverse conditions; indeed, the alpha generated by an active strategy can be traced to "downside capture" as much as gains from well-chosen securities. At a time when valuations in many stock and bond sectors are historically high, and when rates may be poised to rise, active's flexibility offers a measure of prudence as well as potential gains.

It's an uncertain world; can you afford not to use both approaches? Market surprises in 2016 underlined the difficulty in predicting what's coming next. The long run of gains since the financial crisis that buoyed passive strategies may not necessarily be the arc of the future. A recent analysis by eVestment Alliance of passive and active large-cap stock returns from 1985 to 2015 showed a cyclical pattern in the performance of the two approaches over the last 30 years; however, recognizing that a pattern may exist doesn't mean one can anticipate the start and end of a new phase — meaning it's wise to hold both types of investments.

Investors deserve to have choices. Accepting the ups and downs of active investing is not simply a financial issue. It's also one of temperament. Some people would rather take a chance on outperformance than settle for the mediocrity of an index return, accepting the risks of underperformance. As such, the issue is the type of risk one wants to accept in one's portfolio — as well as the preferred level of volatility.

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