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Three Approaches to Investing

Active Investing

Active investing uses the skills of an investment manager who strives to help investors earn greater returns than the market or pursue other goals, such as risk reduction or income enhancement. It involves substantial research and possibly a fair amount of trading. These activities raise the cost of investing, meaning the manager has to beat the market by enough to cover the higher costs just to break even.

Passive Investing

Passive index-based investments track the return of an asset class or market segment by seeking to replicate the underlying index. Market-capitalization weighted approaches are the most common construction methods used, where market value determines position sizing. This is the framework used to create many of the more commonly reported market indexes, such as the S&P 500 Index. While benefits vary by product, passive strategies often have comparatively high levels of transparency, a greater potential for tax efficiency, and the ability to trade intraday.

Smart Beta

Smart Beta strategies offer different ways to select and weigh securities within an index in order to emphasize specific investment characteristics or factors. While costs can be higher in comparison to traditional passive vehicles, they are also systematic, rules-based investment methodologies that are easily scalable and generally remain cost competitive. Smart beta approaches can vary considerably by methodology and emphasize a specific factor or sets of factors, such as momentum, value, quality, and dividend yield.

**Market capitalization is a method of assessing the value of a company by multiplying the number of shares outstanding by the stock's market price.*

How Do Active, Passive, and Smart Beta Investing Differ?

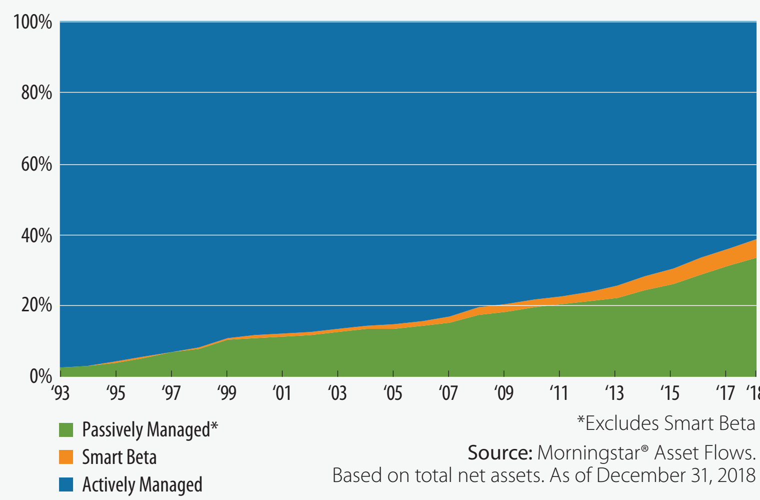
Key Takeaways

- Active, passive, and smart beta are strategies for building a portfolio.
- Active investing involves a professional manager selecting individual stocks, bonds, cash, and other investments for the investor in an effort to do better than the market or to match the market with less risk or higher income.
- The primary goal of passive investing is to track the performance of a particular market-based index—not to "beat the market."
- Although having characteristics similar to active and passive strategies, smart beta strategies are designed to compensate for perceived biases in classic indexing strategies.
- The goal of smart beta strategies is to provide investment exposures to specific factors or investment characteristics that offer the potential for improved risk/return outcomes in a cost-effective manner.

Passive and Smart Beta Investing Are Growing in Popularity

Percentage of funds using active, passive, and smart beta approaches, 1993–2018

Although active management is the granddaddy of the three investing approaches and holds the lion's share of investors' funds, passive management and smart beta (the most recent addition) are steadily growing in popularity.



*Excludes Smart Beta

Source: Morningstar® Asset Flows. Based on total net assets. As of December 31, 2018

To Be Active or Not to Be Active

As the chart above shows, active management is far and away the most popular of the three approaches. However, the long-term track record for active managers is mixed. (see page 2). That being said, active management can play an important role in many portfolios. Whether it may work better than the other approaches for a given piece of an investor's asset allocation "pie" depends, in part, on the efficiency of the market for that particular asset class. In general, active investing tends to perform better with inefficient markets.

What makes a market efficient? According to the Efficient Market Hypothesis, a market is efficient when all relevant information has been incorporated to the prices of stocks and it is therefore almost impossible to "beat the market." Blue-chip stocks are a great efficient market example—the press and analysts follow these companies' every move, making it difficult for active managers to gain an advantage. But in an inefficient market comprising lesser-known securities, such as small-cap stocks or emerging-market stocks or bonds, for example, an active manager may be able to gain an edge by gathering and interpreting available information.

The Case for Active Management

In our opinion, active management, while broadly struggling the last several years, will continue to offer a compelling value proposition going forward. To the extent that underlying company fundamentals have been a limited driver of market prices, versus broad investor sentiment and demand for certain types of equities, active management may have improved prospects as fundamentals ultimately drive long-term results.

Indexing: A Revolutionary Idea in its Time

Index-based investing is an old and familiar concept for today's investors. But when it was introduced in the mid 1970s, it struck investors as bizarre. Why, they asked, would anyone strive to get the same return as the market? Why would they pay a manager to do this? Wasn't the whole point of investing to beat the market?

Pension funds and other institutional investors were the first adopters of passive investing. Wells Fargo offered the first stock index fund, tracking the S&P 500 Index, to the Samsonite pension fund in the late 1970s. Individual investors gradually caught on to the concept, and today index-based investing is very popular.

There's Probably an Index for That

If you're thinking a passive strategy may be right for you, you could be surprised to find that there's an index for just about any asset class you can imagine. An index may be very broad or very targeted. Here's a small sampling of the range of choices:

It's Not Always About Geography

Some smart beta indexes have nothing to do with locations on a map. Examples include:

- Value
- Quality
- Size Momentum
- Low Volatility
- Other Fundamental Characteristics

Cross-border indexes

MSCI EAFE (International Developed-Market Stocks)

FTSE EPRA/NAREIT Developed ex-U.S. Property (Real Estate)

MSCI EM (Emerging Market Stocks)

Bloomberg Commodity
S&P GSCI Commodity
Rogers Int'l Commodity

Source: Wells Fargo Investment Institute

An index is unmanaged and not available for direct investment.

A Look at Active Management

Investment managers generally attempt to beat the market—to pick the stock or bond or commodity that outperforms its peer group. Can they do it? How successful active managers are depends, in part, on market conditions, the economic environment, strategies employed, and other factors. Not all managers are created equal, and certain strategies have had differing levels of success. Manager selection is an art and a science, and individual manager success is not always dependent on how a broad strategy performs. Note that broadly constructed manager strategies can include a wide array of mandates that are designed for specific objectives or include managers with considerable out of index exposures that can skew overall results.

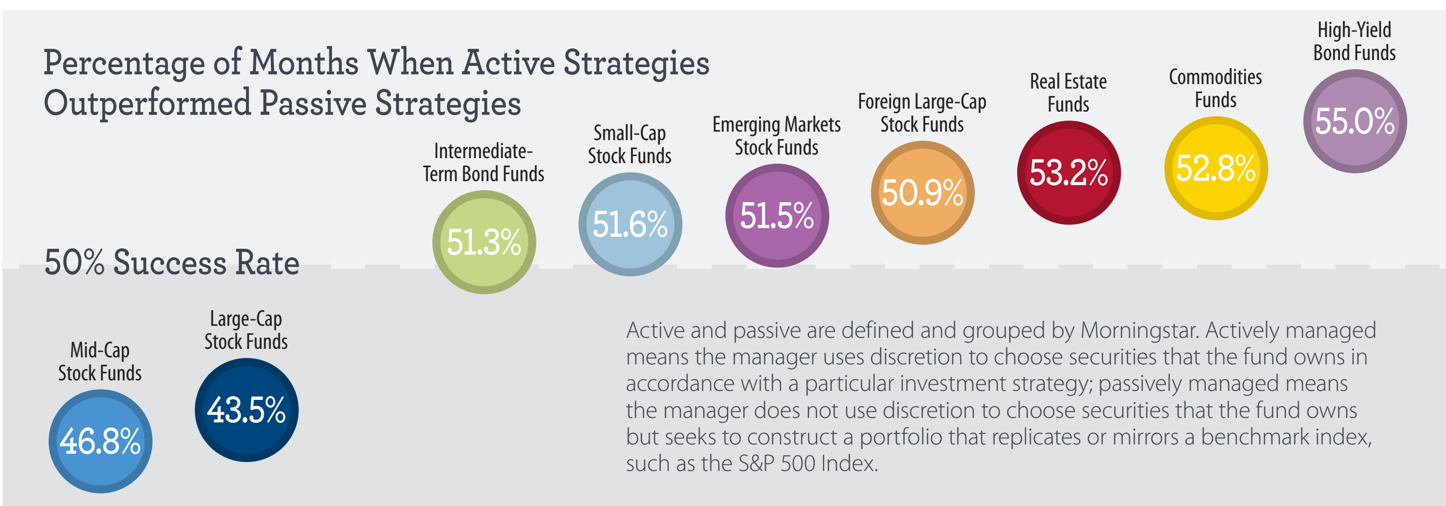
Taking a Smart-Beta Approach

Smart-beta portfolios can offer a blend of active and passive approaches. These portfolios are typically index-based investments that attempt to capture investment factors or market inefficiencies in a rules-based way. For instance, a large-cap-index-based exchange-traded fund may screen out stocks with above-average volatility. Smart-beta funds became popular with investors who wanted index-like fees and transparency while avoiding some of the drawbacks of traditional index funds that track market-weighted indices. As an example, traditional index funds track a market capitalization-weighted index. This type of index typically allocates more assets to stocks as they become larger, which smart-beta advocates say can force investors into overvalued investments.

Using smart-beta products as direct substitutes for products tracking more well-known market-cap indices can be risky, as exposure offered by a smart-beta product could differ significantly from that provided by products tracking a market-cap-weighted index.

Active Managers Tend to Perform Better in Smaller and Less-Efficient Markets

Success rate of active strategies outperforming passive strategies



Sources: Wells Fargo Investment Institute and Morningstar Direct, as of December 31, 2018. The Wells Fargo Investment Institute study included the analysis of all share classes of equity open-end mutual funds and exchange-traded funds, excluding money market funds, funds of funds, and obsolete funds. Data was extracted from Morningstar Direct using its search criteria to categorize the funds according to their respective asset class and subcategorize the funds as either active or passive strategies. The period of study is from January 31, 1987, to December 31, 2018, using monthly total returns. Morningstar's calculation of total returns account for management, administrative, and 12b-1 fees and other costs taken out of fund assets. Success rate is defined as the percentage of active strategies outperforming the passive strategy. Information is for illustrative purposes only and does not predict or depict the performance of any investment or the likelihood of achieving any return on an investment. The investments within the analysis and the asset classes shown may not perform in a similar manner in the future. **Past performance is no guarantee of future results.**

Each asset class has its own risk and return characteristics. The level of risk associated with a particular investment or asset class generally correlates with the level of return the investment or asset class might achieve. ***Stocks*** *are subject to market risk which means their value may fluctuate in response to general economic and market conditions, the prospects of individual companies, and industry sectors.* ***Mid- and small-cap stocks*** *are generally more volatile, subject to greater risks and are less liquid than large company stocks.* ***Bonds*** *are subject to market, interest rate, credit/default, liquidity, inflation and other risks. Prices tend to be inversely affected by changes in interest rates.* ***High yield fixed income securities*** *are considered speculative, involve greater risk of default, and tend to be more volatile than investment grade fixed income securities. Foreign* ***investing*** *entails special risks such as currency, political, economic, and market risks. These risks are heightened in emerging markets. Investments in* ***commodities*** *may be affected by changes in overall market movements, commodity index volatility, changes in interest rates or factors affecting a particular industry or commodity. There are special risks associated with an investment in* ***real estate****, including the possible illiquidity of the underlying property, credit risk, interest rate fluctuations and the impact of varied economic conditions.*

Comparing the Three Approaches

Active, passive, and smart beta strategies differ across a variety of dimensions that must be considered when deciding which strategy, or combination of strategies, may be right for you.

	Active	Passive	Smart Beta
Depth of product availability	There is considerable depth of products available across virtually all asset classes.	Depth of product across asset classes has grown considerably over time, but products in less liquid asset classes can present trading challenges.	The array and depth of products is more limited than traditional active and passive products but will likely continue to grow over time.
Relative cost	Higher	Lower	Can have lower expenses; generally lower than active strategies
Security selection	At manager's discretion within objectives that may be very broad.	Governed by index being tracked and weighted based on capitalization. Dominated by the largest stocks or heaviest debt issuers.	Weighted, other than market-weighted, on mostly fundamental measures, such as: • Value • Quality • Size Momentum • Low Volatility • Other fundamental characteristics (such as weighting companies by sales or dividend yields)
Trading frequency	At manager's discretion; annual turnover can range from very low to high levels but is typically higher than traditional passive vehicles.	Minimal, only when the index is reconstituted or in response to cash inflows and outflows from the portfolio.	Moderate, as securities alter their weights due to changes in fundamental measures or in response to cash inflows and outflows from the portfolio. Some strategies could have higher turnover.
Capital gains realization	Varies; funds are typically managed without regard for efficiency in managing taxable capital gains.	Low	Moderate
Index tracking	No; though managers usually benchmark themselves against an index.	Yes; managers have a broad universe of indexes from which to choose.	Yes; managers have many available indexes from which to choose, and can construct unique indexes that target specific factors or characteristics.
Asset types	All	Most	Primarily stocks
Transparency	Potentially low; mutual funds typically provide updated position data monthly or quarterly.	High; including daily access to underlying holdings and through summary data provided by product sponsors.	High; portfolio holdings are typically based on the composition of a rules-based index.
Diversification within the sector	May vary based on objective	Varies considerably by targeted index	Multi-Factor products can be highly diversified while single-factor or other niche smart beta products can offer limited diversification
Risks	• Management risk – the fund's investment objective may not be achieved • Generally higher management fees and operating costs • Investment Style – certain styles tend to shift in and out of favor which can affect performance	• Indexes can become concentrated in one or more sectors causing concentration risk • Fund cannot take advantage of changing market conditions which can affect performance • Fund may not be able to replicate index entirely	• Not buy-and-hold strategies • May not be well-diversified • Optimal tradeoff between risk, return, and trading costs may not be achieved • Not all approaches are time tested or behave as expected in certain environments

What Strategy—or Strategies—Should You Use?

Prior to the introduction of passive investment strategies, investors had only actively managed funds to choose from. Fortunately, passive and smart beta strategies are now available, and you can decide to use more than one—or all three, in fact. You might decide to go with active investing for certain classes and passive or smart beta for others. Or you may opt for a "core/satellite" approach within an asset class, where, for example, the bulk of the assets is actively managed and a smaller portion is passively managed.

Your investment professional can provide more information about active, passive, and smart beta approaches to investing and help you decide how to employ them in your portfolio.

To help with your investment planning or to discuss the points in this report, please talk to your investment professional.

All investing involves risk including the possible loss of principal. There is no assurance that any strategy will meet its investment objective or that the use of smart beta strategies will produce excess returns even if such strategies have done so in the past.

Traditional indices, such as the S&P 500 Index, weight their holdings by market capitalization. Alternative Indices use other methodology to weight the components within the index and may focus on a specific style (e.g., growth, value) or sector. Fundamentally-based indices are indices in which the component stocks are weighted using one or multiple economic fundamental factors. The fundamental factors commonly used by fundamental index managers are sales, earnings, book value, cash flow, dividends or employees. Products that track this type of index may be thinly traded and have wide bid-ask spreads. This may make these products more costly to trade Some alternatively weighted indices may have significantly higher turnover than more traditional indices because they must be rebalanced regularly which results in greater transaction costs and potentially a higher tax impact for the products that track them.