Active vs. Passive: Opposing or Complementary Strategies?

REFRAMING THE INVESTMENT LANDSCAPE WITH A MIXED APPROACH

The debate between active (attempting to beat a benchmark) and passive (tracking a benchmark) equity investing is ongoing and polarized. Passive proponents point to the challenges of consistently striving to generate benchmark-beating results as evidence of the active strategy’s shortfalls. The active camp insists the dynamic nature of the financial markets provides opportunities for talented managers to outperform. At Northern Trust, of course we offer both options to clients, but ask: Why does it have to be one or the other?

Because alpha (a risk-adjusted measure of excess return versus a benchmark) is difficult to achieve, mainstream thinking suggests investors should use actively managed mutual funds when they believe a fund manager is exceptionally skilled and able to generate attractive risk-adjusted performance, relative to a benchmark, over time. Passive-investing proponents believe maintaining market exposure delivers more consistent results at lower costs.

Moving to the middle
Although we generally agree with this mainstream thinking, we also believe it oversimplifies the debate and positions the camps at opposing ends. Instead, we believe in the middle of the extremes there is a solution supported by evidence and theory.

The oversimplification likely comes from the widely used, Nobel Prize-winning Capital Asset Pricing Model (CAPM) theory, which allocates security returns into alpha and beta (a measure of risk relative to a benchmark), or “skill” and “the market.” At its heart, the CAPM assumes investors expect greater returns for taking on more risk.

Tailoring factor exposure to a fund’s goals
Our solution to the age-old active vs. passive conflict comes from our research, which suggests most active managers’ performance is embedded in the biases (risk factors) that comprise the stock screening process. These typically include market capitalization, valuation, volatility, momentum, and yield. At Northern Trust, the process also includes our proprietary measure of quality. By constructing funds that aim to efficiently capture these factors, we seek to deliver attractive risk-adjusted returns.

Each of these factors captures different risk preferences of different investors. For example, risk-averse investors may shun stocks with strong value characteristics, while risk-seeking investors may favor stocks with high volatility scores. Given the existence of these multiple betas, our fund managers do not have to commit to either end of the active/passive spectrum. Instead, they can move along the spectrum, selecting the combination of risk factors that best suits their fund’s investment strategy and adjusting exposure to the specific factors based on the fund’s goals.

3 pillars of equity fund management
Our approach intentionally focuses on the compensated factors while smoothing out the uncompensated factors, such as sector and industry concentrations. Beyond that, we concentrate on three “pillars” in building our equity mutual funds:

- Implement portfolios efficiently. We developed a “Factor Efficiency Ratio” to help our fund managers manage unintended risks in their fund strategies. Such risks are typically uncompensated and therefore hamper a strategy’s risk/return profile.

- Embrace quality. We believe quality is a key component of the investment process and can improve a fund’s risk/return profile by smoothing out periods of underperformance.

- Stay straightforward, but shrewd. We strive to build funds that are easy to understand while maintaining market savvy. The factors should be well constructed, using combinations of signals in an effort to improve success across business cycles. We believe examining various measures of a factor, such as different indicators of value and quality, can help reduce the volatility that may result during periods of market stress and when relying on a single, often simple, measure. For example, a stock’s price/book ratio is one readily available and fairly simple measure of value, but it’s not the only indicator and may not always be the best gauge.

Our extensive research and design efforts indicate adherence to these three pillars may improve risk-adjusted results over time. We
believe investors should look beyond the single-factor CAPM theory guiding many investment strategies and instead focus on a multidimensional approach, which we believe offers better outperformance potential.

*Price-to-book ratio is a ratio used to compare a stock’s market value to its book value. It is calculated by dividing the current price of the stock by the latest quarter’s book value per share.

Past performance is no guarantee of future results. Investing involves risk including the possible loss of principal. There can be no guarantee any investment strategy will be successful.

Northern Trust

To report IRA fair market values

According to Internal Revenue Service (IRS) regulations, financial organizations must report the year-end fair market value of the retirement accounts of individuals with required minimum distributions (RMDs).

If you’re responsible for an RMD in the 2014 tax year, we included the fair market value of your Northern Funds IRA as of December 31, 2014, on your December 2014 year-end statement. We will report this figure to the IRS via Form 5498. If you have any questions, please call the Northern Funds Center at 800-595-9111.

Northern Trust earns ‘best private bank’ title

For the sixth-consecutive year, Professional Wealth Management and The Banker magazines named Northern Trust the “Best Private Bank in the United States.” The two magazines, both published by the Financial Times Group, also named Northern Trust the “Best Private Bank for Socially Responsible Investing.”

An international panel of industry professionals examined several quantitative and qualitative factors in selecting award winners. The judges said Northern Trust is one of the leading institutions in terms of innovation, client-centered strategy, and quality of advisers.

“While the customer service standards and investment strategies of competitor firms in the U.S. are improving, Northern Trust is still managing to stay at the head of the pack,” said Professional Wealth Management Editor-in-Chief Yuri Bender, one of the judges.

To learn more, visit northerntrust.com/best.

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by phone  call 800-595-9111, Monday thru Friday, 7:00 a.m. – 7:00 p.m. Central Time
automated information line  call 800-595-9111, 24 hours a day, 7 days a week
online  visit northernfunds.com
by mail  write to Northern Funds, P.O. Box 75986, Chicago, Illinois 60675-5986

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