Legacy Trust

Investment Perspectives

The Benefits of Active Management During a Market Downturn

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Key Takeaways

- Heightened volatility and panic selling has created strategic buying opportunities for active managers
- Market dislocations due to extreme selling created a disconnect in value between ETFs and their underlying holdings, favoring direct exposure
- Active tax loss harvesting and other tax-aware portfolio management techniques can add significant value
- Direct ownership of individual equities allows for transparency and clear knowledge of exposure and risks

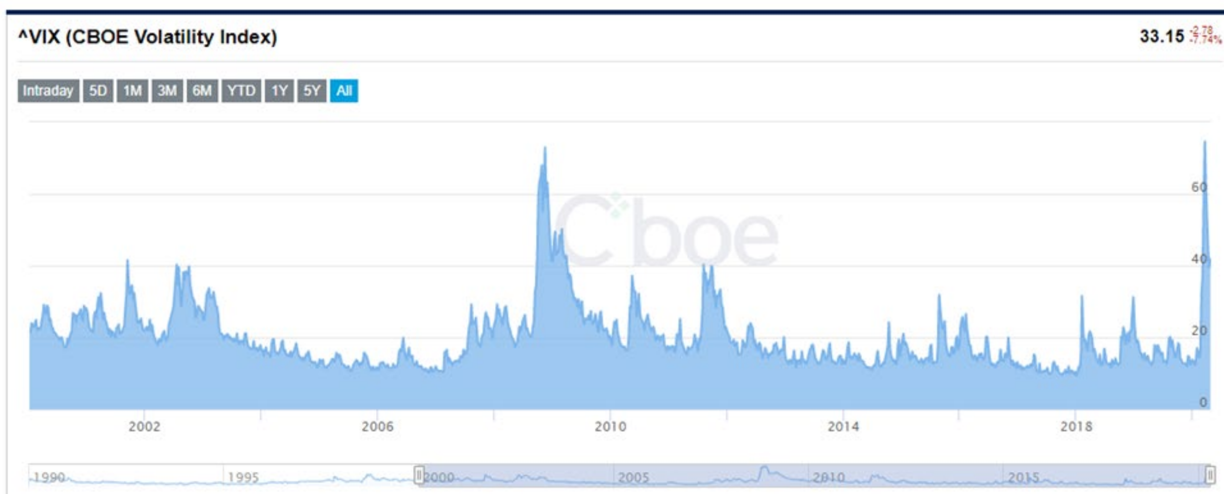
The Covid-19 pandemic has driven significant market turmoil over the past several weeks, bringing with it an economic recession and a bear market for the first time in several years. The bull market that ended in March will go down as one of the greatest in history, but it has also led to a great deal of investor complacency. We believe that active management will be more important than ever during these turbulent times.

The obituary of active management has been written ad nauseum for the better part of my 25+ year career. "Passive management has lower fees," they always say. "Most active managers don't beat their benchmark" is another argument I always hear. "Markets are efficient, so why bother." A case can probably be made for each of these arguments at some point in time and under the right circumstances, but I'll show you why shouldn't buy all the passive hype. This is not the right time or the right set of circumstances to be passive.

So why is active management important during these turbulent times? There are several reasons, but this article will focus on three: 1) Volatility creates opportunity, 2) Taxes matter more than fees, and 3) You should always know what you own.

At the peak of the March market meltdown, the CBOE Volatility Index (Exhibit 1) reached a new all-time high of 75, eclipsing the previous record seen during the 2008 financial crisis. The Volatility Index, or VIX as its commonly referred to, is also know as the Fear Gauge. When it spikes, investors are de-risking.

EXHIBIT 1



Some are doing so to adjust their portfolio positioning while others are being forced to liquidate their holdings to meet cash demands or margin calls. When cash is king, managers sell what they can, not what they want to. This can cause prices of those passive ETFs to disconnect from the value of their underlying holdings. We've seen it occur in stocks, commodities, and even the sleepy municipal bond market.

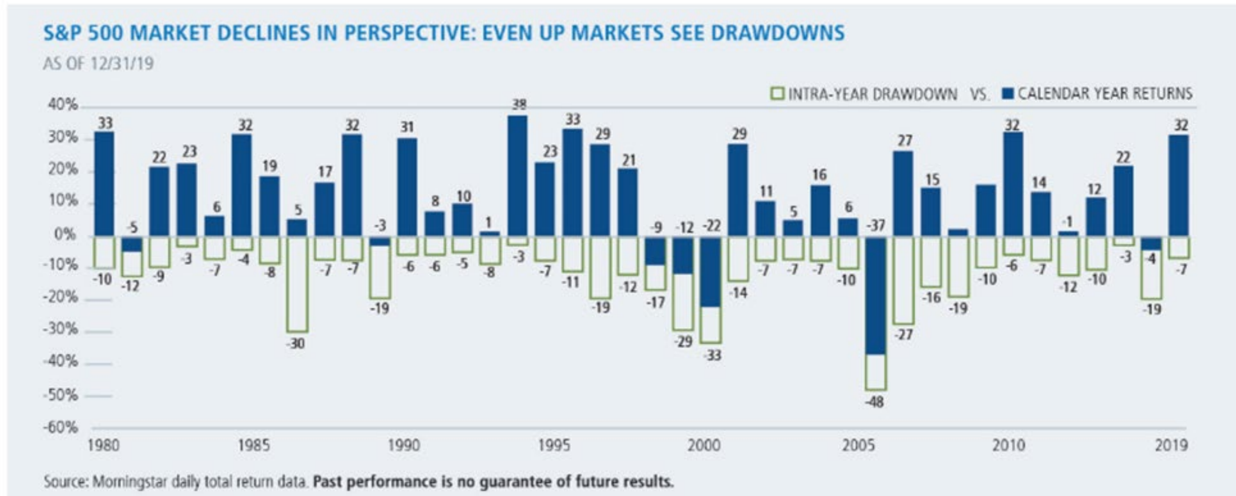
The good news for active management is the ability to identify value. When the VIX spikes, all stocks (good and bad) trade the same, as correlations go to 1. Active managers use this to their advantage and upgrade their portfolios by making strategic changes to their asset allocation or by swapping from defensive to cyclical names for the recovery period. Passive investors simply go along for the ride.

Ben Franklin said there were only two things that were certain in life - death and taxes. It's important to understand the role taxes play in the creation and preservation of wealth. For most individuals, taxes are an ongoing investment expense. Even in retirement accounts like 401(k)s and IRAs taxes are merely deferred, and now with the new CARES Act, even that is being limited. What is an investor left to do?

If you believe in active management like I do, you can take lemons and make lemonade and use market downturns to your tax advantage. By regularly harvesting tax losses throughout the year, you can save thousands on income and capital gains taxes.

About half the time over the past four decades (20 out of 39 years), the market has had an intra-year peak to trough drawdown of at least 10%. In fact, the average is around 16%. As seen below in Exhibit 2, there have been several years where the market has experienced a significant drawdown only to finish the year in positive territory. In 2009, the market saw a 27% drawdown before finishing the year up 27%.

EXHIBIT 2



If you had the misfortune of buying near the top of the market that year, you could have simply held on until the end of the year and recouped your early losses. But you would have missed a great opportunity to lower your taxes.

In the table below (Exhibit 3) we highlight the tax advantage of an actively managed portfolio. Portfolio A is an actively managed portfolio of individual stocks. Portfolio B is a passively managed ETF/Mutual Fund portfolio.

EXHIBIT 3

		Portfolio A Value	Stock 1	Stock 2	Stock 3	Stock 4	Stock 5	Portfolio B Value	ETF/Mutual Fund
Beginning Value		$30,000	$10,000	$10,000	$10,000	$0	$0	$30,000	$30,000
First 6 Month's Return	-20%	$24,000	$12,000	$5,000	$7,000	$0	$0	$24,000	$24,000
Tax Loss Trades				*Sold*	*Sold*	*Bought*	*Bought*	*None*	
Next 6 Month's Return	25%	$30,000	$15,000	$0	$0	$7,000	$8,000	$30,000	$30,000
Next 12 Month's Return	20%	$36,000	$17,000	$0	$0	$10,000	$9,000	$36,000	$36,000
Ending Value		$36,000						$36,000	
Realized Gain/Loss		($8,000)						$0	

While both portfolios end up at the same place, the active manager has added value by harvesting tax losses at the position level. Active management has improved the investor's net worth by taking these losses and redeploying the capital in a tax efficient manner while the passive manager has missed out on this opportunity. Assuming a 1% management fee, the active manager has more than offset the expense.

One of the core tenets of our investment philosophy at Legacy Trust is to treat investments in stocks the same way you would investments in private companies. That simply means doing your homework before you make an investment, and while you own it. Understanding the investment thesis allows you to weather the market's ups and downs when emotions run high.

Too many investors buy the hot stock, mutual fund, or ETF without understanding what they own. They simply look at the name or past performance and assume it's an appropriate investment for their situation. A recent example that highlights this trend is the United States Oil Fund ETF (Ticker: USO). Many investors in USO thought they were buying an investment that tracked the price of oil when in fact they owned futures contracts on oil. These contracts actually saw prices go negative as the they approached expiration.

Other funds and ETFs with names including adjectives like High Quality or Dividend Growth are comprised of companies that have leveraged balance sheets or significant sector concentrations. Many of these portfolios are built using quantitative screens that fail to adapt to rapidly changing market conditions.

In a sign of the times, pandemic darling Zoom Video is replacing insurance broker Willis Towers Watson in the Nasdaq 100 index on April 30. Zoom's stock up 141% this year and currently trades at nearly 400 times forward earnings. It will become part of the QQQ ETF which FactSet describes as "a quirky but wildly popular mashup of tech, growth and large-cap exposure". Buyer beware.

The 11-year long bull market that ended in March will go down as one of the greatest in history, but it has also led to a great deal of investor complacency. Bear markets have a way of shining a harsh light on portfolios and the investments that comprise them. I'm reminded of a quote from Warren Buffett, "You only find out whose swimming naked when the tide goes out." Towels anyone?

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