Passive Management doesn't work with Preferred Securities

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According to a 2019 ETF study by Charles Schwab, 79% of people surveyed indicate that ETFs are their "investment vehicle of choice." The average large cap US equity fund has failed to beat the S&P 500 Index in every calendar year for the past 10 years. Per Morningstar Inc., out of 4600 US-based equity, bond, and real estate funds with over $12.8 trillion in AUM, only 24% beat the passive alternative across the 10 years (through Dec 31, 2018). When presented with these facts, it is easy to see why most investors and advisors default a large portion of their assets to passive ETFs.

'You can drown in a lake that has an average depth of 3 inches'

What many investors miss is determining when passive investing works best and when active investing can give them an edge. Like a lake with an average depth of 3", it can also have areas where the water is over your head and full of snags increasing the risk of drowning.

Morningstar's August 2019 Active/Passive Barometer shows the odds of succeeding with active funds in different areas. A quick review of the 10-year active funds' success rate, by category, reveals some important information.

Category	1-Year	3-Year	5-Year	10-Year	15-Year	20-Year
U.S. Large Blend	32.3	29.0	13.6	8.0	14.5	18.0
U.S. Large Value	34.4	33.3	15.9	7.0	20.4	12.1
U.S. Large Growth	54.3	38.8	30.5	8.0	12.0	—
U.S. Mid Blend	46.3	26.5	14.3	7.7	8.1	11.6
U.S. Mid Value	32.0	33.3	23.8	11.6	26.9	—
U.S. Mid Growth	79.1	59.5	54.0	29.8	26.9	—
U.S. Small Blend	45.3	29.3	26.0	22.1	19.3	34.0
U.S. Small Value	45.1	44.8	39.3	39.5	25.7	—
U.S. Small Growth	75.8	61.3	52.8	35.2	26.3	—
Foreign Large Blend	29.8	29.7	32.6	32.3	31.2	37.1
Foreign Large Value	8.5	23.4	44.1	32.6	—	—
Foreign Small-Mid Blend	34.5	21.4	24.0	82.4	—	—
World Large Stock	55.2	46.6	33.7	31.8	28.7	—
Diversified Emerging Markets	33.9	43.4	55.8	49.0	—	—
Europe Stock	20.8	13.6	23.8	48.1	34.2	—
U.S. Real Estate	56.9	31.9	38.8	35.1	32.8	27.1
Global Real Estate	76.4	19.7	51.9	38.6	—	—
Intermediate Core Bond	26.8	52.6	34.9	31.3	16.6	9.5
Corporate Bond	13.2	68.8	57.8	61.5	—	—
High Yield Bond	37.7	57.7	43.1	57.4	—	—

Source: Morningstar. Data and Calculations as of 6/28/19.

Active investing success rate in the large cap asset class is under 10% and the case for passive can be justified. However, the active investing success rates with corporate bond and high yield bond are over 60% making the case that active management may be justified. The more efficient the market, the stronger the case can be made for passive investing.

The efficient-market hypothesis in financial economics state that prices reflect all available information and, therefore, it is impossible to outperform the market on a risk-adjusted basis. It's the degree of efficiency that is questionable, along with how investors react to the information available to them.

The US large cap market is very efficient. Everyday thousands of very smart analysts and portfolio managers, aided with the latest software and data feeds, pour over companies' financials, industry and economic data looking for an edge. The market is very liquid and it is easy to execute trades.

The preferred market is just the opposite. Relatively smaller than the US large cap market, the securities are not uniform in structure and many tend to be illiquid. Data on preferred securities for the average investor is hard to come by. In addition, the indices used to model the passive ETFs have inefficiencies (that can be exploited by active management) such as:

> **Call risk:** Currently many listed preferred securities are priced at a negative yield-to-call. The indices are indifferent to the call risk and will continue to invest in preferred securities that will result in a negative return if held until called.
>
> **Credit Quality:** Similar to debt, credit quality influences the price of preferred securities. Indices are apathetic to credit quality.
>
> **Concentration risk:** The largest issuers of preferred securities are financial institutions. This results in the indices concentrated in the financial sector regardless of valuation.

Active preferred funds vs. Passive preferred ETFs

The preferred securities category is not broken out in the Active/Passive Barometer. However, using data from Morningstar, we looked at all funds in the preferred stock category. We eliminated funds that were specialized (such as short duration funds) and we used the institutional share class for funds with more than one share class. The resulting data set was small, reflecting the small asset size. We used the two largest preferred ETFs as the passive investment vehicle.

Using Morningstar's Return % Rank Category for the Morningstar Preferred Category and the two largest preferred ETFs (as measured by assets), we ranked their performance over 3, 5, and 10 years as (of 12/15/2019). We then looked at yearly returns for years 2014 through 2018.

Morningstar Preferred Category

Name	Ticker	3 Y Return% Rank Cat	5 Yr Return% Rank Cat	10 Yr Return% Rank Cat	2014 Return% Rank Cat	2015 Return% Rank Cat	2016 Return% Rank Cat	2017 Return% Rank Cat	2018 Return% Rank Cat
Invesco Preferred ETF	PGX	27	26	65	18	1	98	36	28
iShares Preferred&Income Securities ETF	PFF	75	75	100	18	49	94	74	53

Invesco Preferred ETF (PGX) tracks the ICE BofAML Core Plus Fixed Rate Preferred Securities Index (P0P4).

iShares Preferred & Income Securities ETF (PFF) tracks the Ice Exchange-Listed Preferred & Hybrid Securities Index (PHGY). Before January 31, 2019 the PFF ETF tracked the S&P U.S. Preferred Stock Index (SPPREF)

The PFF ETF performance has been in the bottom third of performance for 3, 5, and 10yr return rank. Landing in last place for the 10yr return % rank category with a score of 100. The PGX has performed better ranking 64% in the 10yr return rank category. PGX was rank at the very top in 2015 then fell to the bottom in 2016.

Summary

Passive investing works best for asset classes that are highly efficient (such as large cap US equities, where prices quickly reflect all available information and securities are uniform in structure and easily traded). The preferred securities market is not large, the securities are not uniform, and information can be difficult to come by. It is in this type of environment, that is best suited for active management.

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