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 indicated that ETFs are their "investment vehicle of choice." The average large cap U.S. 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 U.S.-based equity, bond, and real estate funds, only 23% beat the passive alternative across the 10 years (through Dec 31, 2020). 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 three inches, it can also have areas where the water is over your head and full of snags, increasing the risk of drowning.

Morningstar's March 2021 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	10-Year (Lowest Cost)*	10-Year (Highest Cost)
U.S. Large Blend	31.1	30.0	16.5	8.4	11.2	12.8	17.2	4.1
U.S. Large Value	52.1	35.6	20.3	14.0	15.4	16.8	26.2	9.2
U.S. Large Growth	34.4	37.0	20.6	9.3	10.9	11.3	17.6	6.6
U.S. Mid Blend	21.6	23.8	13.4	11.9	6.3	8.7	29.6	7.4
U.S. Mid Value	76.8	49.6	44.2	12.5	30.8	–	16.7	8.3
U.S. Mid Growth	42.6	59.5	54.6	40.7	30.5	–	47.8	33.3
U.S. Small Blend	29.4	19.5	16.8	12.7	10.0	29.6	27.0	11.1
U.S. Small Value	46.2	27.4	23.1	29.3	31.3	–	35.0	15.0
U.S. Small Growth	60.1	55.2	54.0	41.2	28.4	–	46.7	36.4
Foreign Large Blend	56.0	41.5	26.7	20.0	14.0	14.6	35.9	17.9
Foreign Large Value	80.2	41.3	24.2	31.7	–	–	42.9	23.8
Foreign Small-Mid Blend	25.0	11.8	11.5	22.2	–	–	25.0	0.0
World Large Stock	53.3	42.0	30.8	30.4	32.0	–	34.8	21.7
Diversified Emerging Markets	69.6	59.6	48.1	45.4	35.7	–	58.3	33.3
Europe Stock	73.7	48.1	37.5	32.4	30.6	–	42.9	0.0
U.S. Real Estate	71.1	67.5	53.2	45.0	27.5	28.6	62.5	25.0
Global Real Estate	75.0	60.3	38.5	48.1	–	–	45.5	45.5
Intermediate Core Bond	53.7	38.5	34.5	27.9	15.9	9.7	47.4	11.1
Corporate Bond	48.4	35.5	49.1	40.5	–	–	37.5	25.0
High-Yield Bond	54.8	46.2	59.0	42.3	–	–	59.5	40.5

Source: Morningstar. Data and calculations as of Dec. 31, 2020. *Green/red shaking indicates that active funds in this fee quintile had above/below average success rates.

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 asset classes are over 40%, 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 states 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 U.S. large cap market is very efficient. Every day, 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 U.S. 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 07/09/2021). We then looked at yearly returns for years 2016 through 2020.

Morningstar Preferred Category

Name	Ticker	3-Year Return % Rank Cat	5-Year Return % Rank Cat	10-Year Return % Rank Cat	2016 Return % Rank Cat	2017 Return % Rank Cat	2018 Return % Rank Cat	2019 Return % Rank Cat	2020 Return % Rank Cat
Invesco Preferred ETF	PGX	57	56	37	98	36	28	71	31
iShares Preferred & Income Securities ETF	PFF	63	71	84	94	74	53	84	12

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 5- and 10-year return rank. The PGX has performed better, ranking 37% in the 10-year return rank category.

Summary

Passive investing works best for asset classes that are highly efficient, such as large cap U.S. 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 this type of environment that is best suited for active management.

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