WealthManagement.com

IN RECENT YEARS, INVESTORS HAVE FLOCKED TO LOW- AND NO-FEE INVESTMENTS AND PROVIDERS. BUT THERE MAY BE A DOWNSIDE FOR INVESTORS WHO FOCUS ONLY ON FEES WHEN MAKING INVESTMENT DECISIONS.

Not insured by FDIC or any federal government agency. May lose value. Not a deposit of or guaranteed by any bank, bank affiliate, or credit union.

TRANSAMERICA®

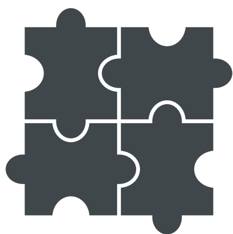
Insurance / Investments / Retirement

THE RISING POPULARITY OF EXCHANGE-TRADED FUNDS (ETFS) and passive investment strategies has focused retail investors' attention on fees — or perhaps it's been a byproduct of a more fee-conscious approach among investors. In August 2019, according to research firm Morningstar Inc, assets in U.S. index-based equity mutual funds and ETFs eclipsed assets in active equity funds for the first time in history.[1]

Competition around fees has also spread to other areas of the industry. For example, low-cost solutions such as robo-advisors have sparked debate about just how much investors should be paying for advisory relationships.

While expenses such as fees play a part in a range of financial decisions, focusing on them to the exclusion of other key traits can be counterproductive. Put simply, you get what you pay for: A no-frills investing experience may be O.K. for some people, but others may benefit from more expert oversight, whether it's skilled portfolio managers choosing investments or seasoned financial professionals guiding clients through the wealth management process. More importantly, focusing too narrowly on fees can mean missing out on investment opportunities that could help move a portfolio more closely toward an individual investor's unique needs.

1. "Index Funds Are the New Kings of Wall Street," The Wall Street Journal, 2019



MOVING BEYOND "ACTIVE VERSUS PASSIVE"

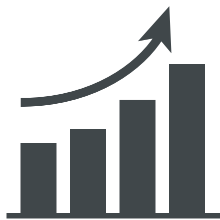
When fees drive the investment conversation, it's tempting to think about active and passive investing as mutually exclusive styles. As the thinking goes, you either support passive investing (say, investing in funds that are designed to mimic certain stock indexes) or active investing (investing in funds where portfolio managers make the decisions on what investments are included in the portfolio), but you can't support both.

But it's a mistake to think that way, according to Mike Sosnowski, director of advanced markets at Transamerica. "It's not a binary decision to be made by financial professionals or clients, even though I think that's become the norm," he says. "We need to change that conversation to finding the most appropriate mix of active and passive investments, given a client's individual circumstances." Indeed, Sosnowski says many investors can benefit from integrating both types of styles into their portfolio. To figure out the right mix, it's important to understand the typical risks and benefits of each approach.

It's important to understand the typical **risks** and **benefits** of each approach.

The standard way of understanding active and passive approaches is to think in terms of benchmarks. The passive approach is based on the idea that, over time, markets are efficient, so it's a better strategy to simply keep pace with a particular benchmark than to pay higher fees in hopes of beating it.

Many investors apply a similar logical frame to active investments: they assume that an active strategy attempts to beat a benchmark's returns by finding inefficiencies that the broader market misses. That perspective isn't entirely accurate, however. In reality, active investment strategies aim to maximize the opportunity for positive returns while also hedging against the potential for losses compared to a benchmark.



ALL ASSET CLASSES ARE NOT ALIKE

All other things being equal, a low-fee index fund could work for a long-term, buy-and-hold investor who wants to track the performance of large-cap U.S. companies. While that particular investor might benefit from a passive-only strategy, they likely want to look beyond large-cap stocks when building their portfolio. “If financial professionals intend to fine-tune their clients’ portfolios by diversifying across a broad array of asset classes, it’s important not to limit your choices artificially to, say, just 500 of the largest U.S. stocks,” Sosnowski says.

”It’s important not to limit your choices artifically to just 500 of the largest U.S. Stocks.”

-Mike Sosnowski, *Director of Advanced Markets at Transamerica*

Indeed, matching a strategy to an investor’s unique circumstances typically involves a mix of asset classes and styles that match their time horizon, risk tolerance, available funds, and financial goals. For some asset classes, there can be advantages in having the expertise and resources professional investment managers bring to the table. Consider fixed income investments. Bond markets are complex, and the lack of a transparent marketplace analogous to stock exchanges puts a premium on expertise. These markets also have lots of inefficiencies that active investors can exploit. “Fixed income is an area where active management actually has fared quite well, even during the recent decade-plus sustained bull market,” Sosnowski says.

Location matters, too: Investors seeking exposure to foreign stocks should consider that active managers have had material success when compared to passive strategies. And the proof is in the data: A recent Morningstar report comparing active and passive funds revealed that long-term excess returns among foreign-stock funds favored active strategies.[2] In other words, this is an example of an asset class that has been more target rich for active managers.

2. "Active Funds vs Passive Funds" Morningstar Research Services LLC., 2019

When it comes to financial advisors, it can be worth paying extra for personalized assistance — even though it may be tempting to go for the lowest-cost option.

Diversification is crucial to a well-balance portfolio.

Finally, the popularity of passive investments has arguably reduced their utility as a single solution for an investor's complex needs. Reason: The more investors who pile into the same relatively narrow set of passive investment opportunities, the less individualized those strategies become. In this way, active strategies can open investors to a comparatively broad universe of investment options. "As markets evolve, and especially as they become more volatile, it's essential to locate opportunities outside those core 500 companies to help control the level of risk in a given portfolio," Sosnowski says.

Diversification is crucial to a well-balanced portfolio. Understanding that there's a place for both active and passive strategies in a portfolio means an informed investor can take advantage of the best of both worlds.

FINANCIAL ADVISORS HELP LINK INVESTMENT DECISIONS TO FINANCIAL GOALS

Diversifying beyond the crowded positions in passive strategies can be daunting for the average investor, however. Experienced financial professionals can offer valuable assistance when it comes to connecting a client's goals to their investment strategies. For an individual investor, expanding the field of investment options means more research, which can lead to what Sosnowski calls "paralysis by analysis," which may in turn lead to sub-optimal decisions. "A lot of the time, people end up making decisions based on whatever comparative metrics they understand, whether that's a Lipper average or commissions and fees," he says. "They kind of throw up their hands and just click the mouse."

Diversification does not guarantee a profit or protect against a loss in a declining market.

When it comes to financial professionals, it can be worth paying extra for personalized assistance — even though it may be tempting to go for the lowest-cost option. In addition to understanding their clients' financial goals and building portfolios designed to reach those goals, financial professionals also can play a crucial ongoing role in their clients' lives. Long-term relationships with these professionals offer more information and more opportunities to use as a basis for adapting strategies to suit financial goals, whether they change slowly or rapidly. "Is a robo advisor going to be able to address legacy planning objectives or the nuances of family situations?" asks Sosnowski. "A human can offer a much more dynamic plan that takes more information into account and brings it all back to the client's long-term goals."

When financial professionals build deep relationships with clients, they can help them avoid making investment moves that ultimately hurt returns.

Financial professionals are also good insurance against drifting off course. Building a relationship with a human means a personal touch which can be useful in trying times. When these professionals build deep relationships with clients, they can help them avoid making investment moves that ultimately hurt returns. For example, some investors move in and out of passive investment vehicles, likely because they try to time the market and capture gains or avoid losses. That type of activity can seem tempting, but it often backfires. According to research firm DALBAR, market timing mistakes are a big reason why the average equity fund investor's 9.66% annual return underperformed the S&P 500's 13.12% annual return during the 10 years through 2018.[3]

A trusted financial professionals can help a client keep an eye on the big picture and stay the course, whether markets are rising, falling, or somewhere in between. "With the availability of various platforms to make quick investment decisions from a smartphone, it's more important than ever to make sure investors understand the broader strategy behind their portfolio and how it aligns with their objectives," says Sosnowski.

3. "Quantitative Analysis of Investor Behavior," DALBAR Inc., 2019

FOCUS ON YOUR PLAN

Instead of dividing the investing world into low-cost and higher cost solutions, think first about what you want from your investment plan. In short, let your goals drive the conversation around investment strategy, rather than fees. Limiting a portfolio to passive or active strategies can unnecessarily restrict your ability to build the diversified portfolio that best reflects your financial goals.

Fees are still an important component of any investment decision, however. It's important to make sure that when you do pay more, you get value for your money. Paying higher fees for an actively managed investment could be worthwhile if it helps diversify your portfolio into complex asset classes or helps generate a risk/reward equation tailored to your specific needs. A higher fee could also be worth it if it yields a financial professional who can offer expert advice about both passive and active strategies, and how they can work together to support your financial goals.

For more information on how Transamerica can fit into your clients' long-term financial plan, speak to a representative today at **866-505-3920**.

MIKE SOSNOWSKI, Director of Advanced Markets for Transamerica.

Mike joined Transamerica in 2008 and has over 20 years of financial services experience. He is a Certified Fund Specialist® (CFS®), Certified Financial Planner™ (CFP®), Chartered Life Underwriter® (CLU®), Chartered Financial Consultant® (ChFC®), Retirement Income Certified Professional® (RICP®), and graduate of Colorado State University. He holds FINRA Series 6, 7, and 63 registrations, as well as a Colorado life insurance license.

Important Information.
Investments are subject to market risk, including the loss of principal. Asset classes or investment strategies described may not be suitable for all investors. Past performance does not guarantee future results.

Fixed income investing is subject to credit rate risk, interest rate risk, and inflation risk. Credit risk is the risk that the issuer of a bond won't meet their payments. Inflation risk is the risk that inflation could outpace a bond's interest income. Interest rate risk is the risk that fluctuations in interest rates will affect the price of a bond. Investing in floating rate loans may be subject to greater volatility and increased risks.

Equities are subject to market risk meaning that stock prices in general may decline over short or extended periods of time.

Investments in global/international markets involve risks not associated with U.S. markets, such as currency fluctuations, adverse social and political developments, and the relatively small size and lesser liquidity of some markets. These risks may be greater in emerging markets.

Securities are distributed by Transamerica Capital, Inc. member of FINRA.
1801 California St., Suite 5200, Denver, CO 80202

© 2020 Transamerica. All Rights Reserved.
252038 10/20

TRANSAMERICA®
Insurance / Investments / Retirement