# ACTIVE OR PASSIVE

financial fitness

By Erik Ford

One of the contentious topics in investing for the last several years is whether active investing or passive investing is better for the individual investor. This article will not settle the argument, but, hopefully, provide the reader with some points to consider when making your investing decisions or listening to investment advice. We will keep to generalities for the most part for the sake of brevity while providing enough context and information to be useful for the average investor. This article will assume investing through mutual funds or exchange-traded funds (ETFs), which are the vehicles through which most individuals invest.

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The first question is what is the difference between active and passive investing? Active investing is what most people probably think of when they think of investing generally. The investment funds are invested by a portfolio manager or managers who take a hands-on approach to the active portfolio. Typically, there is a deep level of analysis by a research team into individual investments and the macroeconomic and political environment to provide a basis for decisions to buy or sell into or out of a portfolio. This approach comes with a cost through personnel, infrastructure, and trading costs. The latter can be surprisingly high if the portfolio manager is very active and trades frequently. These costs can be relatively high, and the goal of most active managers is to beat an identified benchmark (e.g. S&P 500) and do so after covering operating costs. Time has shown that beating target benchmarks can be difficult and elusive for even the best portfolio managers.

Passive investing does not strive to beat its comparable benchmark, but to match it as close as possible less minimal costs. Costs of passive investments are generally much lower because they do not have the manager or personnel, research or trading costs of an active portfolio. For example, if a passive fund is benchmarking off of the S&P 500, then its holdings are defined by the third party that defines the index and trades are only necessary when there is a change in the index or money is added to the fund. There is no need for research or strategic decision making, greatly reducing costs. The appeal of a passive strategy is that since beating the market is so difficult, minimizing expenses and matching the market is better in the long run.

The potential merits of active investing are that they can provide returns in excess of their benchmark (after expenses) and can make strategic decisions as market environments change. While they can provide excess returns, history says that it has been difficult. Active managers that consistently beat their benchmark over time are a minority and as the time period measured is longer, that minority shrinks. The environments that tend to be more favorable to active management are periods of market disruption and market sectors where information is not as widely available. For example, data on domestic large-cap stocks are quickly dispersed and easily obtained. That category has proven very difficult for active managers to beat benchmarks (although not impossible). On the other hand, a niche category such as micro-caps or emerging markets, where public information is not as widely available, may provide better opportunities for active managers and the results tend to bear this out.

On the passive side, investors benefit from fully participating (less very small costs) in the market's performance (based on the index targeted), both up and down. Matching the market or index while it is rising may be very satisfying, but also matching it on the way down can be disappointing. Passive investments do not use hedges to protect their assets or increase cash allocation during market disruptions or turmoil. Investors get all the upside, but also all the downside.

There are also alternatives that fall in between the active and the passive. These hybrid strategies take elements from both, using a combination of algorithms and active manager decisions to construct and manage a portfolio.

So, what should the investor do? Without the benefit of hindsight (which would make investing much easier), there are good reasons to include both types in a diversified portfolio. The passive investment alternatives provide a good core to a portfolio with low costs that will follow the selected market sectors, but not provide any reduction in volatility beyond what is achieved through diversification. Augmenting that core with active strategies to access niche market sectors, including a specific strategy or a favored star manager is one way to blend the two methods. There are those that are committed to active management and those who are equally committed to passive management. Views can be passionate on this topic. How you incorporate these into your own investment program is a personal choice, but understanding the differences is a place to start.

Investing involves risk. Depending on the types of investments, there may be varying degrees of risk. Investors should be prepared to bear loss, including total loss of principal.


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