Active vs. Passive

Having studied investments for 25 years I can honestly say I have learned a lot. Through it all I have always tried to learn from my mistakes and constantly adapt the way I invest. I have made mistakes but they have gotten smaller and smaller as I hopefully have become more astute. It is in light of this, that with great enthusiasm, I bring to your attention the debate about Active vs. Passive management.

Active management refers to a mutual fund that employs a professional manager to hand pick stocks to put into our portfolios. There have been many famous active portfolio managers but for example perhaps none more famous than Warren Buffet.

Passive management on the other hand is when you buy an "index" such as the S&P 500 and track the market. You are not trying to pick the "best" stocks in the S&P 500 but rather participating in the ups and downs of the market as a whole. There is likely no greater advocate for passive investing than John Bogle the founder of Vanguard Investments. John's contention was that it is extraordinarily difficult to beat the averages year after year. Eventually the challenge of outperforming the index will be too difficult in large part due to the extra expenses that actively managed funds charge as well as other factors.

I have always been in the camp that active money management has an advantage. An active manager who has dedicated his life to researching investments, backed by teams of analysts and researchers, should have an advantage over simply buying the index regardless of the extra expense of their salary.

I have read countless articles debating the auspices of both strategies. For years I have internally debated about moving to a passive strategy but some of our active managers have really been positive. Others have been fabulous only to fall flat after years of outperformance.

I recently read an article that truly inspired me. It was titled Active "and" Passive. It struck a chord with me that helped me see the debate in a whole new light. Portfolios do not need to be black or white but rather can have elements of both Active and Passive management.

Active management has been shown to shine in less transparent asset classes such as small company stocks or less covered regions such as emerging markets. Typically “focused” funds that invest in a smaller amount of positions also have a better chance of outperforming a passive portfolio.

Where passive portfolios are best employed is for big blue chip companies such as those found on the S&P 500 or large foreign companies. The lower costs of indexing along with other factors such as tax efficiency, low turnover and holding no cash all make indexing appropriate for these assets.

Our portfolios will use this approach. At the heart of the portfolio we will have very low cost indexes that track the broader markets and surrounding these we will have active managers for our small company and other select sector investments.

One caveat to this strategy is bonds. I strongly believe that in the less fluid bond markets, an active manager can give you a decided advantage. The Bill Grosses of the world can make a difference with their expertise, teams of analysts and buying power. I believe the small added expense is worthwhile. Bonds are not as easily bought and sold on an exchange as are stocks. They are much less liquid and require a professional buyer. That is not to say we won’t be using any indexes for bonds but much less than with stocks.

I hope you found this to be intelligible and welcome any questions or concerns you may have.

Yours Truly,

Steve