Active & Passive Investment Management

What do each of these terms really mean?

Investment management can be active or passive. Sometimes, that simple, fundamental choice can make a difference in portfolio performance.

During a particular market climate, one of these two methods may be widely praised, while the other is derided and dismissed. In truth, both approaches have merit, and all investors should understand their principles.

How does passive asset management work? A passive asset management strategy employs investment vehicles mirroring market benchmarks. In their composition, these funds match an index – such as the S&P 500 or the Russell 2000 – component for component.

As a result, the return from a passively managed fund precisely matches the return of the index it replicates. The glass-half-full aspect of this is that the investment will never underperform that benchmark. The glass-half-empty aspect is that it will never outperform it, either.

When you hold a passively managed investment, you always know what you own. In a slumping or sideways market, however, what you happen to own may not be what you would like to own.

Buy-and-hold investing goes hand-in-hand with passive investment management. A lengthy bull market makes a buy-and-hold investor (and a passive asset management approach) look good. With patience, an investor (or asset manager) rides the bull and enjoys the gains.

But, just as there is a potential downside to buy-and-hold investing (you can hold an asset too long), there is also a potential downside to passive investment management (you can be so passive that you fail to react to potential opportunities and changing market climates). That brings us to the respective alternatives to these approaches – market timing and active asset management (which is sometimes called dynamic asset allocation).

Please note that just as buy-and-hold investing does not equal passive asset management, market timing does not equal active asset management. Buy-and-hold investing and market timing are behaviors; passive asset management and active asset management are disciplines. (A portfolio left alone for 10 or 15 years is not one being passively managed.)

Active investment management attempts to beat the benchmarks. It seeks to take advantage of economic trends affecting certain sectors of the market. By overweighting a portfolio in sectors that are performing well and underweighting it in sectors that are performing poorly, the portfolio can theoretically benefit from greater exposure to the “hot” sectors and achieve a better overall return.

Active investment management does involve market timing. You have probably read articles discouraging market timing, but the warnings within those articles are almost always aimed at individual investors – stock pickers, day traders. Investment professionals practicing dynamic asset allocation are not merely picking stocks and making impulsive trades. They rely on highly sophisticated analytics to adjust investment allocations in a portfolio, responding to price movements and seeking to determine macroeconomic and sector-specific trends.

The dilemma with active investment management is that a manager (and portfolio) may have as many subpar years as excellent ones. In 2013, more than 80% of active investment managers outperformed passive investments indexing the S&P 500 (which rose 29.60% that year). In 2011, less than 15% did (the S&P was flat for the year).[1,2]

The two approaches are not mutually exclusive. In fact, many investment professionals help their clients use passive and active strategies at once. Some types of investments may be better suited to active management than passive management or vice versa. Similarly, when a bull market shifts into a bear market (or vice versa), one approach may suddenly prove more useful than the other, while both approaches are kept in mind for the long run.

Contact us for help in retirement planning.

Citations.

1 - forbes.com/sites/investor/2015/03/30/active-versus-passive-management-which-is-better/ [3/30/15]
2 - macrotrends.net/2526/sp-500-historical-annual-returns [2/2/17]