Active vs. Passive Investing? Consider Pairing the Two Approaches

The debate that pits an active approach to investing -- buying and selling securities in an attempt to outperform the market -- against a passive investment style that simply follows the ebbs and flows of a given market index has been argued in the investment world for decades.

Even if you are an investor who favors active management, it may make sense to hold a blend of active and passive funds to help lower your overall portfolio expense ratio.

While purists in either camp will hold fast to their respective beliefs, a more reasonable approach may be to consider holding both types of funds to help address multiple investment objectives.

Active vs. Passive, By Definition

Active investors believe in their ability to outperform the overall market by picking stocks they think will perform well. Passive investors, on the other hand, feel that simply investing in a market index fund will produce higher long-term results. Passive investors believe this is due to market efficiency. In other words, they feel that all information available about a company is reflected in that company's current stock price, and it is impossible to predict and profit on future stock prices. Rather than trying to second-guess the market, passive investors buy the entire market via index funds.

Active investors counter that the market is not always efficient and that through research, active fund managers may be able to uncover information not already reflected in a security's price and potentially profit by it. For example, some active investors feel that the small-cap market is less efficient than the large-cap market since smaller companies are not followed as closely as larger blue-chip firms. A less efficient market could potentially favor active stock selection, they reason.

Current Performance Comparisons: A Mixed Bag

A review of the current S&P Indices Versus Active Funds (SPIVA®) U.S. Scorecard, a well-respected resource in the active-versus-passive debate, may help add perspective to the issue.

For the year ended December 31, 2013, the domestic equity markets as represented by the S&P 500®, S&P MidCap 400®, and S&P SmallCap 600® posted record-breaking 32.39%, 33.5% and 41.31% gains respectively.[1] By comparison, results are mixed for active domestic equity managers. For instance, according to the report, 55.80% of actively managed large-cap funds and 68.09% of actively managed small-cap funds underperformed their above-mentioned benchmarks.[1] The exception? Active midcap funds, 61.03% of which posted better returns than their S&P MidCap 400® benchmark.[1]

When 2013 performance was broken down according to investment style (e.g., growth versus value), with the exception of small-cap growth funds, actively managed growth funds in the large-cap, midcap, and multi-cap categories all bested the returns of their respective benchmarks.[1]

Viewed over longer three- and five-year time periods, the data showed that the majority of active managers across all the domestic equity categories underperformed their respective benchmarks.[1]

Takeaways for Investors

If you'd like to reap the potential benefits of both an active and an index-based approach to investing, you may want to consider the following strategies.

Consider index funds for efficient markets, active management for less efficient areas. Proponents of index investing tend to believe that there is no proven way for an active manager to beat the market over long periods of time. Others hold fast to the notion that through proper due diligence, active fund managers can find pockets of inefficiency -- parts of the market that do not trade as actively or that investors pay less attention to than other areas -- to capitalize on. Historical market data shows that regardless of the time horizon, one area where active managers have tended to beat the market most frequently is international small-cap equity.[1]

Two approaches to managing portfolio risk. When the broad market turns volatile, adding a defensive, actively traded fund to a portfolio of index holdings potentially may help to smooth out bumps and moderate overall portfolio risk. While you may sacrifice some upside performance when the market rallies, you may also help to manage downside risk when the market slides. Alternatively, passive investors can potentially build risk management into their portfolios by diversifying among a range of index funds covering a wide, varied swath of the market.

Use a passive/active blend of funds to manage portfolio expenses. Active funds tend to charge much higher annual expenses than their index-based cousins. For instance, as of December 31, 2012, the average dollar-weighted expense ratios of actively managed domestic large-cap, midcap, and small-cap funds was 0.82, 1.00, and 1.07 respectively. By comparison, the index versions of these fund categories charged 0.11, 0.19, and 0.23 respectively.[2] Even if you are an investor who favors active management, it may make sense to hold a blend and active and passive funds to help lower your overall portfolio expense ratio.

Sources:

[1]S&P Dow Jones Indices, "S&P Indices Versus Active Funds (SPIVA®) U.S. Scorecard," March 20, 2014.

[2]Vanguard, "The case for index-fund investing," April 2013.

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