Who is better at investment decisions – humans or computers

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For those of you not versed in the lingo of investing, active management traditionally refers to mutual fund type investments in which a “manager” picks stocks that he/she thinks will do better than others.

The manager might buy Ford stock rather than GM stock, feeling that research suggests Ford has a better financial future. There are a legion of articles comparing these actively managed funds to “passively” managed ones (passive referring to a computer just buying all of the stocks in any given index (say the S&P 500) without any effort to pick out one over another. In response, “passive” funds are absorbing large amounts of investors’ cash over the last year.

As in much of life, how true the statement that active management is inferior to passive management “depends.” I’d back up here and note that virtually every single investor and advisor is an active manager. The very first decision on investing is the decision of how much to keep in cash, how much to fixed income and then how much to stocks. The second decision is which fixed income and which stocks. I’d argue strongly that both of these decisions are all “active” management. It is actually possible now to buy cheap funds that literally own the world’s fixed income and stocks in roughly the proportion of their value, but almost no one buys them. If you don’t (and you don’t), you have had some active management in designing your portfolio.

Second, it is very hard to compare actively managed funds to passively managed funds in many instances. Here’s a couple. If the actively managed fund contains investments from more than one particular index, it becomes almost impossible to compare returns. Seeing a balanced fund of global stocks and bonds being compared to the S&P 500 stock index is unfair and unwise. But you will see it all the time.

Actively managed funds may have different risk profiles than their passively managed competitors. For example, a fund manager fearing a market drop might be holding significant cash while the passive fund remains fully invested. These two funds have different “risk adjusted” profiles — for both the upside and downside.

There are also clearly markets in which active management may be a superior strategy. These markets are those which are not “efficient.” These would be markets that are smaller and outside of developed economies. Having some research and local exposure may indeed supply an investing advantage.

It is probably fair to say that in large efficient markets like the US, that a passive fund investing in a well known index like the S&P 500 will usually outperform most actively managed funds investing in the same stocks. Fair enough. But before we throw out all active management, it is only fair to know that we all start out doing this ourselves.

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