Active? Passive? What does that mean when it comes to investment funds?

NEWS

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Guest columnist

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Q: I'm reading that a smart investor only uses "passive" funds — what does that mean?

A: A short answer is that "passive" investment funds use computers and algorithms to pick their contents. They usually try to buy many stocks or bonds in a given index, and do not use a manager to try and pick out individual securities that might beat others (the "active" approach).

However, the terms active and passive are misleading. Every investor must make regular active management choices. One such choice is an initial asset allocation. Choices that follow involve the behavior in response to market movements.

Even if using low-cost, diversified passive index funds, the initial asset allocation might involve the active inclusion or exclusion of asset classes based on valuation, geography, or timing features. About one half of the world's stock market capitalization exists outside of the United States. A truly passive equity allocation would reflect this, but I suspect that a very small percentage of "passive" portfolios" have anywhere near a 50% allocation overseas. These "benchmark" portfolio managers have therefore made an active choice to allocate assets with a domestic tilt for reasons of their own. Delving deeper, it is unlikely that "passive" foreign equity allocations actually correspond directly to stock market capitalizations or other indexing features, but instead reflect the portfolio managers' bias towards those markets.

Therefore, I'd argue that a prudent investor (professional or amateur) is always an active manager of asset classes. The asset classes invested in themselves may use otherwise "passive" vehicles such as index funds or ETFs.

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But often, some of the asset classes invested in may use actively managed funds when the asset classes investment choices are not available as representative indexes. There is also a good argument that in markets that are smaller (for example, some small country stock or bond markets), an active approach might pay off. Larger markets (think the U.S. and Europe) have so much more information available about their securities that an active choice is unlikely to outperform just owning the large index itself.

A prudent investing approach might use passive style index funds and ETFs for all asset classes that have suitable choices, and add actively managed funds for asset classes that have poor index type choices (foreign real estate, timber, and until recently, commodities).

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You might also split your investments between active and passive styles in smaller country markets or even in small U.S. companies. You should recognize that you are always making active choices in terms of how much of each asset class goes into the portfolios. How you respond to various asset classes as they move up and down in price is also an active process.

We believe that clients should understand the difference between our making active choices in portfolio composition vs. "active" management *within* an index. The active management of portfolio composition is value added and universally necessary, while we feel that much of the active management inside of many indexes is costly and not ultimately rewarding.

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