A Review of Passive vs. Active Management

Should you be a passive index investor or an active stock picker? There are competing schools of thought. One is that a passive index fund is just as good as an actively managed fund, if not better. The other is that managers can have a positive effect and it is good to pay for that expertise.

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Not Black and White

The truth, as it happens, is not so black and white. It is possible to pick individual stocks and bonds, or broad classes of assets, and do well. Many investors put their money in mutual funds, and aside from index funds, the management is usually active. That means the manager is picking individual securities or groups of securities, and putting the money where they think returns will beat the relevant market.

The key thing to remember is that there is a difference between the effect asset allocation has on fund variability, absolute returns and the volatility of the fund itself. The short version is that asset allocation—what kind of securities are in the fund and their respective weighting—accounts for the lion's share of variability. Variability is the amount that one's returns differ between funds. An oft-cited paper by Gary P. Brinson, Randolph Hood and Gilbert L. Beebower was the first to quantify the effect, in 1986. They found that about 93.6% of the variability was due to the allocation, and that active management actually hurt returns, costing the average pension plan 1.10% per year.

To put that in perspective, the mean average return over the 10-year period Brinson, Hood and Beebower used (1974-1983) was 9.01%, whereas the benchmark portfolio returned 10.11%. So, active management seems to cost. But that is not always the case. The study goes on to further explain this complex topic, which includes a review of active managers that do add value.

The Difference

The difference, it appears, was the kind of active management used. Selecting broad asset classes and weighting them a certain way seemed to beat picking individual securities. That is, the various kinds of securities one might have (stocks and bonds for most investors, with a smattering of cash) can all move differently in the same market. That means if you want returns, you want to allocate your assets in an effort to minimize the downside and maximize the upside.

This does not mean, however, that one can ignore the management of the fund and just plug in a certain percentage of stocks and bonds. The investing world is more complex, and later studies showed that stock picking can work. Notably, in their 2006 paper, Craig French and Daman Ko looked at hedge fund returns and compared them to the S&P 500® Index.

They found that hedge fund managers can and do show skill in picking stocks or allocations, and sometimes the returns reflect that. But while a few managers excel at those two skills, market timing (i.e., accurately choosing when to invest and divest) was something nobody did particularly well. That means that if you are looking at whether a manager is a good one, and provides returns in addition to the market, it is probably better to ask about how they build strategies based on picking stocks or picking weights of asset class, rather than how well they timed the investment.

In fact, an index fund generally will not match the performance of an index because of transaction costs. So if you're worried about matching the market, an index fund is not the way to do it, though index funds will generally get very close to the market return since index fund expenses are generally very low compared to actively managed funds. Aside from transaction costs, the reason index funds slightly "underperform" is that it is difficult for an index fund to perfectly represent the entire market.

Past performance also is not the only way to pick a manager. "I think it is certainly safe to say that passive investing works, but active management can outperform," French says. Past performance is not the only way to find a skilled manager: Jones and Wermers (in a 2011 study) suggest four potential criteria for identification of superior asset managers:

- Past performance
- Macroeconomic correlations
- Fund/manager characteristics
- Fund holdings - Security Selection

That can be a complicated comparison for most investors to do without the help of an advisor.

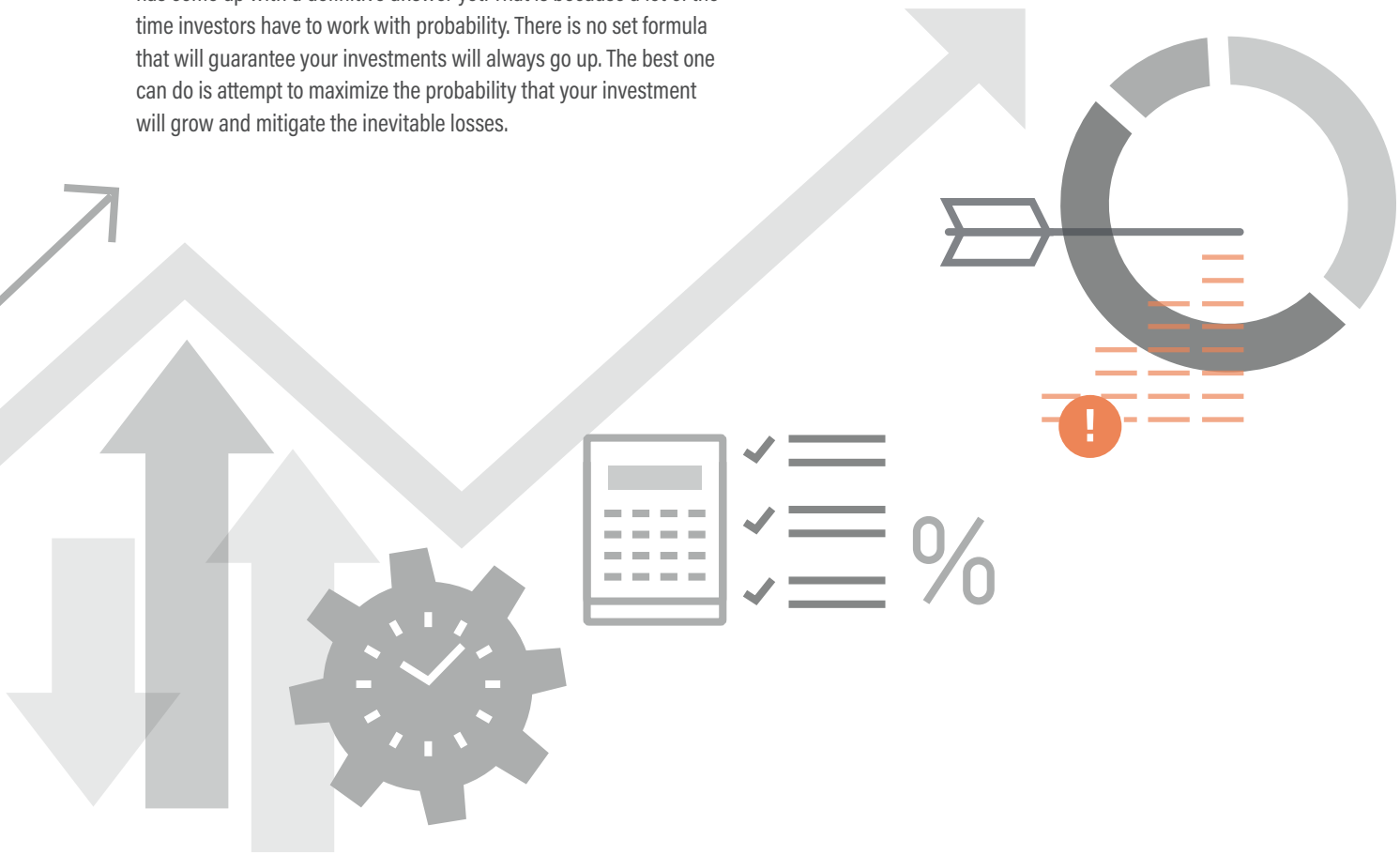
French notes that even as far back as the 1970s, there have been attempts to separate "luck" from "skill" in managing funds. Nobody has come up with a definitive answer yet. That is because a lot of the time investors have to work with probability. There is no set formula that will guarantee your investments will always go up. The best one can do is attempt to maximize the probability that your investment will grow and mitigate the inevitable losses.

Conclusion

Active management has potential to add value, and active funds have a place in a carefully balanced portfolio. But it's important to bear in mind that active management brings with it a wider range of potential risks and generally higher expenses, with a greater likelihood that performance will deviate from the index.

A long-term approach to investing and the advice of a professional can help investors build a portfolio that properly balances risk and reward while accounting for the investor's particular goals and resources.

The best one can do is attempt to maximize the probability that your investment will grow and mitigate the inevitable losses.



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