



## Active versus Passive Investing

There are two distinct approaches that can be taken to invest in asset classes: active or passive. *(These definitions can apply to any investment, but for simplicity we will use stocks here.)*

### What's the difference?

Passive investing is the effort to capture market returns as efficiently as possible by using a low-cost, broadly diversified portfolio of stocks.

Active management is an attempt to generate returns that are higher than the broad market through stock selection, frequent trading, and market timing. In simple terms, it's trying to "pick the winners" to "beat the market."

The active approach is a path taken by millions of people. The common method is to pay someone to pick the future winning stocks (a manager), often through a mutual fund or separate account manager.

### What are the failings of active management?

Long odds – Over four decades of research has consistently shown that most actively managed portfolios **do not** produce better long-term results than a passive approach. The website for the U.S. Securities and Exchange Commission (SEC) provides a good summary in this regard:

*"In any given year, most actively managed funds do not beat the market. In fact, studies show that very few actively managed funds provide stronger-than-benchmark returns over long periods of time, including those with impressive short term performance records." (<http://www.finra.org/investors/mutual-funds>)*

Winners don't repeat – Although most active managers underperform, some do better than the market. Shouldn't we utilize proven winners? Unfortunately, substantial research shows that **few winners repeat their success**. In other words, the past tells us very little about who will win in the future. For example, Standard & Poor's Persistence Scorecard measures the ability of a fund manager or strategy to deliver above-average returns consistently over multiple periods. From the December, 2016 scorecard:

*All investments have the potential for profit or loss. Past performance does not guarantee future success.*

*"It is worth noting that less than 1% of large-cap funds and no mid-cap or small-cap funds managed to remain in the top quartile at the end of the five-year measurement period."*

*(<http://us.spindices.com/documents/spiva/persistence-scorecard-december-2016.pdf>)*

Skill or luck? – Unfortunately, research suggests that luck may have a much larger impact on stock picking than we imagine. A [2010 study](#) reviewing U.S. stock funds over a 30-year period estimated that a mere **3% of active funds appeared to demonstrate any skill**. [Another study](#) from 2008 examining nearly 2,100 funds over 30+ years came up with a slightly lower estimate of skill – 0.6% (after expenses). Even the authors of the study expressed surprise, with professor Russ Wermers describing the prospect of picking a winning fund **"almost hopeless."**

These are just some of the problems that plague an active investment approach. Other issues include concentrations of risk (fewer securities), tax-inefficiency, changing investment styles, fund management changes, lack of portfolio transparency, and the financial drain of increased fees. Taken together, these disadvantages are nearly insurmountable for an active approach.

### ***Why does active management fail?***

Market efficiency – Inherent in an active investment approach is the notion that markets are *inefficient* – meaning stocks are priced incorrectly and mistakes can be exploited for a profit. There is a logical problem here: If markets are inefficient and pricing errors are prevalent, it's not clear that prices would be corrected in a reasonable timeframe to generate above-average profits. In other words if markets can't set prices correctly, it won't do any good to find "mispriced" stocks.

The idea that markets are actually quite good at setting prices goes back to the 1800's, and it has been the focus of academic research for over a century. The research shows that markets do a decent job, and even most active managers will acknowledge that markets are reasonably efficient. Markets may not set prices perfectly, but they do it well enough to make it *exceedingly* difficult to systematically "beat the market."

In the words of the Chief Investment Strategist at one of the largest active investment firms:

*"Let me start with a common sense observation about market efficiency: It is clearly hard for active managers to outperform the market, which has been true for as long as anyone has tracked the results of active managers."*

*– Michael J. Mauboussin, Legg Mason Capital Management*

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Cost – Active management is expensive. The research staff, data services and trading costs for active stock picking add significantly to investment expenses. According to the [2018 Investment Company Fact Book](#), the average **annual expense ratio of actively managed stock funds is 0.78%** despite having dropped over recent years, while the **annual expense ratio for passive stock funds is 0.09%** on average. These expense numbers do not include the impact of frequent trading, which has more of a hidden impact. According to the Dimensional [2018 Mutual Fund Landscape](#), “Equity trading costs, such as brokerage fees, bid-ask spreads, and price impact, can be just as large as a fund’s expense ratio.” Altogether these costs create a significant hurdle for active managers each and every year, and it directly reduces investors’ net returns.

### ***Passive Wins***

Hope springs eternal, and many of us like to think we are above average (or can at least find someone that is above average) in most pursuits. This is also true when it comes to picking investments. However, the evidence just doesn’t support this concept. Academic researchers, including multiple Nobel Laureates in Economics, have overwhelmingly supported a passive approach as the most logical way to pursue investment returns.

### ***Implementation***

A common way to implement a passive investment approach is through the use of index funds, which mirror a broad market benchmark (a common example being the S&P 500 index). These funds are very useful in capturing the returns of broad economic forces in a given market, and we utilize them in many portfolios. Firms such as Vanguard and Fidelity offer extremely cost effective index products.

A more unique manner of passive investing that we often incorporate in portfolios is provided by [Dimensional Fund Advisors](#) (DFA). This institutional investment firm incorporates strategies backed by academic research which are designed to enhance results. For example, factors such as company size and value/growth measures have been shown to produce different long-term stock results, and DFA adjusts stock portfolios for these characteristics. DFA also focuses closely on how securities are bought and sold and avoids the use of commercial indexes, all in an effort to minimize costs. The goal is to deliver the performance of broad capital markets along with improvements through portfolio design and trading efficiencies.

### ***Summary***

Randomness, unpredictable behavior and unexpected events all make it difficult to predict the future consistently. This is essentially what active stock pickers try to do, and their track record is abysmal.

Studies have regularly shown that investment returns are provided by markets, not by people trying to outsmart markets. Such efforts have generally had a negative impact for investors and favored only the active manager. The most reliable way to invest is to capture as much market return as possible by using a diversified, low-cost, passive approach.

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