Active vs. Passive Investing

There are two basic approaches towards investing monies. These two approaches, known as active and passive management, come with unique characteristics as well as their own distinctive benefits and drawbacks. This month’s financial article will focus on the details of these two investment approaches.

Active management is a “hands-on” approach to managing monies where an investment professional, or a team of investment professionals, manages investment dollars towards a stated objective. Examples of this objective may be “long-term growth of capital” or “providing a sustainable income”. There is a thought process and rational for each investment decision made by the investment manager. Decisions to buy, sell, or hold an investment in a portfolio is based on the objective of that fund.

Passive investing, on the other hand, is a laissez faire “hands-off” approach where dollars are invested in order to mirror an index’s performance. Stated another way, passive management’s goal is simply to replicate a given market’s composition, not a stated investment objective. Since an index cannot be invested in directly, passive investing seeks to mimic the results of an index.

There are advantages and disadvantages of each investment approach that should be carefully considered before investing. Fees, taxes, and manager discretion are all aspects that should be considered when deciding between hiring an active or passive manager.

Investment fees are an important difference between these two investment approaches. Active management has actual human people making investment decisions in the portfolio, and there is an inherent cost associated with human capital. With passive investing, there are generally no “brains” behind the operation as the portfolio allocation is simply set to mirror an underlying index. Passive investing is generally a more cost effective approach.

Since an active manager seeks to achieve clearly laid out objectives, they will buy and sell securities in order to try and achieve those goals. This may cause a taxable capital gain distribution if underlying investments in that portfolio are sold for a profit. There tends to be more trading or turnover within an actively managed account, generally making it less tax efficient. With passive managers, being the goal is simply mimic an index, there tends to be less turnover and therefore tends to be more tax efficient.

Manager experience and judgment should also be considered. When employing an actively managed strategy, the manager is buying, holding or selling securities based on a stated objective. A manager has the discretion to make decisions and has greater control over the holdings within an actively managed account. This may, or may not, provide better risk adjusted returns over passively managed funds. It is important to understand the manager’s approach and track record in correctly evaluating securities.

Which investment approach is better? The stated investment goal of the investment portfolio should be considered in context to your overall goals and investment objectives. Set your objectives and expectations clearly from the start. If your investment objective is to match investment results of a given index, passive management may be best, but remember, indexes don’t have an inherent objective. If your objective is better defined in the context of an actively manger’s stated investment objective, and that manager has shown a successful track record, active management may be a better alternative.

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