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Active vs. passive investing: Which strategy is best for you?

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With billions of dollars worth of asset management fees at stake, a vigorous debate is raging about which asset management strategy is best, active or passive.

Through your employer's 401(k) plan, there is a good chance you have access to both. Here are some important things to consider before deciding what's right for you.

While active investment managers spend hundreds of millions of dollars advertising their ability to outperform by picking winners and avoiding losers, the majority are not successful. Over longer periods of time, and after deducting their fees, only about 4 out of 10 active managers have been able to deliver on their promise of outperformance, according to Morningstar data.

Passive strategies, on the other hand, advertise that they do not seek to outperform the market, but simply replicate its return. But it's important to understand that, because they're run by computer algorithm and allocate capital based primarily on a company's size, passive strategies historically have been more volatile because they saddle investors with overvalued securities as share prices are blindly bid higher, then endure sharp sell-offs as an economic cycle rolls over.

Advantages of each

Active strategies offer investors risk controls that passive strategies simply do not provide. They employ the professional judgment of seasoned experts to allocate capital and avoid excessive risk.

If you are overly sensitive to market losses, sticking with active strategies, while not preventing you from experiencing losses, should provide an added "sleep at night" benefit.

Also, active strategies generally are more effective in less efficient markets, like emerging markets or high yield bonds, where theoretically it is easier for professionals to find mispriced securities and add value.

Of course, as economist Burton Malkiel hypothesized in his 1973 book, "A Random Walk Down Wall Street," as more capital starts chasing these inefficiencies, any market can become too efficient for most to consistently outperform.

Passive strategies are highly automated and therefore much less costly to execute than most time and manpower-intensive active strategies. This gives passive strategies a distinct cost advantage.

Another advantage passive funds have over actively managed funds is less obvious. It's called the "free ride" effect, which describes how passive investors benefit from the hard work of active investors without paying for it.

Key to the persistence of this advantage is that active management remains the dominant strategy. As long as it does, share prices should continue to be driven primarily by active managers' profit-seeking motive.

Investor stampede

Because active strategies tend to outperform during difficult market environments while passive strategies tend to do better during bull market periods, like the one we've been in for the past five years, recent investor activity is best described as a stampede into passive strategies.

An article that appeared in Value Investor Insight in February, "The Triumph of the Index?" claimed that, while a meaningful majority of all invested money is still actively managed, a whopping 98% of net flows into equity funds for 2014 was directed into index funds.

In April, the Wall Street Journal's Jason Zweig cited research from Morningstar estimating that, over the last five years, investors have redeemed $73.6 billion out of "active" U.S. stock funds while allocating $208.8 billion into "passive" index funds.

As a result, the passive fund industry, once a cottage industry, has mushroomed into a huge business controlling over $5 trillion and 26% of all professionally managed assets, by Morningstar's estimates.

What's right for me?

Given that over long periods of time markets generally go higher, and passive strategies tend to outperform in rising markets, one can argue that long-term investors should be better off with passive strategies. I believe all portfolios should contain some exposure to passive strategies.

You cannot ignore, however, the reality that investors can be emotional when it comes to their money, and many desire the feeling of safety that comes from knowing there are professionals with risk controls guiding their portfolio in times of turbulence.

Also somewhat paradoxically, because passive strategies allocate capital based primarily on a company's size, not its expected future profitability, the more assets that are invested passively, the easier it should become for active strategies to outperform.

For these reasons, I am a strong advocate of all portfolios containing at least some exposure to active investments as well.

Finally, it is worth noting that many 401(k) plan sponsors hire experts to assist in the selection, monitoring, and de-selection of their plan's funds. A disciplined oversight process can meaningfully increase the odds of finding active strategies that beat their index.

Average investment management fees

Passive strategies are highly automated and therefore much less costly than most active strategies.

	ACTIVE	PASSIVE
Intermediate term bonds	0.39%	0.08
Developed international	0.78	0.13
Domestic large-cap	0.58	0.05
Domestic small-cap	0.96	0.09
Emerging markets	1.09	0.14

Source: Francis Investment Counsel — Journal Sentinel

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