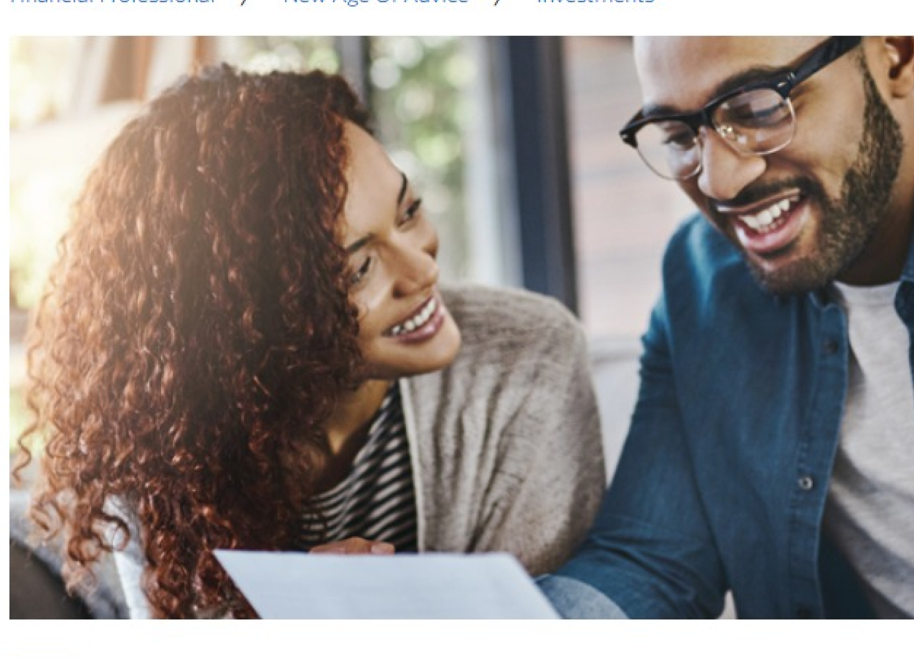

INVESTMENTS

Active or Passive Investing? We Say Both

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Why It Matters:
- Suitability should drive every aspect of investment planning and advice.
- Using only one strategy may limit your potential client base.
- By using both strategies, you can better leverage all asset classes.

Active or passive investments — that's the choice, right? Well, it doesn't have to be.

The financial industry has hotly debated the topic for years and some professionals strictly adhere to an either/or approach. Yet similar to picking specific investments, the client's needs should be your foremost consideration when determining an overall strategy. Active *and* passive investment options could be included in the conversation, depending on the client. More on that soon, but let's grab a quick refresher on both investment strategies before diving in.

Active investing

Active investment management is, well, active. Active fund managers closely monitor the prices of securities and trade in and out of positions as frequently as their fund's strategy dictates. The goal is to outperform a stated benchmark of similar assets, often times an index, like the Standard & Poor's 500® (S&P 500). Many people believe active investment is all about beating a benchmark, but in reality it's more about gaining as much upside as possible while also hedging against losses in comparison to the benchmark. Investors in an active fund are buying the underlying assets and the asset manager's expertise.

Passive investing

Passive investing is sometimes thought of as a set-it-and-forget-it strategy. In passive investing, the fund manager doesn't target specific securities, but rather attempts to mimic the returns of a stated strategy or index by purchasing securities in like proportions. For instance, a popular passive investment strategy is to mirror the S&P 500, wherein the fund manager buys stocks from the largest 500 companies in the United States and expects similar market returns. The passive investment strategy is based on the philosophy that markets are always efficient and a security's price always reflects its true value. Professionals who prescribe to this philosophy believe you cannot beat the returns of the market.[1]

Investing for the client

Your client's needs should help you determine which strategy is the best option for them—and sometimes the best option is a mixture of both strategies. If you focus on your client's needs first, you'll be more likely to provide a strategy that helps the client achieve future goals.

Consider that certain asset classes and sectors have traditionally done better when actively managed. For example, over the past 10 years, actively managed small cap funds focused on developed markets outside North America have done better than their counterparts roughly 85% of the time. [2] Similarly, the median active bond manager has outperformed the median passive bond manager by more than 50 basis points.[3]

Yet if your client is highly averse to fees and okay with market returns, a passive strategy may work best for them. Passive strategies tend to have lower fees because passive management requires less frequent trading and securities research[1]. Active managers must pass on the cost of trading and research to shareholders.

Advisors generally have access to the same investment options. Your process for assessing those options and assembling a portfolio is what makes your advice valuable. Consider the following as you weigh which strategy is appropriate for your client:

- Look for high-conviction managers who are committed to their stated strategies.
- Monitor tracking error to see how far from the stated benchmark a manager tends to move.
- Concentrate on risk profiling, including a thorough analysis of quantitative risk measurements and a deep understanding of each client's unique circumstances.

Of course these are just some of the considerations you should take into account when assessing which strategy is right for a particular client. Whichever techniques you apply in your analysis, remember there is no one-size-fits-all solution for financial advice and your clients will always benefit from a comprehensive assessment of all options.

Things to Consider:

- Create a thoughtful risk profiling system to help match clients to strategies.
- Analyze your book to ensure your clients are in the best strategy for their needs.
- Educate your clients about each strategy so they can make better investment choices.

1. "Stock Market Strategies: Are You an Active or Passive Investor?", Scott Wolla, St. Louis Fed, 2016

2. "Bonds are Different: Resolving the Active vs. Passive Debate," PIMCO, 2018

3. "Here's Where Active Management Actually Works," Institutional Investor, April 2019

4. "Bonds are Different: Resolving the Active vs. Passive Debate," PIMCO, 2018

Securities have investment risks, including possible loss of principal.

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