MCDONNELL CAPITAL MANAGEMENT

insights

Active vs. Passive Investment Solutions

Christopher J. McDonnell, CFP®, AIF®

What's all this I read about low cost (passive) investment solutions?
Passive management refers to investing in indices that are equally weighted in a particular asset class. An example would be an S&P 500 ETF that is *equally* invested among all 500 companies in the S&P 500. Academics and institutions typically prescribe to the tenants of passive management. Passive management subscribes to the theory that markets are efficient, they work, and any attempt to try and time the market results in taking "uncompensated" risk. Efficient market theorists believe there is an "efficient" relationship between risk and return, and investors are compensated in proportion to the risk they take on. They believe that market prices reflect the vast amount of current information and expectations, and therefore are priced fairly, or appropriately. History proves that asset classes move in random, unpredictable patterns and it is *impossible* to predict which particular classes will be the leading performers in any given year or even market condition. Thus, these theorists believe over or underweighting inside a particular asset class opens the door for inconsistent performance, and can lead to taking on increased risks, which is likely not prudent for the investor.

Should I pay for performance?
Active managers take the opposite approach, striving to "beat" the market by taking advantage of, what they believe to be, pricing "mistakes". They attempt to predict the future by using a proprietary financial model or theory. A large cap growth manager, for example, believes they can beat the broad market returns by selecting his/her best 50 of the 250 growth stocks in the S&P 500. Active managers subscribe to the theory of having "intellectual capital" above and beyond what the market reflects, and therefore better predict how a particular company or industry will perform in the future. They, of course, charge an additional fee for this capital.

History demonstrates that too often active management proves costly and ineffective for the investor. They miss out on the strong returns provided by the broad market because they selected the wrong securities at the wrong time. For the investor, it is additionally difficult to try and select which manager will outperform the market in the coming year. They can only rely on past performance information to select who they think is best. The reality is that while some active managers certainly can outperform the broad market in any period, none of them have proven to do so consistently. Even the best active managers have years of market underperformance. As a result, those who subscribe to passive management respond with, "so why should we pay them?" In addition, financial planners with experience financial modeling argue that years of additional fees (sometimes the comparative difference is over 1% annually) compound, which can adversely affect potential portfolio growth.