Wealth of Knowledge

Active vs. Passive Investing: Finding the Sweet Spot

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When it comes to investing strategies, people generally choose either an active or passive approach, depending upon their needs and risk tolerance level.

The term "active investing" refers to a strategy in which the investor typically works with a portfolio manager to buy and sell securities on their behalf. They actively make decisions regarding investments based on a given criteria and changing market conditions. It is a risk managed approach to investing. In these strategies, there is a screening methodology that indicates, for example, that you should purchase shares of Facebook versus General Electric.

"Passive investing," on the other hand, refers to a "set it and forget it" strategy. Few real-time decisions are made about investments; instead, a market index is followed. Think of it like setting cruise control in your car — in a passive approach, investors or their portfolio managers pick their allocation percentages and do not make changes based on market conditions. Passive investing in indexes can include broad market indexes like the S&P 500 or small cap indexes like the Russell 2000. They may also include sector indexes (like technology or healthcare) or non-stock investments (like bonds and commodities).

In the fourth quarter of 2018, the U.S. stock market sold off with great ferocity, catching many investors and portfolio managers alike off guard. If you employed an active investment strategy, then you watched the rise and fall of stocks and made adjustments accordingly, hopefully limiting your losses. However, if you employed a passive strategy, then although you saw the same rise and fall of stocks, you did not make changes to your portfolio based upon current market conditions.

The portfolios that tend to do well over time have a structured or disciplined element that guides making changes to investment allocations. It is helpful to have someone overseeing portfolios, as people tend to make emotional decisions at the wrong time. For example, if a portfolio goes down by 10 or 20% and the investor sells half of the portfolio and moves that money to cash without a disciplined approach to get reinvested, then the market timing can be very damaging to the long-term portfolio performance.

There is a third approach to investing, a hybrid approach, in which the portfolio is made up of components of passive investments. Objective criteria is followed that indicates when to change the weighting of passive investments within the portfolios based upon current market trends. This is called a "trend following" approach, which has historically reduced draw down (or major losses) in times of great stress.

In summary, when you look at the entire investing landscape, there are several strategies you could employ. If you are interested in taking a risk management approach, you may choose the active strategy, and consciously make decisions regarding your investments based upon market conditions. However, if you are just interested in following a market index, you would employ a passive approach. The third option available is a hybrid strategy whereby you would actively change which passive strategies are in your portfolio in order to change how much exposure you have in the market.

If you feel there's room for improvement in your investment strategy, contact us today to discover how a hybrid approach may work for you.

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