

You can have the best of active and passive mutual funds
Investing in both can improve your returns.

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Since my investment career began in the late 1980s, I've been watching the development of a great divide between two competing forces in the financial world: active management versus passive management.

The battle boasts much intellectual fervor on both sides. It is a partisan and nearly religious difference of opinion. I share this with you in an attempt to bridge a divide you may be feeling as you consume financial press on this topic. Personally, I love the fight and believe it yields better results from both sides.

On one side, active managers attempt to beat a particular market or asset class by selecting the "better" securities and avoiding the "losers." They believe their knowledge and experience will lead them to better-than-average investment returns, justifying higher compensations.

Across the chasm, passive managers, often called index managers, would suggest that the markets are efficiently priced overall, making it difficult to identify winners and losers. They would also say that it is costly and foolish to try to beat market averages when, ultimately, the market returns will be sufficient anyway.

My view is that the combination of these methodologies is better than the wholesale adherence to either one.

I reviewed the performance of two common asset classes, large-cap U.S. stocks and U.S. bonds, over the four-year period ending 2004. I compared the signature index in each asset class to the average actively managed fund.

Over the four years, the differences between the average actively managed funds and the indexes were not terribly large for these two asset classes. If you owned large-cap U.S. stocks within a fund over this period, you probably didn't experience much of a positive return regardless of whether you owned a passive index fund or an actively managed fund.

If you were simply diversified and owned bonds over the same period, your experience was markedly improved whether you owned active or passive investments. It is the diversification that brings the bigger benefit, not necessarily the type of investments used to diversify.

Truth be told, both active and passive funds are choosing from the same basket of securities; they just use different methods for selection of the securities. There are pros and cons to both methodologies.

I appreciate that both strategies are easily accessible to investors.

For my money, I'll hedge my bet by investing money in both structures. As an additional thought, your future success as an investor is probably going to be driven by factors other than your selection of active or passive managers. My apologies to the great debaters in both camps.

Passive management

PROS

* Passive, or index investments, generally create less taxation of gain due to lower turnover of the holdings.

* Passive management is generally less expensive to operate.

- * Passive management provides a higher certainty of getting the market rate of return.

- * For most investors, it is easier to understand passive management.

CONS

- * Passive management forces you to hold the "bad" securities with the "good" ones.

- * Most index funds are "cap weighted," meaning their results are more heavily dependent upon the return of their top holdings.

- * Performance will be dictated solely by the market with no managerial control exercised during turbulent or largely negative return periods.

Active management

PROS

- * Active management allows managers the opportunity to exploit inefficiencies in the global markets to potentially achieve superior returns.

- * Active management can be more defensive if a manager correctly perceives storm clouds on the horizon.

- * Active management can be held to a customized standard such as total return or low risk versus simply achieving a market return.

- * Active management can be customized to a specific allocation or purpose.

CONS

- * Active management typically costs more than passive.

* Mistakes can and do happen as managers make bad decisions.

* It can be more difficult to use active management within a specific allocation if a manager's style changes (e.g. allows fund to drift from small cap to mid cap).

* It is challenging to identify quality managers.

How to choose

Here are nine suggestions for the general use of actively managed investments, passively managed investments, or both:

1. If you can afford to hire a quality adviser to help you in selecting good managers, let him or her do the research and make recommendations. Otherwise, passive/index funds probably make more sense.
2. If your portfolio is not large enough to access the lower priced institutional shares of a fund, stick with passive. A good rule of thumb might be to not pay more than 1.2% in operating expenses for an equity fund or 0.6% for a bond fund that is actively managed.
3. If you want to hold both, hold the passive funds in your taxable account and the actively managed funds, particularly high turnover funds, in your tax-deferred or tax-exempt accounts.
4. The assets that likely make up the core of your portfolio (large U.S. stocks and U.S. bonds) traditionally make a better case for passive management as they are heavily researched and very liquid.
5. The "bets" you take, hopefully with a smaller

percentage of your wealth, are by necessity better candidates for active management.

6. Newer investment markets like China, India and other Third World economies may benefit from the experience that an active manager can provide.

7. If you can only afford to buy a few funds for your portfolio, a "total market" index fund can provide broad diversification in a single fund solution.

8. Most passive funds, particularly funds known as "exchange traded funds," generate a transaction fee for the buying and selling of the fund. If you are a frequent fund trader, you might consider using no-load/no-transaction fee funds that are generally available through the large discount brokerages like Schwab and Fidelity.

9. Lower-return asset classes, short-term bonds for example, typically benefit from the lower expense ratios of passive funds since the expenses will be much larger relative to the return opportunity of that particular market.

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