Morningstar® Managed Plan Solutions℠ Active v. Passive Investing

In investing, there are probably few debates that generate as much controversy as the longstanding active vs. passive debate. The latter, of course, is a simple way to get broad exposure to the market or certain segments of the market. It espouses the tracking of a benchmark as a means to long-term success. Active investing, on the other hand, takes a different tack, with funds that follow the mantra trying to build portfolios that are differentiated from a benchmark, hence their active nature.

So, which one is the right strategy? At Morningstar Investment Services, we believe that active investing is the way to go, although we certainly believe that a passive approach has its benefits. In particular, we appreciate the low costs and instant diversification that passive strategies deliver. Those two features make passive strategies a tough hurdle for many active funds, particularly those that come loaded with high costs.

It should come as no surprise, then, that we advocate a low cost approach to active investing as well. It simply doesn't make sense to overpay for an active manager, because the hurdle for success only rises the more you pay for a fund. As such, when evaluating funds, we consider expenses to be one of the cornerstones of our assessment of their potential.

Looking at expenses is the easy part, and it gets more complicated from there. Some evidence suggests that indexing works best in bull markets and runs into trouble when the going gets tougher. In particular, researcher Steven Dunn argues that when any asset class does well, an index fund will tend to outperform its actively managed counterparts. Thus, "Dunn's Law" asserts that when, for example, small-cap growth funds are doing well, a Russell 2000 Growth Index fund will outperform the average small-growth offering.

Ironically, this forms what we consider to be one of the strongest reasons for avoiding an indexing strategy. In particular, we believe that a fund really earns its keep in a down market, and the more it can protect investors when it comes to downside volatility, the more likely it is that investors will actually own it for the long run. In fact, we worry that one of the fundamental issues with traditional indexes is that they tend to do well in up markets because they buy more of what is hot, leading to a precipitous decline in slowing markets. This is precisely what happened in 2002-2004, when many index funds fell sharply because they owned too many of the tech stocks that had roared in the previous years. Meanwhile, some of our favorite active managers steered clear of the sector to reap good gains during the period that index funds stumbled.

We also believe that index funds simply can't beat active managers in certain illiquid, poorly followed parts of the stock and bond markets. This is the case in areas such as small caps and high yield, for instance, because they are relatively inefficient areas of the market; an active manager that does individual security analysis is likely to have a positive impact on performance in these market segments. It's no surprise that for investors with the longest time horizon, these are the asset classes worth overweighting because of their very inefficiency.

So, are we arguing that markets are inefficient? Perhaps so, but the argument is a bit more nuanced. In particular, we think that over short-term periods, markets can often move out of equilibrium, creating longer-term opportunities for investors who have the foresight to take advantage of them. Invariably, those are active investors since passive ones must always be in agreement with the market. It thus follows that we believe in the veracity of active funds over the long haul.

We would be remiss, of course, if we were to conclude by saying anything other than that active investing requires enormous patience. While it's easy to speak about the value of taking advantage of short-term anomalies in the market, the fruits of these types of decisions are borne out over time. For anyone to reap their benefits, a long-term, active approach is the way to go.

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