Active vs. Passive Investing: What's the Difference?

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Active vs. Passive Investing: An Overview

Whenever there's a discussion about active or passive investing, it can pretty quickly turn into a heated debate because investors and wealth managers tend to strongly favor one strategy over the other. While passive investing is more popular among investors, there are arguments to be made for the benefits of active investing, as well.

- Active investing requires a hands-on approach, typically by a portfolio manager or other so-called active participant.
- Passive investing involves less buying and selling and often results in investors buying index funds or other mutual funds.
- Although both styles of investing are beneficial, passive investments have garnered more investment flows than active investments.
- Historically, passive investments have earned more money than active investments.
- Active investing has become more popular than it has in several years, particularly during market upheavals.

Active Investing

Active investing, as its name implies, takes a hands-on approach and requires that someone act in the role of a portfolio manager. The goal of active money management is to beat the stock market's average returns and take full advantage of short-term price fluctuations. It involves a much deeper analysis and the expertise to know when to pivot into or out of a particular stock, bond, or any asset. A portfolio manager usually oversees a team of analysts who look at qualitative and quantitative factors, then gaze into their crystal balls to try to determine where and when that price will change.

Active investing requires confidence that whoever is investing the portfolio will know exactly the right time to buy or sell. Successful active investment management requires being right more often than wrong.

Passive Investing

If you're a passive investor, you invest for the long haul. Passive investors limit the amount of buying and selling within their portfolios, making this a very cost-effective way to invest. The strategy requires a buy-and-hold mentality. That means resisting the temptation to react or anticipate the stock market's every next move.

The prime example of a passive approach is to buy an index fund that follows one of the major indices like the S&P 500 or Dow Jones Industrial Average (DJIA). Whenever these indices switch up their constituents, the index funds that follow them automatically switch up their holdings by selling the stock that's leaving and buying the stock that's becoming part of the index. This is why it's such a big deal when a company becomes big enough to be included in one of the major indices: It guarantees that the stock will become a core holding in thousands of major funds.

When you own tiny pieces of thousands of stocks, you earn your returns simply by participating in the upward trajectory of corporate profits over time via the overall stock market. Successful passive investors keep their eye on the prize and ignore short-term setbacks—even sharp downturns.

Key Differences

In their Investment Strategies and Portfolio Management program, Wharton faculty teaches about the strengths and weaknesses of passive and active investing.

Passive Investing Advantages

Some of the key benefits of passive investing are:

- **Ultra-low fees:** There's nobody picking stocks, so oversight is much less expensive. Passive funds simply follow the index they use as their benchmark.
- **Transparency:** It's always clear which assets are in an index fund.
- **Tax efficiency:** Their buy-and-hold strategy doesn't typically result in a massive capital gains tax for the year.

Passive Investing Disadvantages

Proponents of active investing would say that passive strategies have these weaknesses:

- **Too limited:** Passive funds are limited to a specific index or predetermined set of investments with little to no variance; thus, investors are locked into those holdings, no matter what happens in the market.
- **Small returns:** By definition, passive funds will pretty much never beat the market, even during times of turmoil, as their core holdings are locked in to track the market. Sometimes, a passive fund may beat the market by a little, but it will never post the big returns active managers crave unless the market itself booms. Active managers, on the other hand, can bring bigger rewards (see below), although those rewards come with greater risk as well.

Active Investing Advantages

Advantages to active investing, according to Wharton:

- **Flexibility:** Active managers aren't required to follow a specific index. They can buy those "diamond in the rough" stocks they believe they've found.
- **Hedging:** Active managers can also hedge their bets using various techniques such as short sales or put options, and they're able to exit specific stocks or sectors when the risks become too big. Passive managers are stuck with the stocks the index they track holds, regardless of how they are performing.
- **Tax management:** Even though this strategy could trigger a capital gains tax, advisors can tailor tax management strategies to individual investors, such as by selling investments that are losing money to offset the taxes on the big winners.

Active Investing Disadvantages

But active strategies have these shortcomings:

- **Very expensive:** Thomson Reuters Lipper pegs the average expense ratio at 1.4% for an actively managed equity fund, compared to only 0.6% for the average passive equity fund. Fees are higher because all that active buying and selling triggers transaction costs, not to mention that you're paying the salaries of the analyst team researching equity picks. All those fees over decades of investing can kill returns.
- **Active risk:** Active managers are free to buy any investment they think would bring high returns, which is great when the analysts are right but terrible when they're wrong.

Special Considerations

So which of these strategies makes investors more money? You'd think a professional money manager's capabilities would trump a basic index fund. But they don't. If we look at superficial performance results, passive investing works best for most investors. Study after study (over decades) shows disappointing results for the active managers.

Only a small percentage of actively-managed mutual funds ever do better than passive index funds.

All this evidence that passive beats active investing may be oversimplifying something much more complex, however, because active and passive strategies are just two sides of the same coin. Both exist for a reason, and many pros blend these strategies.

A great example is the hedge fund industry. Hedge funds managers are known for their intense sensitivity to the slightest changes in asset prices. Typically hedge funds avoid mainstream investments, yet these same hedge fund managers actually invested about $50 billion in index funds in 2017 according to research firm Symmetric. Ten years ago, hedge funds only held $12 billion in passive funds. Clearly, there are good reasons why even the most aggressive active asset managers opt to use passive investments.

However, reports have suggested that during market upheavals, such as the end of 2019, for example, actively managed Exchange-Traded Funds (ETFs) have performed well. While passive funds still dominate overall, due to lower fees, investors are showing that they're willing to put up with the higher fees in exchange for the expertise of an active manager to help guide them amid all the volatility or wild market price fluctuations.

Active vs. Passive Investing Example

Many investment advisors believe the best strategy is a blend of active and passive styles. For example, Dan Johnson is a fee-only advisor in Ohio. His clients tend to want to avoid the wild swings in stock prices, and they seem ideally suited for index funds.

He favors passive indexing but explains, "The passive versus active management doesn't have to be an either/or choice for advisors. Combining the two can further diversify a portfolio and actually help manage overall risk."

He says for clients who have large cash positions; he actively looks for opportunities to invest in ETFs just after the market has pulled back. For retired clients who care most about income, he may actively choose specific stocks for dividend growth while still maintaining a buy-and-hold mentality. Dividends are cash payments from companies to investors as a reward for owning the stock.

Andrew Nigrelli, a Boston-area wealth advisor and manager, agrees. He takes a goals-based approach to financial planning. He mainly relies on long-term passive investment indexing strategies rather than picking individual stocks and strongly advocates passive investing, yet he also believes that it isn’t just the returns that matter, but risk-adjusted returns. A risk-adjusted return represents the profit from an investment while considering the level of risk that was taken on to achieve that return.

"Controlling the amount of money [that] goes into certain sectors or even specific companies when conditions are changing quickly can actually protect the client."

For most people, there’s a time and a place for both active and passive investing over a lifetime of saving for major milestones like retirement. More advisors wind up using a combination of the two strategies—despite the grief; the two sides give each other over their strategies.