Wealth Management

Is the tide turning back to active investing?

The flood of money going into passive investments seems to suggest that active investing is on its way out the door. With passive investing having lower fees and strong performance, the choice seems a no-brainer. Investors, however, need to consider which strategy is right for them and not just blindly follow the trend.

Active investing is what you imagine when you think of traditional investing. An investor hires a manager to build and manage a portfolio, based on the assumption that an experienced professional can outperform the market. Passive investing takes a different view. Proponents believe that over the long run active investors fail to outperform the market; in fact, they argue, it's even difficult to achieve returns that are consistent with the market.

With passive investing, investors put money into a fund that uses an algorithm to track an index. Passive investments cost less, typically about 0.25% of the total investment, because no advisor is involved. Active investment fees are higher.

The fee difference is a major reason why investors have been putting money into passive investments. But cost should not be the only factor considered when selecting an active or passive strategy.

Passive investments hold securities in the same amount as a company's percentage in an index. Active investors, on the other hand, can choose to overweight or underweight the percentage of stocks held in their portfolio relative to the market. Thus active investments can mitigate risk by limiting exposure to a risky sector. An investor can also choose to heavily invest in a sector that they predict will achieve above-average returns. Passive investments produce returns in line with the market — no less, but no greater.

Another important consideration with passive investing is that many indices are dominated by the "big six" companies: Microsoft, Google, Facebook, Amazon, Apple, and Johnson & Johnson. If one company falters, their performance will drag down the overall performance of the market.

Passive investing has boasted strong performance since the bull market began nine years ago. A look back at history suggests, however, that active and passive switch off in how they perform relative to the state of the economy.

Active investments, with the exception of the 2008 financial crisis, tend to do better during bear markets, while passive performs well during bull markets. Active investments outperformed passive investments in 18 of 23 market corrections over the past 30 years, reports Hartford Funds. In 2017, active investments bested passive for the first time since 2009, indicating a possible reversal of the trend.

Active investing is based on the premise that markets do not always accurately reflect true value, as evidenced by market cyclicality. Portfolio managers can adapt their investment strategies to changes in the economic and geopolitical climate. The new tax code and trade disputes with China provide an environment in which active investment management may be essential to navigate complexity.

Finally, today there are also so many passively managed funds that choosing which one to invest in may verge on an active strategy.

The main takeaway is that the active-passive debate is not so black and white. There are advantages and disadvantages of each, and active and passive strategies are not mutually exclusive. The best approach is the informed one — the one that is right for you, given your unique financial situation.

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