Passive vs. Active Investing

Let's talk about active and passive investing and some of the commonalities and differences.

Active investing involves investment and portfolio managers performing research on individual securities. Passive investing, in contrast, involves buying. A diversified portfolio, something like a market portfolio or an index like the S&P 500 or something like that. Dow Jones industrial average.

Active investing involves costly research. It's costly because it requires data. Think of Bloomberg terminals or Reuters data feeds. Collecting social media or even trading data from individual exchanges. You also require technology and algorithms to collect, manage, and process the data. And the most expensive part of research is or are the people that are involved in the research.

The cost of research may be worthwhile if it generates a risk adjusted return that's greater than what you'd get with just investing in the market. It's also important to consider the fees that are associated with investment vehicles that use active strategies.

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Typically, active investment vehicles, like mutual funds, charge management expense ratios in excess of two and sometimes 3% per year. This means that if the investment strategy that you're investing in returns 8%, you as the investor would only see 6% or less of that actual return.

Passive investing, on the other hand, generally follows an index or the simple market. It's extremely low cost to implement and passive investment vehicles like index funds and exchange traded funds called ETF's have extremely low expense ratios. The ETF with the lowest fee often charge less than .2% or 20 basis points per year, much, much lower than an active investment vehicle.

While the costs for passive investments might be lower, how do the returns compare between an active and a passive investment strategy?

Most academic evidence suggests that active investments might not be worth the additional associated costs after subtracting the higher costs associated with active investing.

Actively managed mutual funds, they often have lower average or lower average risk adjusted returns than for passive investments, suggesting that it might not be worth it.

ETF's have seen a dramatic increase over the last 10 or 20 years and this difference between the costs that are lower for ETF's versus the costs that are higher for active mutual funds has helped to explain this large increase in ETF assets under management.