
Active vs Passive Investment Management

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Active vs Passive Defined

Active Management

- Changes in portfolio holdings in order to seek improved performance (human judgment)
- Identify securities, industries, countries or asset classes that will outperform benchmark

Passive Management

- Seek to mimic the return of a published index (I.e S&P 500)
- Achieve index returns through full replication or sampling method

Historical Evidence

From 1982 to 1990.....

- Vanguard Index 500 beat 71% of all actively managed mutual funds before taxes and 92% of funds after taxes

From 1990 to 2000.....

- Vanguard Index 500 beat 77% of all actively managed mutual funds before taxes and 91% of funds after taxes

Pros & Cons ~ Passive Investing

Pros

- Low Fees
- Low Turnover = Lower Transaction Cost & Lower Taxes
- Easy to Measure
- Easy to Control Total Portfolio Risk
- No Surprises

Cons

- Less attractive in less efficient markets
- Exposed on the downside
- Higher concentrated risk during market peaks
- Tracking error

Pros & Cons ~ Active Investing

Pros

- More attractive in less efficient markets
- Advantage of gaining by owning parts of the market not in the indexes
- Customization: after-tax investment, completion strategies, downside strategies
- Fiduciary role and performance incentives

Cons

- Most active managers underperform
- High hurdle rate: fees and taxes
- High maintenance

Portfolio Implementation ~ Combining Active & Passive

- Combination of Active & Passive
- Cyclical Nature of Active vs Passive
- Controlling the Risk of Underperformance
- An Example of Active/Passive Mix

Setting The Active/Passive Mix

- Threshold for underperformance in a single year = 15%
- Converted tracking error = 6%
- Active manager tracking error threshold = 8%
- Recommended Active Mix = $(2)/(3) = 75\%$
- Recommended Passive Mix = $1 - (4) = 25\%$

Conclusions & Recommendations

- There is a place for both active and passive strategies
- There is no strong argument for one or the other by itself
- Investor control is key to portfolio formation
- Active management works better in less efficient markets
- Both active and passive strategies exhibit cyclicalities
- Most indexes are incomplete and not really objective
- Review risk tolerance and financial objectives
- Make sure asset mix, passive/active mix and multiple manager composition provides the best odds of matching future financial goals
- On an ongoing basis review total portfolio risk exposures relative to target return after all costs (ie. Taxes, fees and inflation)