

# Capital Markets Brief

December 20, 2001

## The Case For Active Management: Part II

**I**n the last Capital Markets Brief, I discussed the pros and cons of active and passive investing. The primary focus was on the value-added by investment skill, with the conclusion being that the current market environment may be the most friendly we have seen in a long time for active money managers. In this Brief, I will address some of the other factors to consider before deciding whether to embrace an active, passive or hybrid approach to investing. Aside from trying to add investment value over the market, active management also involves minimizing the costs involved in investing without detracting from the intended benefits. Implementing and following a cohesive total portfolio plan involves educated, active decision-making.

**M**any retail investors believe that they pay nothing for their participation in mutual funds. Fund expense ratios, which incorporate most of the costs of managing the portfolio, are generally misunderstood. Investors also do not realize that they incur a cost whenever they wish to buy or sell shares of mutual funds (transaction cost). Most investors do not realize that they may incur capital gains taxes when they have not sold their shares in a mutual fund (fund distributions). Active management at the macro level (total investment portfolio) allows investors to minimize these sometimes unnecessary costs which detract from performance.

**S**everal decisions must be made before an investor embarks on a long-term investment program. These are all active decisions whether they are based on perceptions and/or beliefs. It is not

a question of whether you invest in index funds or actively managed funds, but rather of how you can one create a diversified investment plan that will best meet long-term financial objectives. These long-term financial objectives will then drive the asset side of the balance sheet in terms of risk, liquidity, etc. The choice between passive and/or active strategies can only be dictated by the confidence and odds that certain investments and investment strategies will best meet long-term investment objectives (liabilities). For example, how do investors know that they should diversify their investment program to include traditional and non-traditional assets? It is not because that is the total market available, but because they have a preconceived notion or bias. Only a well-disciplined, actively managed investment approach at the macro level will allow for the most appropriate mix of assets, managers or indexes.

**T**he net performance of their total investment assets (after fees and taxes) is most relevant to investors, but this is rarely reported and many times misunderstood. The success of any investment program should be measured using the balance sheet approach to risk. This approach measures the real growth (market value of liquid assets net of fees and taxes) versus future cash flow needs (liabilities or financial goals). Even if an all-passive investment strategy is used to best meet these future cash flow needs, there are a number of active decisions required regarding oversight of the total plan.

**P**ast experience suggests that for larger pools of tax-exempt money (> \$10 million), a combi-

nation of passive and active management strategies is warranted. The passive approach would be employed for the large, liquid core equity portion of the portfolio (value and growth stocks) and the active strategies would be employed for the remainder of the equity and bond portions of the portfolio. For taxable investors, the story is quite different. The odds of generating superior net performance for taxable asset pools depends on experienced managers as well as on the macro-manager at the total account level.

**T**he stock market today is well-diversified relative to periods over the past 20 years, with no concentrated industry or sector risk. This, coupled with the growing complexity in the investment arena due to the increasing number of asset choices, fund options, manager choices, changing tax laws and creeping management costs, suggests that now may be an opportune time to embrace actively managed strategies on both the total fund level as well as the asset class level.