Portfolio Strategies WORKSHOP

Index Funds and the Balance Between Active and Passive Investing

By Maria Crawford Scott

For many investors, the real entertainment section of the newspaper in recent months has been the financial section and its updates of the wild party thrown by the broad market indexes last year.

On the other hand, nothing is more depressing than watching the party from outside and not participating in the fun. That can happen to investors if their self-managed stock portfolios or mutual fund managers fail to keep pace with the overall markets.

One way of ensuring at least partial participation in a year such as 1995 when the markets move fast and far is through the use of an index fund. In addition to ensuring participation in the broad market moves, index funds bring another advantage—their flexibility allows you to choose the amount of participation, either a little or a lot.

The Index Fund Concept

An index fund consists of simply buying and holding stocks that track a market index. The most common market index is the Standard & Poor's 500, but other market segments are covered as well. For example, there are small stock index funds, international index funds, value stock index funds, and growth stock index funds. An index fund provides a "market" return less any management and transaction costs, which are held to a minimum. An index fund is both a stock selection and a market timing strategy—no active decisions need to be made other than picking the index, which is why it is often referred to as "passive" investing.

In contrast, an active approach consists of choosing an investment strategy, the basis on which individual securities are selected, and making timing decisions concerning when to enter and exit the market. Investors can either make the active decisions themselves, by managing their own individual stock and bond portfolios, or they can hire active managers—mutual funds, for example—to make the individual security selections for them. Of course, picking an active mutual fund manager is itself an active decision.

Passive investing is the least costly approach, both in terms of an investor's time commitment and in terms of actual expenses, including both management and transaction costs. For individual investors, the relatively low minimum investments also mean that significant diversification can be achieved for even small amounts of money. In terms of return, passive investing ensures the return of the chosen index—no less (except for expenses), but also no more.

In contrast, an active approach is more expensive, whether it involves your own time and expenses (if you are selecting stocks yourself) or incurs a management fee charged by a mutual fund adviser or private investment adviser. In addition, stocks are usually bought and sold more frequently in an active approach, incurring both transaction costs and taxes on gains. For individuals purchasing stocks or bonds on their own, an active approach can require a significant amount of capital to achieve the proper amount of diversification.

In terms of returns, investors using an active approach take the risk that they may not participate in any overall market move. This can occur for several reasons. First, it is difficult to outperform the overall stock market without added risk, and even when a fund or approach is able to outperform the market, it is difficult to pick in advance the approach or particular mutual fund that will do so. Active management can also skew a portfolio toward a particular market segment, producing returns that differ from expectations. Lastly, an active portfolio can become "overdiversified," particularly if many mutual funds with similar strategies are chosen. This can lead to "closet indexing," in which the buy and sell decisions by the funds, taken as a whole, cause the group to look very much like an index fund, but with performance that is less than an index fund due to the active management expenses in terms of manager fees and transaction costs.

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On the other hand, many investors feel that they can make active decisions, either in terms of picking individual stocks or selecting a good mutual fund, that will allow them to achieve higher returns than the market, and they are therefore willing to take on some "selection" risk. In addition, some investors would actually prefer to take on more risk than is inherent in an index fund, which allows them to add to their return potential.

Finding the Right Mix

Let's assume you decided to invest your portfolio according to the following allocation: 10% money market fund, 50% large-cap stocks, 10% international, and 30% small-cap stocks.

At the extremes, you could either be a fully active investor, and buy individual securities in every single category, or you could be entirely passive, investing your entire portfolio only in index funds.

The fully active approach, of course, would require a significant amount of money in order for your portfolio to be diversified (an almost impossible feat in the international arena). It would also require an enormous time commitment—you would have to become an expert in large-cap stocks, small-cap stocks, and international stocks; if there were a commitment to bonds, you would have to become a bond expert.

The fully passive approach would involve only a minimal amount of time—picking the indexes—and a small investment. But there would be no chance to benefit from any market inefficiencies you may feel you can exploit.

Most individuals, of course, will not be at the extremes. What's the right mix? For the most part, that will depend on the amount of "active" risk you want to take on (the risk that your active decisions will not produce the extra returns you expect) and on the amount of time and effort you are willing to commit to take on any active risk.

In particular, index funds allow you to focus your time and energy on the areas in which you think your active decisions can add value. Their diversification benefits also allow you to make active investment commitments with lesser capital commitments—for instance, the lack of diversification in a three-stock holding can be balanced by an additional holding in an index fund. And you can vary the size of your active "bet" by varying the size of your commitment to an index fund—for instance, by indexing only a small portion of your portfolio, your active decisions will have a larger impact on your overall return.

In the allocation strategy outlined above, you may choose to index all assets except the portion committed to small stocks, which consists of individual stocks you actively select, where you may feel your expertise lies. Alternatively, you may feel strongly about the expertise of a particular mutual fund manager that uses a value approach to investing in large-cap stocks, and so you decide to commit 20% of your large-cap stock portfolio to this fund and index the rest of your portfolio.

The range of possibilities, needless to say, is endless. Here are some guidelines, however, to an effective mix:

- For the passive portion of your portfolio, use low-cost index funds that cover a broad market index (such as the S&P 500 for large-cap stocks and the Russell 2000 for small-cap stocks).
- Invest the active portion in funds or individual securities that specialize in market segments that offer opportunities for undiscovered (by the market) value, such as small stocks, foreign stocks, or a particular investment approach.
- Make sure you do not create a closet index fund with your active portion by choosing funds or approaches with overlapping investment styles or that invest in similar market segments.
- The mix of passive and active approaches should be based on a balance of the extra expenses incurred by the active strategies (including your time) and the value you think you can add by making active decisions.

Index funds give you the opportunity to participate in the market party. But most individuals want the opportunity to participate in private parties, as well. The selective use of index funds gives you the flexibility to decide just which parties to attend.