

# Beginning Investor

*A series providing guidance for new investors on how to become successful investors. See [AAIL.com](http://AAIL.com) for the other articles in this series.*

## Active Versus Passive: Which Do You Choose?

How involved do you want to be with selecting individual stocks and securities? Though there is no right or wrong answer, it is an important question to ask. The answer has definitive implications for the types of investment vehicles you use. Two factors can help you determine the answer: your personal inclinations and the level of expenses you are prepared to incur.

### Personal Inclinations

How likely are you to research individual stocks, mutual funds and exchange-traded funds (ETFs)? Consider both your personal interest level and your available time before answering. Do you enjoy analyzing financial statements, dissecting business models, staying on top of relevant financial news and sorting through fund return information? Alternatively, how much time can you realistically put into managing your portfolio?

Some individual investors truly enjoy analyzing stocks and bonds and set aside time every week (or even every day) to do it. Others find quarterly earnings reports to be the most boring thing they've ever read. Some really want to get into the nuts and bolts of security and fund analysis, but just have too many other demands on their time to do it regularly.

If you are someone who is willing and able to analyze individual securities and funds, you are more suited to following an active investment strategy. Active management means you decide which stocks, bonds, mutual funds and ETFs to invest in, and when to sell them. Alternatively, if you are someone who does not want to do the regular analysis or if you lack the time to do it, a passive strategy might be more suitable. A passive strategy involves holding mutual funds and ETFs that are designed to mimic the returns of an index, such as the S&P 500.

### Expenses

A passive strategy can incur the lowest level of investment expenses. Because the composition of the major market indexes does not change very often, little buying and selling occurs within passive mutual funds and ETFs. In addition, since the fund managers merely have to follow an index, overhead costs are lower. The cheapest (both in terms of annual expenses and tax costs) mutual funds and ETFs are those that track well-known indexes. Opportunity cost can occur, however, if an active strategy produces a higher return than a passive strategy. You lose the performance advantage you would have achieved if you had followed an active strategy.

Active management carries higher expenses. Individual securities are bought and sold more frequently, which results in greater transaction and tax costs. If an actively managed fund is used, annual expenses are also higher because of the additional costs of hiring a team of analysts to research individual securities. Opportunity costs can occur if active management results in returns that are below performance of the broad market indexes. You lose the better returns you would have achieved if you hadn't followed an active management strategy.

### You Can Choose Both

The decision to use an active or passive strategy is not an either/or choice. Rather, you can combine both. The advantage of combining the two strategies is that part of your portfolio will always perform in line with the broad market indexes. At the same time, you give part of your portfolio a chance to outperform the market by selecting good stocks, bonds and funds.

Regardless of what type of strategy you choose, you will need to regularly review your portfolio. Even a passive strategy does not exempt you from knowing what is held in your portfolio and ensuring your allocations are in line with your long-term financial goals.

—Charles Rotblut, CFA, Editor, *AAIL Journal*