

Fiduciary Focus: Active vs. Passive Investing

W. Scott Simon | 02-03-05 |

Active Investing and Passive Investing in the Context of Prudent Fiduciary Investing (Part 1)

This month's article is the first in a series that examines active investing and passive investing within the context of modern prudent fiduciary investing.

Before going any further, I must disclose my own bias: I am committed to passive investing. I wrote a book in 1998 called *Index Mutual Funds: Profiting from an Investment Revolution* (now out of print) for which John C. Bogle provided the introduction. That book included some material on the Uniform Prudent Investor Act and the Restatement 3rd of Trusts (Prudent Investor Rule) that led me to [write an article](#) in a California legal periodical on index funds and the California Uniform Prudent Investor Act. That article, in turn, led me in 2002 to write [The Prudent Investor Act: A Guide to Understanding](#).

While I did bring a predisposition to favor passive investing as I went about analyzing the process described in the Act and the Restatement in my latest book, I tried, nonetheless, to be as balanced as possible in presenting that analysis. I would, therefore, ask all those who are ready to fire off critical e-mail to me as a result of reading this series of articles to please remember that.

I would also ask those who are committed to active investing to remember that there is a big difference between investing your own money and investing money for others as a fiduciary. You can invest your money to your heart's content in the latest, hottest investments, but the standards are a lot different when you invest money that's not yours. This doesn't mean that fiduciaries are restricted only to U.S. government bonds; it just means that there are certain rules of prudence by which fiduciaries must conduct themselves.

Two Fundamentally Different Approaches to Investing

A fiduciary implements the asset allocation for a trust portfolio with an appropriate investment strategy. Before selection of any investment strategy, it would behoove the fiduciary to understand the significant differences between two fundamentally different approaches to investing--active investing and passive investing.

The decisions made by a fiduciary in selecting either an active or passive investment strategy (or some combination of both) to implement a trust portfolio's asset allocation stand at the very center of the issues surrounding fiduciary responsibility.

Active Investing

Many investors (whether acting on their own or in a fiduciary capacity for others) engage in an active approach to investing. That is, they invest in each time period in the investments they believe offer the best odds of maximizing portfolio values. In short, they attempt to "beat the market." These attempts involve stock picking and market timing.

The goal of stock picking (whether individual stocks or stock mutual funds) is to identify, and thus profit from, mismatches between the current market prices of stocks and what are perceived as their “true” underlying values. Restatement Commentary defines active investing as involving searches “for advantageous segments of the market, or for individual bargains in the form of underpriced securities.”

The goal of market timing is to shift money in and out of different investments to profit from short-term cyclical events in financial markets. Most of the money managed by stockbrokerage firms, trust companies, individual investment advisors, and others is invested using active investment strategies.

The investment information system, composed of the media, mutual fund families, stockbrokerage firms, investment advisory services, and other entities, derives vast sums of money by encouraging investors to believe that they can beat the market. Hopes of finding the next hot stock tip, identifying the next winning mutual fund, or crowning the next investment guru saturate this world that many investors live in and from which they get their information about investing. This system is enormously powerful in how it affects the emotions of investors (both amateur and professional) and how it impacts their investment decision-making.

Although both the Act and the Restatement permit active investing, Restatement Commentary cautions fiduciaries about the perils that can characterize this approach to investing. These perils include the greater risks and higher costs and taxes of stock picking and market timing:

Active strategies, however, entail investigation and analysis expenses and tend to increase general transaction costs, including capital gains taxation. Additional risks also may result from the difficult judgments that may be involved and from the possible acceptance of a relatively high degree of diversifiable [i.e., uncompensated] risk. These considerations are relevant to the trustee initially in deciding whether, to what extent, and in what manner to undertake an active investment strategy and then in the process of implementing any such decisions.

Passive Investing

Other investors engage in a passive approach to investing. Passive investing includes investing in index mutual funds and asset class funds. The goal of passive investors is to match a market return. Since this goal is more modest than that of active investors who attempt to beat the market return, many investors seem to think that passive investing is somehow safer than active investing.

Even though both the Act and the Restatement permit passive investing, fiduciaries should understand that passive investing is no panacea for escaping investment risk. Because “risk is risk,” there’s no guaranteed safe way to reap the rewards of investing in financial markets. Although no amount of diversification can reduce the compensated risk that’s inherent in all investment portfolios (whether active or passive), passive investing is demonstrably the best way to rid a portfolio of as much uncompensated risk as possible (and the only way of eliminating the risk of underperforming a given financial market). Nonetheless, fiduciaries should understand that passive investing cannot eliminate the risk of losing money.

Index Mutual Funds and Asset Class Funds

The manager of an index mutual fund seeks to capture the long-term performance of the target index tracked by the fund. This is achieved by holding in the fund all (or a sample) of the investments that are represented in the index in the same proportional amounts. An

index is representative of an asset class, which is made up of investments with common characteristics. Usually index funds track the performances of widely recognized indexes.

The manager of an asset class fund seeks to capture the long-term performance of the underlying asset class tracked by the fund. This is achieved by holding all (or a sample) of the investments that compose the asset class in the same proportional amounts. This type of fund captures returns by purchasing securities with comparable risk/return characteristics according to an identifiable factor such as market size. An asset class fund may or may not track an index.

Comparing an Index Fund to an Asset Class Fund

Rex Sinquefeld, a pioneer in passive investing and who along with Roger Ibbotson in the 1970s was the first to present in an organized and comprehensive way the historical returns of discrete asset classes, contrasts the trading practices of managers of index funds with those of managers of asset class funds:

[Index fund managers] tend to hold securities in their portfolios in the exact proportions of the target universe.... [They] do not materially overweight a security held in the target index. Maintaining target-like portfolio balance seems to be their primary concern.... Index fund managers] tend to seek 'immediacy of execution.' In general, when orders are placed, brokers are instructed to complete all or most of the buy program in a few days, at most.... [In contrast, asset class fund managers] may overweight positions by purchasing large blocks [of securities] below current bid prices and underweight positions by trying to avoid purchases at or above current ask prices.... A large fraction of [the] portfolio holdings depart from perfect balance.... Brokers are instructed to try to purchase securities without pushing prices. As a result, a large portion of [the] buy program will be unexecuted, even after several weeks, and many positions will be underweighted. Uninitiated blocks [of securities] are considered if the execution terms are favorable, so many positions will be overweighted.

Absent trading rules and other investment techniques, index funds and asset class funds are similar in the sense that the managers of neither type of fund 1) pick stocks for the purpose of trying to beat the market, 2) market time, or 3) attempt to predict the future.

In next month's article, I'll discuss how the simple arithmetic of a zero-sum game creates a powerful argument in favor of passive investing.

W. Scott Simon is an expert on the Uniform Prudent Investor Act and the Restatement 3rd of Trusts (Prudent Investor Rule). He is the author of two books, one of which, *The Prudent Investor Act: A Guide to Understanding* is the definitive work on modern prudent fiduciary investing.

Simon provides services as a consultant and expert witness on fiduciary issues in litigation and arbitrations. He is a member of the State Bar of California, a Certified Financial Planner® and an Accredited Investment Fiduciary Auditor™. Simon's certification as an AIFA™ qualifies him to conduct independent fiduciary reviews for those concerned about their responsibilities investing the assets of endowments and foundations, ERISA retirement plans, private family trusts, public employee retirement plans as well as high net worth individuals.

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