



# Understanding active management

Investing fundamentals series



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## Understanding active management

**For over a decade, there has been some debate over how best to invest. Traditionally, active management has been the most common approach, with professional investors researching and selecting individual stocks and bonds, with a goal of creating a portfolio that may outperform the overall market.**

More recently there has been a shift toward passive investing, in which investors effectively buy an entire index on the premise that “you can’t beat the market.” The goal has become reducing costs and tracking the index as closely as possible.

These “passive” strategies attempt to replicate well-known indices, such as the S&P/TSX or the S&P 500. Investment decisions are essentially automated by the index-providers, eliminating the cost of a human actively researching and trading securities.

But there’s still a strong argument to be made for actively managed portfolios.

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## Active vs. passive

The key selling point for passive management is the low fees. With no human portfolio manager to pay, costs are much lower than active management. While fees can affect returns, there's more to successful investing than cutting costs.

**Despite higher fees, active managers have the potential to add value to investor portfolios.**

	Active	Passive
<b>Philosophy</b>	Believe market prices may at times be inaccurate, creating opportunity to either buy at a discount, or sell at a premium	Believe market prices accurately reflect all known information
<b>Management</b>	Managed by highly trained financial professionals according to a specific discipline	Unmanaged, aims to replicate the movement of a specific index
<b>Strategy</b>	Managers seek to buy investments they consider "under-valued" and sell investments they consider "fully valued"	When index rises, the investors gains. When the index falls, the investor loses
<b>Returns</b>	Has the potential to outperform the broad market despite higher fees	Will underperform the market as fees are deducted from index returns
<b>Risk</b>	Potential to limit exposure to market bubbles	Fully participates in market bubbles

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# The value of active management

## Diversification

Many, but not all, active managers seek to diversify the portfolios they manage as a means of mitigating risk. As one sector gains, the active manager may trim their position to maintain portfolio diversity.

Not so with passive strategies, which may be susceptible to bubbles. This was the case in the late 1990s, as the dot-com bubble inflated. When it burst spectacularly in 2001-2002, passive portfolios followed the market from its peak to its trough. In the 2008-2009 downturn, a concentration in financials could similarly have affected investors.

## Downside protection

One of the benefits of active management is that it provides the potential to minimize exposure to dramatic market correction. A passive portfolio will not only track its underlying index higher but will also follow it downward if the index drops suddenly.

A skilled portfolio manager may recognize a building market bubble, for example, and reduce their portfolio's exposure to the affected industries. They may decide to invest in securities they believe will be more resilient if the market corrects. They also may hold more cash to allow them to buy in the event of a market correction.

## Capital market efficiency

Some parts of the investment world tend to be priced with a high degree of accuracy, such as the largest companies in the US, which are constantly analyzed. But smaller companies and foreign markets are less closely scrutinized, making inaccurate pricing more common.

Active managers who analyze these companies have the potential to discover opportunities that are under-priced, in the belief that over time, the market will recognize their value.

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## The price difference

As stated earlier, passive investing seeks to reduce the cost of investing by eliminating securities research and reducing trading costs.

Actively managed funds do tend to charge higher management fees than passive funds. So, what do you get for these higher fees? Typically, a team of highly trained investment professionals who analyze stocks and/or bonds to determine their fair value.

Understanding the fair value of an investment is the first step in determining whether its price is too high or represents an opportunity. Buying undervalued investments provides a degree of downside protection and reduces investment risk.

It is important to note that the published returns of actively managed mutual funds already take management fees into account. They are therefore reflective of the returns an investor would experience over a given reporting time frame.

Rather than comparing the management fees of active and passive portfolios, investors may be better served comparing their historical returns on an after-fee basis. While past performance may not be repeated, it can shed light on how the portfolios have fared over the long-term, in both rising and falling markets.

For investors seeking a low-cost way to track the major indices, passive investing may make sense. If an investor prioritizes either risk mitigation or the pursuit of outperformance, active management has the potential to achieve either goal.

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**Talk to a financial advisor to learn more about how actively managed investments may suit your financial goals.**

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