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Granite Insight

Passive vs Active Investing: What a Fiduciary should know.

Lately, there has been much discussion of passive vs active money management. The question for a proactive fiduciary is: which is better? The are many variables to consider, but one thing is for sure, the fiduciary needs to understand the pros and cons of both. The fiduciary needs to have a defined investment process. Below, we examine a few points which we believe are the most important in the passive/active consideration.

Every ten years or so the academics in the investment world claim that there is no need to actively invest. Active managers will cyclically underperform the index. And if you look at data only in specific periods of time, this may appear true; and then pundits declare active investing dead. Historically, a portion of the investor world still had their money in the active space; but as demographics change, millennials have decided that they no longer need actively managed money at all. Recent data suggests that there is more money in passive strategies than in active strategies. There are more fund choices in index and ETFs than there are existing stocks.

Interestingly enough, the argument is somewhat flawed. Like all things, this behavior is very cyclical and will move in the opposite direction for a period of time. Unfortunately, the utilization of passive strategies has created a problem. Often, people don't realize they have only invested in a few very heavily weighted stocks in the index. If one remembers the end of the tech bubble in 2000-2002, WalMart, Microsoft, GE, etc…were the market. Today, we see the same thing, as more passive investors come in and push similar stocks up through index purchases. The valuations become higher and the stocks purchased are exposed to more risk. If passive investors start selling in earnest, the index, and your returns, will be driven down.

Additionally, there are some asset classes that should not be indexed, such as Fixed Income, Small Caps, Emerging Markets, and others: where the index construction is too vast to invest correctly. There are many active managers in certain sectors that do better than the index, after fees, with less risk. While large cap indexes are easier to assimilate, they are still exposed to mass investor selling.

Why is this important? When one invests in indexes, the investor is guaranteed permanent underperformance and negative alpha (Alpha is how much added value a manager provides vs. the benchmark, positive is good and negative is bad). So how does an investment fiduciary justify permanent underperformance with negative Alpha? In our minds eye, this is tough to do in many sectors.

We believe a proactive fiduciary may use a mix of indexes and active managers. A good fiduciary should provide active managers, in certain asset classes; these managers will do better than their indexes, with less risk . Once the employer or hired fiduciary have an appropriate process in place, the investments should follow the process.

An experienced, knowledgeable and proactive fiduciary can reward employees with a documented and consistent investment process!

Please call Granite Group to uncover more details about passive investing at 203-210-7814.

Additional information: If you would like specific information on operational and investment best practices, please contact Granite Group Advisors. Granite Group is record-keeper and mutual fund neutral.