JACOBI
CAPITAL MANAGEMENT

Passive vs. Active Investing

One primary question that confronts many individuals is whether to follow a "passive" investment strategy or to be a more "active" investor. Each approach has its adherents.

Passive Investing

Passive investing is based on the concept that an individual should invest in a broad selection of stocks or other securities, rather than trying to pick single issues that will be big winners.

Underlying this approach is the assumption that no one individual or group will be able to consistently make investment decisions that will provide a return greater than the market as a whole. The primary goal with passive investing is to earn a market return rather than trying to "beat" the market.

Many passive investors implement this strategy using what are known as "index funds." An index fund is a type of mutual fund, exchange-traded fund, or unit investment trust whose primary investment objective is to mimic the performance of a specific market index such as the S&P500 Index or the Russell 5000 Index. To achieve this goal, an index fund will hold all (or a representative sample) of the securities in the chosen index, in the same proportion as those securities exist in the index itself. For many investors, index funds have significant advantages:

- Lower management costs: Without the need to pay for expenses such as investment research and the costs of buying and selling, index funds typically have lower management costs.
- Lower portfolio turnover: With a passive investment strategy, there is less portfolio turnover (buying and selling) in an index fund than with an actively managed fund.
- Risk management: Using an index fund helps manage the risks inherent in investing by spreading the total risk over a broader, more diversified portfolio. This diversity does not, however, protect against the risk of a general market decline.

Active Investing

Active investing, in comparison, is based on the view that an investor can achieve a return greater than that provided by the overall market by actively buying and selling selected stocks or other securities. In effect, active investors are trying to outguess the market and focus on specific stocks or securities that they believe will change in value. Active investing thus offers the potential for greater rewards, at the price of greater investment risk. Other points that should be noted include:

- Higher expenses: Including trading costs, research expenses, and generally higher management fees. Higher costs mean that an actively managed portfolio needs a higher overall rate of return, just to break even.
- Income tax impact: Frequent buying and selling can result in short and long term gains and losses, which can complicate tax planning.
- Concentration increases risk: By focusing on a limited number of securities or investment sectors, there is less diversification and thus greater investment risk.
- Luck or skill? If an active portfolio manager is successful at beating the market, can he or she achieve the same results year after year?

Which is Better?

There are many published studies on whether passive or active investing provides the greatest investment return. Depending on the time frame involved in a particular study, both approaches can be shown to have done well. Ultimately, the question of which approach is “better” often comes down to the facts of an individual’s own situation. Personal needs and preferences also play a role in deciding which approach to take. For some investors, a blend of both strategies can be useful.

As a starting point, consider the following key questions:

- Investment goals: What do you want your money to do for you? Are you seeking current income, to pay monthly bills? Or, are you accumulating funds to meet a future goal?
- Risk tolerance: Investing does involve risk, including the possible loss of principal. In general, risk is related to expected return: the higher the risk, the higher the potential return; the lower the risk, the lower the potential return. Can you afford to lose a portion, or even all, of your investment, without it affecting how you live?
- Dollar amount of investable assets: Generally, investors with larger amounts of capital are better equipped to bear a higher level of risk. Also, the investment vehicles open to an investor can vary, depending on the amount of money available.
- Income taxes: Income taxes can have a significant impact on your investment results. For high-tax bracket investors, income taxes are a very important consideration.

Seek Professional Guidance

The choice of whether to use a passive or active investment approach is an individual one. For many investors, the guidance of trained financial professionals can help in making this decision.

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