Indexing Essay, Research Paper

Active and Passive Indexing

The first index fund began in 1971, with $6 million funded by Samsonite, the luggage-maker. Since then, there have been many arguments of whether an active index fund or a passive index fund offers better long-term results for investors.

Index funds are already the fastest growing sector of the mutual fund business. From 1986 to 1996, the amount of money invested in index funds grew from $556 million to $65 Billion. And if anything, individual investors have been slow to embrace passive management. Institutional investors invest a far larger percentage of their assets passively.

Many individual investors are simply uneducated and unaware of the arguments and experimental evidence supporting passive management. Institutional investors and academics have known for years (many for decades) that passive investing is extremely difficult to beat and that the majority of active investors will fail in their attempt to outperform the market.

Active indexers assert they can outperform the marketplace. Passive (index) portfolios state they can mirror the performance of the indices. Both have their good times and their bad times. Active indexers raise cash in times of increased risk and instability while passive indexers remain fully invested. This can be quite painful during times of large declines in the market.

Passive portfolios mirror the gains of the indices during roaring bull markets and eventually outperform the majority of active money managers who must remain diversified and who sometimes take on additional risks in an attempt to produce the performance and safety that they have promised their clients. The evidence has piled up during today’s bull market that the average dollar managed by active managers does not keep up with the market index. Finally, indexing is a way to avoid being blind-sided in certain areas of the marketplace. Active management themes can easily find themselves on the wrong side of an investment. There is a perception among investors that a strategy designed to match stock market returns is less risky than a comparable actively managed portfolio. Since the index approach invests in a manner that is most friendly with the market’s natural liquidity, it produces the least disturbance. The passive investor also has diversified his risk. Specific negative things can happen to individual companies or groups. As a passive investor, one is not exposed to any of these things. However, it does not mean you have a risk-free investment.

The downside to passive index investors is that they “fuel the fire” of a market that appreciates well beyond its true value. Index mutual funds must put new money to work…they can not hold cash…and their investors all buy the exact same stocks. When stocks go down, index funds, being fully invested, will receive the ultimate effect of the decline. Combined with this loss is the fact that they will also have to sell shares to cover shareholder redemptions. These funds will get hit harder than many active portfolios with a cash cushion. Most active managers of investment portfolios raise cash as they perceive higher valuations, excessive instability, and extreme risks, therefore; reducing the display to loss during declining markets.

Another downside to passive indexing is the impact they have on market instability. This gives the patient active money manager a welcome opportunity to take advantage of stock selection at very attractive prices and, to some extent, time the market in making their decisions of when to buy and when to sell. Index investing is a tricky business that can roil markets.

Actively indexed funds have gone upward over the last decade. This has occurred despite the fact that investors have poured huge amounts of money into active funds over this period. The costs of investing in index funds have trended downward as they have become more popular with investors.

The costs of active index funds just might decrease in the future, thereby narrowing the cost gap with passive index funds. But all evidence to date has shown just the opposite trend – the costs of active funds continue to go up and the costs of index funds continue to go down.

Actively indexed funds typically generate relatively large amounts of taxes while passive index funds generate relatively small amounts. Some of the resulting gap in performance caused by taxes would seemingly be narrowed if the federal government were to lower tax rates. Congress did this at the end of July 1997 when it reduced the maximum long term capital gains tax rate from 28% on investments held more than one year to 20% on investments held 18 months or longer. The tax bill provides that in the year 2001 this rate will be reduced to 18% for investments held five years or longer. Finally, active money managers serve the specific needs of their clients. They manage portfolios based exactly on the investor’s objectives and tolerance for risk. They make decisions based on a stated time frame and they are capable of changing the goals and direction of a portfolio on a moment’s notice. They are the investor’s personal link to the market and the protector of their capital. The value of these services is immeasurable to most investors.

One thing that really does not influence the investor as much as it should is the lack of appreciation with respect to the tax consequences of passive index management. The capital gains, created during the year by a fully active index manager, is reported to the IRS, and the investor ends up being taxed. For a taxed investor, the buy-and-hold is a winning strategy. Turnover is the enemy of the investor who pays taxes. Conversely, most investors would be more than happy to pay taxes on the returns produced by active money managers during periods of declining markets. Not many investors prefer losses to earning some gains and interest, even with the tax man waiting.

The effect of so many investors buying index funds is that they tend to guard the money market. An investor could actually, in a cost-effective manner, buy and sell the market. The asset funding of active managers, combined with the efficiency of the passive manager, allows one to implement strategies that provide an optimal mix of securities to match a particular scenario, objective, or risk aversion.

From time to time, it is possible that the major assets can get out of balance. Investors can run up prices where the lawfulness market is overvalued. When this reaches a untrustworthy level, more self-corrective measures are needed. This is where the expertise of the active manager becomes useful. As an investor, you are always trading off what Jeremy Bentham, the British economist, referred to as the “pain-pleasure calculus.” Good returns produce pleasure. Bad returns produce pain. An active money manager is always balancing off the pleasure vs. the potential pain. The active manager tends to determine what that balance is and if it finds that the market is deployed otherwise, it works in balancing the portfolio. Tactical asset funding combined with a passively managed portfolio has been called the “holy grail” of investing by Jonathan Burton, of Dow Jones’ Asset Management magazine.

During declining markets, index funds take the full force of the market’s loss. Managers of these funds are forced to sell stocks in order to meet the demand for redemptions as their investors got out of the market. During markets of very little movement, investors quickly drain of insufficient or no returns on their investment. Finally, a philosophy of capital preservation causes the active manager to raise cash, providing a cushion for portfolios during times of extreme risk.

Active or passive? Both have their advantages and their risks, but the two are found to be the best long-term plans for both performance and safety.

Index (passive) funds are likely to beat active funds, yet the Morningstar data show that 92% of all the money is U.S. stock funds is in active funds.