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The Sound Investor Series #5

Active and Passive Investing – What Does that Mean?

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Let's first start with the short answer.

- Active investing is when you try to beat the market. Sometimes active investors win, but most times they don't.
- Passive investing is when investors make investments in the hope of earning the same return as the market. For the most part this works, although due to costs, passive funds earn slightly less than the market.

I strongly believe that most individual investors will earn more over the long-term by being passive rather than active investors.

I know it's no fun trying to match the average return; it is sort of like playing for a tie. But this is not a ball game and investors need to keep their egos in check. Remember, only half of investors can be above average and there are a lot of professionals playing the same game. Given all the advantages professionals have, part-time investors very seldom win.

A local analogy may help explain some of the differences between active and passive investing. If you are traveling from Norwalk into New York City, there are a number of ways to get there including taking the train or a car. Passive investing is similar to taking the train. It's easy and you will get there when the train gets there, but never before. Everyone gets there at the same time and very importantly, no one is left behind. It is also less expensive than driving.

If you drive, you may or may not beat the train. There is a chance you will get to the City before the train, but there is also the risk that you will arrive much later. Driving, like active investing, requires constant attention to figure out when to change lanes or just stay put, similar to deciding what and when to buy or sell.

Active investors use a number of strategies attempting to beat the market. By far the most popular is picking a portfolio of individual stocks with the hope it will outperform the market. It is called active investing because you actively pick the stocks you own.

The mutual fund industry is built on active stock picking strategies and before costs; many professionals do pick stocks that slightly beat the market. But unfortunately, after the costs are taken into account most mutual funds under-perform the market. The amount a fund falls short of the market's return is its "Performance Gap."

The "Performance Gap" is really important because if you don't keep up with the market, all your return assumptions will be wrong and you might be very disappointed when it is time to retire.

Index funds were developed to help investors control and reduce their performance gap. They are called index funds because the index they follow, like the S&P 500, determines what stocks are bought and sold. The fund managers do not decide what stock to own and are therefore passive.

It is very difficult for an index fund to get the exact same returns as their index benchmark, such as the S&P 500. This is because indexes do not take into account investor costs, such as commissions, when calculating the market's performance. But in the real world there are costs, and these cause a small performance gap.

At least once a year you should look at the performance gap of your investments. After considering all your costs, you should aim to keep the gap under 1 percentage point.

Ed Hynes, CFA, is President of Farm Creek Securities, LLC based in Rowayton, CT. (203) 838-1025. This article is the fifth in a series on basic investment topics available at farmcreeksecurities.com. Before putting money in any investment, you should carefully consider your investment objectives; and the risks, charges and expenses of any investment. Past performance is not an indication of future performance and there are risks to investing including the loss of principal.

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