Active vs. Passive:
The Debate Rages but the Rules Have Changed

It is one of the oldest and most contentious debates in the investment industry, but do we even know what we’re arguing about anymore? In this piece, we’ll take a trip through time and attempt to clarify what active and passive used to mean, and what they have become.

In the beginning…
There wasn’t really much to debate. When the first mutual fund was launched, it gave investors access to the stock market. But, the “stock market” essentially meant a relatively small universe as the only real index was the narrow Dow Jones Industrial Average. Later, the S&P 500 offered a broader index of stocks, but it was just an index. So really, there was no passive – there were professionally managed funds and a passive index to compare it to, but there has never been a way to invest directly in an index.

Then…
When index mutual funds were created, the real debate began. At this point, because investors could now actually invest in a vehicle that tracked a market index (which is what active managers were trying to beat) directly, passive investing and index investing came to mean essentially the same thing: owning the same stocks in the index AND at the same weights as determined by their market capitalization (number of shares outstanding multiplied by their current price).

Now…
The terms have all diverged (or converged), largely due to the advent and proliferation of new types of indexes that fall under the broad moniker Smart Beta. They take traditional market capitalization indexes and reweight stocks by something else, such as dividends, quality, or stock valuations, etc. As such, passive and indexing don’t necessarily mean the same thing any longer.
So what DO they mean?

Passive: Any basket of investments that is designed to track an index, whether through a traditional market capitalization weighting, or otherwise.

Active: Any strategy that is designed to generate excess return, reduce risk, or both, relative to a "market" index. There is an additional distinction to be made here given that there are now essentially two types of active:

1. Traditional: Strategies that attempt to outwit the market by making forecasts about the behavior of securities, sectors, or asset classes and
2. Smart Beta or Factor: Strategies that attempt to outperform the market by strategically tilting toward the types of companies that have proven to beat a simple market over time. Here, a manager can passively track an index that is not "the market," hence the overlap between passive and active.

A key consideration to keep in mind, however, is cost. Traditional market capitalization weighted indices tend to be very cheap and efficient. Therefore, investing in something that costs more should demonstrate some value above and beyond the market, whether it be excess return, risk reduction, or some combination thereof.

The choices afforded investors in this current era is what makes the debate more important than ever. A modern investment fund can now be a low cost, index vehicle while still trying to do better than the market. Let’s look at an example.

As can be seen, the manager is not trying to handpick high quality stocks through forecasting. Rather, he or she is simply managing to an index of companies that demonstrate quality characteristics. Thus, we have demonstrated what happens when an investor combines the traits of an active tilting investment strategy with that of an index investment strategy. This is Smart Beta or Factor Investing.

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Conclusion

To summarize, in the past, passive simply meant an index of stocks weighted by market capitalization and active meant a professional manager trying to pick stocks that would outperform that passive index. Now, a professional manager can be active and try to outperform a market index, but he/she can do so either by (1) trying to forecast asset returns (traditional active), or (2) passively managing to an index of securities that are weighted by something other than market capitalization (Smart Beta or Factor Investing). As noted earlier, in order to justify using an active stock picker or an active index, the benefit needs to exceed the higher cost. Because active indexing tends to provide stock picker return patterns, the evolution of the debate becomes much more important in evaluating what exactly investors are getting for their money – make sure to ask if the thing you own is accomplishing its objective. You don’t ALWAYS get what you pay for, and cheaper isn’t always better.

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<th>Passive Index</th>
<th>Smart Beta</th>
<th>Active Fundamental</th>
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<tr>
<td>Objective</td>
<td>Track a market</td>
<td>Outperform the market</td>
<td>Outperform the market</td>
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<td>Active Index/Factor Investing</td>
<td>Traditional active</td>
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<tr>
<td>Strategy</td>
<td>Weight by market cap</td>
<td>Weight index by a characteristic</td>
<td>Forecast security or asset returns</td>
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<tr>
<td>Complexity of objective /strategy</td>
<td>Simple</td>
<td>Moderate</td>
<td>High</td>
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<tr>
<td>Source of complexity</td>
<td>None</td>
<td>Definition of characteristic</td>
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<tr>
<td>Cost</td>
<td>Lowest</td>
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At Symmetry Partners, we subscribe to the notion that active (or factor) indexing removes the pitfalls of trying to predict the future behavior of securities and asset classes. We construct portfolios that access the markets and the factors that have been demonstrated to outperform them over time. Therefore, we believe we sit at the crossroads of traditional passive and active, offering benefits of both. For more information, please contact your financial advisor or visit [www.symmetrypartners.com](http://www.symmetrypartners.com).

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**Dow Jones Industrial Average (DJIA)** represents a price-weighted average of 30 stocks traded on the New York Stock Exchange (NYSE) and the NASDAQ.

**Standard & Poor's 500 Index** represents the 500 leading U.S. companies, approximately 80% of the total U.S. market capitalization.

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