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Active Funds vs Passive Funds

Are you having more fun with the grandkids than taking time to worry about the stock and bond markets? Here are at least two ways of letting others help manage your money.

They are referred to as active funds and passive funds. Below is a general comparison and not a complete analysis of a complex topic. Contact your financial advisor for more info and to obtain a current prospectus.

Active Funds are the familiar mutual funds. The MFS Investment Management company is credited with introducing the first mutual fund, the Massachusetts Investors Trust, in 1924. There are now close to 10,000 mutual funds.

An investment management company hires a manager to manage a fund that has a specific objective. The objective might be stock growth, fixed income bond, utilities, European, health care, etc.

That one fund might have 50 different stocks with similar objectives, such as only health care stocks. Even if one stock should lose value, there are 49 left to continue diversification and soften any loss.

The company usually has many different and diversified funds in their family of funds that they manage.

To currently measure the performance of these active managed mutual funds, indexes were invented many years ago. For instance, the Dow Jones Industrial Average, invented in 1889, is an index of 30 industrial stocks.

Through the years, the Dow Jones has dropped and added new names, but "The Dow" is still 30 stocks.

The Standard & Poor's Index, invented in 1926, is an index of 500 of some of the largest stock companies in the world. The 500 change from time to time.

There are thousands of these indexes on any investment topic you can name. These indexes are put together by companies such as S&P, Vanguard, and others.

They are frequently used for comparison. For instance, how does your growth mutual fund compare to the S&P 500 Index, considered a growth market index?

You could compare a stock mutual fund investing in utility stocks to the Dow Jones Utility Index. It might be informational and educational.

One strategy is to buy the index. Buying the 500 stocks that make up the S&P 500 Index would mean buying 500 stocks. That might be a challenge, and expensive.

Passive Funds were introduced in 1993 to offer a unique way of doing just that. Instead of buying the 500 stocks, an investor would buy just one stock listed on a stock exchange representing all 500.

Being on an Exchange, these passive funds can be traded just like any other stock. This way of passive investing uses a term called Exchange Traded Funds, or ETFs.

According to research firm ETFGI, there are now at least 5,000 ETFs trading globally, with more than 1,750 based in the U.S, and more coming. The ETFs are called Passive Funds, because there is very little active management since they typically track a specific market index.

According to Morningstar Investment Research, the average passive Exchange Traded Fund carries an expense ratio of 0.44%, which means the fund should cost about $4.40 in annual fees for every $1,000 you invest. The average active mutual fund costs about 0.74%.

Frequently, active funds are compared to passive funds to see if the extra cost of active funds is worth it.

This comparison between active funds and passive funds is an on-going discussion as to which is better.

Generally, they are comparable. An active growth fund just might beat the performance of the passive S&P 500 ETF for a while, but then they swap performance leadership.

Mutual funds usually are actively managed to buy or sell assets within the fund in an attempt to beat the market and help investors profit. ETFs are mostly passively managed, as they typically track a specific market index; they can be bought and sold like stocks.

There has been a migration from active funds (mutual funds) to passive funds (ETFs), probably because ETFs are the new investment in the investing world.

Currently, there is about $17 trillion invested in active funds and about $4 trillion invested in passive funds.

Imagine an investment objective of a balanced portfolio. It might be composed of ½ stock and ½ bond using either mutual funds or ETFs. It certainly would be well diversified. But which is best for you?

One question is, who will win the performance race with them flip flopping from time to time? Active mutual funds one day and passive ETFs the next day? At the start of the day, no one can predict the best on any day, but there is a possible way to hedge your bet.

Suppose you had a managed portfolio composed of both. This hybrid portfolio could be an interesting investment strategy, hopefully using the best of both active and passive investing.

Ask your financial advisor if such a product is available. It might become an interesting diversification within your overall portfolio.

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