Investment Strategies: Active vs. Passive

As simply defined by one of the most successful investors of all time, Warren Buffet, "investing is laying out money now to get more money back in the future." Investors may hire financial professionals who possess the analytical skills, expertise and knowledge of the market and securities to assist them in attaining returns on their investments. One such professional is a portfolio manager. The portfolio manager develops and implements investment strategies aligned to their client's objectives, risk tolerance, liquidity needs, etc. as outlined in their client's Investment Policy Statement. This week's article discusses the difference between two types of investment strategies which the portfolio manager may utilise in the management of a client's portfolio of securities.

<u>Types of Investment Strategies: Active vs. Passive</u>

The concepts of active and passive investing are implied by their names. Active investing is a more hands-on investment strategy where a portfolio manager takes an active approach in choosing the types of securities to invest in. The aim of this strategy is to outperform the market's returns by capitalising on mispriced securities. Where such opportunities arise, the market is described as inefficient as securities prices do not reflect all the information available. Therefore, the portfolio manager conducts research and analyses the market patterns to determine which securities are undervalued, and therefore a good buy, as well as which securities to sell, in an effort to make a profit.

In contrast, passive investing is a more hands-off approach investment strategy where the portfolio manager buys and hold an index fund. This index fund tracks the performance of a particular financial market index, for example, the All TT Index[1]. In this strategy, the aim is not to outperform the market but to gain similar returns.

Advantages and Disadvantages of the Active and Passive Investment Strategies[2]

Active Investing

The advantages of active investing include the following:

- **The opportunity to outperform the market** –The aim of active investing is to beat the market, as such, there is a possibility to gain above the market's returns.
- **Flexibility** – A portfolio manager that uses an active investment strategy is not tied to a certain fund or security.
- **Risk Management** – The portfolio manager can choose the different segments to invest, thereby avoiding or minimising potential losses in particular segments.

The disadvantages of active investing include the following:

- **Human Error** – The performance of the investment is dependent on the skills of the portfolio manager, who can make an error in judgment and fail to make a profit on the investment.
- **Higher Costs** – Higher management fees are charged in order to pay for the skills and the expertise of the active portfolio manager.

Passive Investing

The advantages of passive investing include the following:

- **Low Cost** – Passive investing utilises the buy and hold strategy. There is less buying and selling of investments hence management fees are lower than active investing.
- **Less risky** – The investor is aware of what they are getting into, and it is generally unlikely that the investments drastically underperform the market index. Since passive investment is long-term, the investor can be less concerned about the market volatility.
- **Transparency** – Investors can be aware of their portfolio investments at more regular intervals than active portfolio managers.

The disadvantages of passive investing include the following:

- **No chance to outperform the market** – The objective of this strategy is not to outperform the market's returns therefore the investor forgoes the possibility to make extra returns.
- **Limited Flexibility** – The investor has to accept the construction of the index. There is no option in choosing the underlying holdings of that index.

Active and passive investing is not an "either or" condition. While these strategies are different, the portfolio manager can employ a mixture of to yield greater returns on their client's portfolio.

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[1] Measures the price movements of listed companies that are registered in Trinidad & Tobago.

[2] https://www.rathbones.com/sites/default/files/literature/pdfs/rathbones_active_vs_passive_investing_james_pettit_investment_report_full_website.pdf

The portfolio manager provides investment advice and may engage in the buying and selling of securities on behalf of the client. In that regard, no person who performs the aforementioned activities can do so without being registered in accordance with Section 51 of Securities Act, Chapter 83:02 of the Laws of the Republic of Trinidad and Tobago ("SA 2012"). The portfolio manager is required to act in the best interest of the client. Through the aforementioned activities which the portfolio manager performs, the Trinidad and Tobago Securities and Exchange Commission ("TTSEC") is able to protect investors from the malpractice of the professional. The TTSEC encourages investors to conduct their necessary research in the securities they wish to invest as well as the entities which they choose to conduct their investment activities as outlined under Section 51(1) of the SA 2012.

For more information on the securities market and the role and functions of the TTSEC, please visit our corporate website at www.ttsec.org.tt. To become a smart investor, download our Investor Protection App (IPA) via the Google Play and Apple Stores. You can also take the investor education online course on our investor education website, www.InvestUcateTT.com, and test your knowledge in our interactive investing game InvestorQuestTT at www.InvestorQuest-tt.com, and remember, to connect with us via Facebook; Twitter, Instagram, LinkedIn or You Tube.

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