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MITIGATING MAYHEM

Pros and cons of active vs. passive investing in a volatile market

By BERNADETTE STARZEE

With nearly $8 trillion wiped out from world stock markets in the first few weeks of this year, Long Islanders have seen their retirement funds and other investments take a nosedive.

With continued volatility expected amid uncertainty in oil markets, emerging countries and the upcoming U.S. election, investors are wondering just how low the markets might go.

The current bear market shines a spotlight on the debate over whether investors should be in actively managed funds versus passive ones.

While investments in actively managed funds are manipulated based on the research and expertise of a manager or team of managers, passively managed funds are tied to a market index. For instance, the Vanguard 500 Index fund is invested in the 500 stocks of the Standard & Poor 500 Index; if one company on the index represents 1.2 percent of the index, the same portion of the funds will be invested in that company.

Over the last decade, there has been considerable movement from actively managed accounts to passive ones like index funds and exchange-traded funds, amid widespread reports that indices and ETFs outpace actively managed funds in the majority of cases. For instance, according to the most recent SPIVA U.S. Scorecard by the S&P Dow Jones Indices, over the last 10 years, 79.59 percent of large-cap active managers failed to deliver incremental returns over the S&P 500 index.

"If you just bought the S&P Index, you would in most cases have had a better experience than you would with an active manager," said Charles Massimo, CEO of CJM Wealth Management in Deer Park. "Active investors will pick a few stocks that will outperform the index, but it's almost impossible to do it on a consistent basis."

As recent times have demonstrated, "the market is a risk itself," Massimo said. "When you bring on an active manager, you're adding increased risks. The manager could totally screw up and buy the wrong stock at the wrong time."

Active funds typically have far fewer stocks than, say, the S&P 500 or the Russell 3000.

"There's far less risk if the funds are spread across 3,000 stocks than 30," Massimo said. "If any financial advisor recommends active over passive, if I'm an investor or client, I would ask long and hard, why? Show me the data; they're going to have a difficult time producing any consistent data."

According to Massimo, investors on average pay 1.2 percent in fees to an active manager versus 0.2 percent to a passive manager.

This means it's not merely good enough for an actively managed fund to match an index.

"If the fund's internal costs are 1 percent more, and the S&P is up 10 percent, the active fund has to be up by over 11 percent to show its value," said Lawrence Sprung, president of Mitlin Financial in Hauppauge. "It may not sound like a lot, but it's a 10 percent difference."

However, Sprung does not see himself as being strictly in one camp versus the other.

"I think there are opportunities and situations to use both," he said. "For certain areas of the markets, such as large-cap companies, I don't think there's a lot of opportunity for outperformance by using active investments. But there are other market segments that are more inclined to get a benefit from active versus passive, such as international, emerging markets or small-cap companies in narrow niche areas that are not as closely followed by analysts."

Because there are pros and cons to both active and passive management, a combination of both strategies is generally the most advantageous, said Eric Szczurowski, a financial advisor with Kuttin Wealth Management in Melville.

While the passive strategy is generally best in a rising market, he said, "in the recent environment, active managers are much more favorable – they're paying attention and making updates to mitigate some of that downside, as opposed to being passive and going along for the ride."

Whether an active or passive investment is best depends largely on the investor, Szczurowski said.

"If you're a passive investor, the hardest part is to maintain discipline when markets are volatile," he said. "If the passive investor lets his emotions get the best of him and forgets the investments are for long-term goals like retirement or their children's education, and they withdraw money when the market falls, they're locking in those losses. When the market rebounds, they're going to miss it.

"There's a lot going on – with elections, the oil markets, interest rates – and you may have more exposure than you think," Szczurowski continued. "If you have someone who's watching what's going on who doesn't have the same emotional ties that can advise you, they can protect you."

Photo by Bob Giglione

LAWRENCE SPRUNG: There are opportunities and situations to use both actively and passively managed funds.

Investors who choose active over passive investments "have to do a lot more due diligence to find those funds that will do well," Sprung said. "People who don't have an advisor don't want to go that route – it's better for them to go the passive route. I don't think most individuals have the knowledge or capacity or technology to screen which niche players can add value."

The big-name mutual fund companies are "positioned in such a way that they're more of a marketing company than an investment company," Sprung said. "Whatever kind of strategy you're looking for, they have something for that strategy. They have many different funds but they may only be good at managing two or three of them."

Over the last few weeks, "there has been no discrimination – everything has been down," Sprung said. "Other than being in cash, there's been no hiding."

The current climate demonstrates a need to go back to fundamentals, Sprung said.

"Those that are young enough and have enough time on the horizon, this is one of those times that they may consider deploying additional money to work, at lower prices," he said. "But for those who don't have the time or the risk tolerance, it's time to do a check to make sure the way things are positioned and being managed are still in line with their goals and objectives, and make sure any changes that need to be made are made."

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