Active vs. Passive Investing:

The Virtues of Active Management

By Charles Lowenhaupt

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As volatility returns to the market and inflation is again top of mind, it would be wise for private wealth holders to revisit the fundamentals of their investment philosophy.

If they have managed wealth properly, very little will have changed over years. As always, the starting question remains same: What is your wealth for? Due diligence, asset allocation process, and diversification remains the foundations of good wealth management. With the new tax law in the U.S., wealth holders may also want to revisit many of their tax strategies. However, what is markedly different in 2018 is the popularity of "passive investing," which was practically unknown in the 1970's. The theory of passive investing is that investing in indices (either through exchange traded funds or index funds or similar representatives of various investment indices like the S&P 500s) is cheap, effective and "performs" better than most managers. There is no active management of stocks and bonds. Instead, the investor chooses the index based on asset allocation.

Tying one's wealth to various indices and utilizing various derivative products to do that has blossomed over the past ten years. Many private wealth holders have adopted the philosophy that it is easier and cheaper simply to track the marker than to try to "beat" it.

The Downside of Passive Investing

In fact, holders of substantial private wealth should now be examining not only the advantages – price and efficiency – but the drawbacks of passive investing. Let us examine some of those.

- Wealth comes from a community and its needs. The wealth creator generally sees a need in the world and builds a business to meet that need. Innovation across every industry segment and the development of new markets around the world have created much of the wealth of the past 100 years. "Passive investing" is simply putting money in a black box. What's inside that box is hard to see because there is no transparency. How does the box add to the world's welfare? These are questions for the wealth holder to answer and also to consider in terms of the culture and values to be passed to future generations.

- The rise of "impact investing" may well be a reaction to passive investing. Impacting investing is a way to use wealth to create both financial performance and social gain. In this way, investors can see their money making a difference. Passive investing has no such intent. The active manager can show the world how the money makes a difference by investing in publicly traded stocks. Some examples:

- Fifty years ago, an investment counselor could tell his clients the story of companies making a difference. IBM, General Electric, Minnesota Mining and other firms were changing the world, and a meeting with the investment professional would allow the story to be understood. "I am investing in progress" was what one young investor said of her investment in General Electric.
- An active manager of Mexican decent saw the challenges of immigrants trying to send money home through Western Union – high fees and many glitches. He invested in his clients' portfolios in Texas banks near the border and in towns which large immigrant communities. Those banks allowed deposits in U.S. accounts to be accessed by the Mexican relatives of migrant workers and became depositories for the migrants and their families. Portfolios performed well and people benefitted.
- A group of investment professionals believed that sustainability would result in increased profits and started a fund to invest in sustainable businesses. eBay was seen as sustainable because it allowed recycling of merchandise and purchase without driving to shopping centers. Similarly, other companies were viewed as geared toward sustainability and the investment portfolio has done very well.

The Blindness of Indices

If there are companies or industries that an investor believes are creating harm, passive investing will make it difficult to avoid such companies. S&P and other accepted indices do not distinguish between tobacco and health care, weapons and wind energy. So long as a Wells Fargo is a disproportionate part of a large cap passive portfolio, investors are likely to hold an oversized position in it. Imagine the shock of the Florida teacher's union when they learned that their passive portfolio was holding the manufacturer of the rifle that filled the students in Parkland, Florida. Indeed, many passive portfolios hold a number of gun manufacturers according to Barron's.

It should never be forgotten that indices are created by committees of actual human beings. The committees are not creating those indices for investment or social purposes and their standards are often unfathomable to outsiders. So analyzing why you own what you own in the underlying index is generally impossible. Consider for example the Dow Jones Industrial Average and the S&P 500. These are two very different indices each intended to measure similar trends.

Many indices do now differentiate based on country or style. For example, many emerging market index funds do not pick the best emerging economies and eliminate the worst. A small cap index fund is bound to represent a number or poorly run small companies in some of the worst governed countries.

Over time capable managers can outperform their benchmark indices, at least for certain periods. Of course, if the entire universe of active managers is considered, the likelihood of prolonged outperformance is limited. But carefully selected managers generally outperform markets, especially in markets which are inherently challenging. The S&P index has had periods of sluggish or no growth during which some active managers have done well. The star case for active management is Warren Buffett, but in fact there are many more who succeed even as markets do not.

Active Managers And Their Fees

The challenge of active management is that often substantial fees are embedded in the programs. Here is where passive investors cite efficiency of that approach. Particularly with smaller, actively managed portfolios, the fees themselves can interfere with performance. However, larger portfolios that are actively managed do benefit from economies of scale. It's worth noting that well-designed passive investing strategies do require a manager to allocate among the various funds. That manager may also charge fees.

A rational philosophy towards investment would not make large capitalization a standard, yet most passive investing is outweighing Apple, Microsoft and other large companies. Most passive investing becomes momentum investing and will often result in spectacular failures. "I invest in the company because it is large" prevents the periodic rebalancing every portfolio needs. Companies like Microsoft or Walmart were once small and there are many portfolios which grew with them.

Indeed, in my experience, substantial family and private portfolios have grown successful over many years by finding opportunities to buy new companies. Knowing when to take some of your gains to find new companies to reinvest has created success over many years for the best run family portfolios. It may be true that one can find indices which are not market weighted. However, once an investor leaves the orthodox and quoted indices, is he or she really investing in an index which is used as a benchmark by other managers?

The Importance of Due Diligence

Due diligence – knowing you own what you think you own and having considered the risks you need to consider – can be quite difficult with passive investing. That's particularly true of those funds that rely on derivative strategies to mimic the index.

Even passive managers must make decisions about reinvestment, when to trade, when to purchase and how to purchase new holdings, custody, and administration. There can be differences between the management fees of passive funds of the same index, albeit in the few basis points. How do you evaluate and continue to monitor those decisions? Consultants managing passive portfolios often respond when asked about due diligence: "We perform that due diligence by using only the best-known funds, the same ones used by the big institutions." One must only remember Lehman Brothers or AIG to conclude that name alone does not ensure solvency.

About the Author – Charles Lowenhaupt

Charles A. Lowenhaupt is a recognized leader and wealth counselor for ultra-high net worth individuals and families around the world. He is Chairman and Partner of Lowenhaupt & Chasnoff, LLC, the first U.S. law firm to concentrate in tax law and established by Charles' grandfather in 1908. Charles has a Bachelor of Arts degree, cum laude, from Harvard University. He also has a Juris Doctorate, Order of the Coif, from the University of Michigan Law School. He is a member of the Bar of Missouri and New York. Charles is the author of three books: Freedom From Wealth (with Don Trone and translated into Portuguese), The Wise Inheritor's Guide to Freedom from Wealth, and The Chase Continues.

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