Why Passive Is Better Than Active Investing

There are few topics in the investing world that generate more conversations and heated debates than this topic. We did a Google search on the topic “passive vs active investing” and over 21 million results came back! Let’s look at this debate and make our case for why passive investing (the approach we follow) is better than active investing.

Definitions

Passive investing involves buying and holding a basket of securities. Securities are rarely traded. The best example of a passive investment is an index fund, for example, the S&P 500 index. This index is made up of the 500 largest U.S. companies. If you buy a mutual fund or Exchange Traded Fund (ETF) that replicates the S&P 500 Index, you are using passive investing.

On the other hand, **active investing** takes a hands-on approach and is short-term focused. It requires someone to make regular and frequent decisions about a portfolio’s holdings. When and what securities to buy and sell is done by someone or a team of people following specific rules. At its core, active investing is identifying an underpriced or under-valued security and buying it in hopes that the security will go up in value.

Is Passive Investing Better than Active Investing?

Over the short term, maybe not. In the longer term, yes. Here’s the evidence.

According to Morningstar (an investment information provider), 51% of active mutual funds and Exchange Traded Funds (ETFs) outperformed their average index in the first half of 2020. However, only 24% of all active funds topped the average of their passive rivals over the 10-year period ending June 2020. Over longer time periods, active funds tend to perform worse. Other independent studies show similar results.

Success rates vary by investment category. By investment category, we mean funds that focus on large or small U.S. stocks, non-U.S. stocks, real estate, and different types of bonds. Here are some examples. This chart shows the percentage of active funds that outperformed their indexes over the ten-year period ending in June 2020.

Investment Category	% Outperformed *
Large U.S. Stocks	9.5%
Small U.S. Stocks	15.5%
Non-U.S. Stocks	20.4%
Corporate Bonds	40%
U.S. Real Estate	40.2%
Emerging Markets	44.7%

**data from Morningstar magazine 04/2020*

Keep in mind that there is no way to predict which active fund will outperform in advance. You can only buy into a fund and hope for the best. Research shows that approximately only 50% of active funds survive more than 10-years. Fund companies simply close the funds that consistently show under-performance. Want more proof of the folly of predicting the future: in 2020, the S&P 500 index (the largest 500 companies in the U.S.) gained approximately 14%; however, more than 40% of the stocks in the S&P 500 were down in 2020. There was no way to know in advance which stocks would be up and which would be down by the end of the year.

Why Do Passive Funds Outperform Active Funds?

Here is the fun part for us. Let's speculate why passive funds do better than active funds. Here are five reasons we believe this is true.

1. **No one knows the future**. Active investing is based on the premise of what will happen in the future. This is impossible because security prices move randomly. As a result, an active investor must ***<u>guess</u>*** correctly for this approach to work and the cost of guessing incorrectly is high. Keep in mind that an active investor must be right **<u>twice:</u>** one when a security is sold and once when something is purchased. Difficult to be right once and impossible to be right twice consistently.
2. **Human behavior**. Emotions always factor in decisions of when to buy and sell. Any investor – you, me, a fund manager – are swayed by our emotions and the environment around us. Who could not be influenced by the events of 9-11 or the pandemic of 2020? Yet, research shows that trying to time the market (sell now and buy in later) is a formula for failure.
3. **Financial Industry Propaganda**. The flood of information in the media is overwhelming and aimed at one thing – to sell something. Television, the internet, newspapers, and magazines survive by selling the services of their advertisers. And the first step in selling something is to get the potential customers' attention. Financial media do this by blaring the newest and greatest financial instruments or ideas.
4. **No one wants to be average**. We live in a success focused world and it's difficult to accept average. Our egos get in the way. Competitive people want to win, darn it! Average is difficult to accept. But shooting for average is the only way to win when it comes to investing.
5. **Costs matter.** The high cost of active trading makes it difficult to surpass a passive index. Morningstar reports that even among active funds, costs matter. For example, Morningstar data shows that the cheapest active funds have an overall 34% success rates versus a success rate of the priciest funds.

One more thought: if you own an actively managed mutual fund or ETF, what do you do when it lags its index? How long do you wait to determine it's time to change funds? These are difficult decisions for active investors. Passive investing avoids this dilemma because our favorite holding period is forever.

Conclusion

Passive investing is the clear winner in our eyes. Passive investing is incorporated into our five investing principles:

1. Risk and return are related
2. No one can predict the future.
3. Passive beats active
4. Diversification improves risks.
5. Costs matter.