Where is the "smart money"?

A great deal of energy has gone into the debate over which investing strategy makes the most sense, and many investors find themselves bewildered by the often contradictory "advice" they receive from television shows, sales brochures, and even academic journals. In the midst of constantly changing market opportunities, so-called "passive" investing provides investors a solid way to capture market returns without being hurt by failed attempts to outguess the market.

Investors tend to follow two broad schools of thought. The first group claims that superior information and skill allows them to exploit opportunities that others miss. We call these investors "active." The other group concedes that because so many intelligent, well-informed and well-funded participants buy and sell in the public financial markets each day, one cannot realistically expect to capture those fleeting opportunities with any lasting degree of success. Meet the passive investors.

Humans tend to look to others' past success for comfort before risking their own money. Unfortunately, specific investment strategies that previously triumphed work best only under certain conditions that may never recur. By the time someone is making money selling us the latest hot idea with their charts and past return numbers, we really can't be sure it will still work for us.

Some active investors (e.g., Warren Buffett, Peter Lynch) genuinely seem to possess superior skill and can profit from choosing just the right investment at the right time, but it is probably fair to say that active strategies produce the greatest profit for product creators and distributors. For example, active mutual funds generally have high relative expense ratios (the percentage of net assets the management company takes from the fund to compensate itself). And significant academic research shows us that active strategies usually do not outperform market indexes over the long run—largely *because* of their expenses! And very active investors can run up large capital gains by continually trading in and out of securities.

Thankfully, in the past few decades it has become easy to invest without needing to predict what everyone else is going to do. Passive investing strategies acknowledge that public securities markets work and are generally efficient, meaning that they quickly incorporate available information into prices. (That is not to say that prices are always fundamentally accurate – because information which changes prices can surface later – but no one knows for certain how much prices should have moved or when they will correct themselves.) So the passive investor's goal is to capture an average market return by purchasing essentially all securities available in that market.

Index funds represent the most common passive investment vehicles and are typically structured as mutual funds or exchange-traded funds (ETFs). (In case you're wondering which type you own, remember that mutual fund symbols usually have five letters ending with 'X' and that ETF symbols generally have three letters.) An index fund will either purchase all securities listed in a published market index (such as the S&P 500 index for stocks or the Lehman US Aggregate index for bonds), or it will choose to hold certain representative securities from the index whose performance statistically provides the same overall return as that index.

Of course, when an index publisher announces a change in the index, an index fund must replace its holdings promptly in order to stay on track. So some passive funds follow unpublished indices or drop the "index" label and retain the flexibility to make changes a few days before or after any official announcement. By purchasing a passive fund, investors expect to realize the average market return net of mutual fund expenses—which are far less than an average active mutual fund's expenses. Capital gains should also be lower because of reduced trading activity, or "turnover."

Passive investors are free to manage overall portfolio risk because they do not have to time the market or race to select the best individual securities. Most informed investors know that the mix of stocks, bonds, and other asset types drives a portfolio's overall volatility and helps determine its long-term returns. For example, a portfolio with 100% stocks will lose much more in a bad year than a portfolio with 50% stocks and 50% bonds. In a good year for stocks, the first portfolio will reward the investor with significantly higher returns.

Not only do active investors need to determine the appropriate asset mix, but they must also try to ferret out the best values and purchase them at the best time—a monumental task at best. In the words of Charles D. Ellis, active investing is a "loser's game." Despite active investors' image of superior intelligence, passive investing looks like the smarter strategy.