Questions You Were Afraid to Ask 4- The Difference between Active and Passive

A few months ago, we started a series of newsletters called "Questions You Were Afraid to Ask." Each month, we look at a common question that many investors have but feel uncomfortable asking. Because when it comes to your finances, the only bad question is the one left unasked!

In our last newsletter, we looked at the differences between stocks and bonds. But these days, most "regular" investors – i.e., non-professional – have neither the time or expertise to research and select individual stocks. (Or bonds, for that matter.) Furthermore, doing so can subject your portfolio to increase risk and unexpected tax consequences. That's why investors usually rely on a different method: Putting their money into some type of **fund**.

An investment fund is when a group of investors pool their money to invest in the same portfolio of stocks or other securities. There are two major advantages of funds: Cost and simplicity. By pooling your money with other investors, you can gain access to a diverse basket of stocks for less than if you bought each stock individually. Funds also make it simpler for investors to get started, since they don't have to research and select each individual company.

These days, most people invest either through an employer-sponsored retirement plan, like a group RRSP, or a self-directed RRSP/TFSA. Either way, this usually involves selecting between one or more funds to invest in. But here lies the problem for many people, even the financially savvy: How do you know which funds to choose? And what's the difference between them, anyway?

Both in this letter, and in next month's, we're going to address that issue. We'll start with one of the most common questions we get, especially from beginning investors:

Questions You Were Afraid to Ask #4:
What's the Difference Between Passively Managed and Actively Managed Funds?

If you're investing in, say, a self-directed RRSP/TFSA most of the fund choices you'll see will fall under one of two categories: Passive vs Active.

Let's start with the latter. An actively managed fund is exactly what it sounds like: A fund where a manager takes an active role in selecting which securities to buy or sell, and when.

Different managers have varying styles and philosophies. For example, some may specialize in finding companies they believe are undervalued, which means they can be bought at what is believed to be a good price.

Others may try to find companies they think are likely to grow by a significant amount. Some managers may specialize in certain industries or market sectors. You get the idea. Either way, with active management, you are paying for one of two things:

- The possibility that the fund will "outperform" the market. This means the fund could do better over a specified period than a benchmark index – like the TSX or S&P 500 – that it measures against.
- The possibility that the manager will be able to protect you against undue risk or limit losses during times of market volatility. (Note that this idea more generally fits the purpose of **hedge funds** than the standard **mutual funds** you'll usually see in your RRSP or TFSA). We'll cover these types of funds next month!)

The possibility of outperforming the market comes with some tradeoffs, however:

- Actively-managed funds often come with more – and higher – fees than passively managed funds. That's because the manager must charge for his or her services.
- While it's possible for a manager to outperform, it's also possible to "underperform." When that happens, you are essentially paying more for less.

Now, let's look at passively managed funds. Here, there is no "active" or research-based management decisions to the buying or selling of holdings. Instead, the fund invests in a specifically designed portfolio and then stays put. The fund may "rebalance" at some other set time frame, often quarterly or annually. This is to reset to its original objective or to match its index better. Otherwise, everything is held for the long-term.

These days, many passive funds are **index funds**. This is when the fund's portfolio is built to try to match a target index, like the S&P 500. So, if you essentially want to replicate a broader stock market, again like the S&P 500, index funds could be the way to go.

Passive funds come with the following advantages:

- Typically, much lower cost, especially with index funds. Because there's nobody actively picking stocks, the fund could come with fewer expenses, and thus, lower fees.

- However the target index performs, with occasional variances, that's how you're likely t perform, too. Given that indices like the S&P 500 have historically risen in value over the longterm that could make index funds a good option for those who want to invest and forget it for a *long period of time.*

On the other hand…

- There's little chance of outperforming the market. That's an issue if you need more aggressive returns. In addition, index funds come with no specific protection against extreme volatility.
- Typically indexes are market weighted meaning, a group of a few companies could make up the majority of the fund.

Note that when you make your selections in a RRSP or TFSA, you can tell whether a fund is active or passive by reading its summary. (More on that in a future letter.) We should also note that passive vs active doesn't have to be a binary choice. Many investors take advantage of both options in their portfolio!

While most funds are either active or passive, there are many types of funds within those two categories. Next month, we'll look at a few of those types, including **mutual funds**, **hedge funds**, and **exchange-traded funds**.

Thanks!

Sheean K. Patel, B.Com, CIM
Wealth Advisor
Portfolio Manager
905-849-3549

Shik Patel, CIM
Wealth Advisor
Portfolio Manager
905-849-3549

Book a meeting with us here!

PS: If you ever come across anyone that could benefit from our services, we'd love to help!
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Patel Wealth Management Group - National Bank Financial Inc.
880 Upper Wentworth St, Hamilton, Ontario. L9A 5H2
305 Church St, Oakville, Ontario. L6J 1N9
www.patelwealth.ca