Active Vs Passive Strategies

Active Strategies: Adding Alpha

Active strategies employ a hands-on approach to investing, usually in the form of a portfolio manager who actively seeks to select securities that have further upside potential.

The overall aim of the portfolio manager is to maximise returns, thereby outperform the benchmark index or beat the stock market's average return. It involves a deeper analysis and looks at a combination of both quantitative and qualitative factors, to determine the most suitable assets for the investor’s profile.

Investors can choose between active, passive, or a hybrid approach, where they have greater control over their investments and can hold securities in different weightage simultaneously aligned with your investment objectives and risk-tolerance.

Passive Strategies: Low-Cost, Broad Exposure

On the other hand, passive strategies rely on the efficient market hypothesis which states that markets are efficient and that prices of securities will always reflect in discount or add all available information. As such, passive strategies will trade at their fair value.

Broadly, active investment strategies offer the following distinct advantages:

- **Flexibility** - Investors have greater flexibility in their investment approach, since they are not necessarily tied to a specific index.

- **Potential for higher returns** - Active strategies employ a handson approach to investing, usually in the form of a portfolio manager who actively seeks to select securities that have further upside potential.

Conversely, passive investment strategies would offer these following advantages:

- **Low-cost** - Passive solutions like index funds or ETFs will have lower fees since there is no material results, and are thus suited for investors with a similar longer-term investment timeframe.

- **Tax management** - Investors could tailor their investing strategies according to the most efficient tax manner.

- **Flexibility** - Because passive solutions like ETF or index funds seek to track the performance of the benchmark index, rebalancing of assets in the funds only takes place when there is a change in constituents or securities in the index. Thus, operational costs are kept low and as such passive funds charge lower fees.

So Which One Works Better?

In emerging markets such as Malaysia, active manager like ourselves are still able to deliver alpha and add returns to outperform the benchmark index.

The active versus passive debate has played out across numerous investment arguments for either approach – the debate still rages on.

The active versus passive debate has been historically characterised as a subsystem and over time, both strategies alternate places to be on top of performance charts. Business cycles and market conditions change, which could easily vary either side of the argument.

The key difference between both strategies is why the two do not have to necessarily be at odds to complement your portfolio.

Why not both?

Active/passive strategies do not need to be mutually exclusive. The investor would seek to blend both strategies to create a diversification that has the potential to give broad market exposure using low-cost passive solutions such as smart-beta ETFs and quantify funds that select the right combination of both active and passive investing strategies.

However, irrespective of both approaches, it is important to understand that neither strategy comes without risk nor do they necessarily provide guaranteed returns. Thus, instead of deliberating between active or passive - it is more useful for investors to instead make it difficult for active managers to consistently pull undervalued stocks and sell them at higher prices.

The strategy is also premised upon the efficient market hypothesis which states that, as per the law of one price, securities will always trade at their fair value, cannot be excluded.

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To a certain extent, the active vs. passive debate has been mischaracterised as a subsystem, but instead, the debate still rages on. A single investor or portfolio is going to have some exposure to both strategies.

In the same vein, because active strategies do not track an index, investors also have greater control over their investments and can hold securities in different weightage simultaneously aligned with your investment objectives and risk-tolerance.

From an investor perspective, this means your returns will only be as good as how the market performs overall - no better or worse-off. Because passive solutions like ETF or index funds track the performance of the benchmark index, rebalancing of assets in the funds only takes place when there is a change in constituents or securities in the index. Thus, operational costs are kept low and as such passive funds charge lower fees.

Active/passive strategies do not need to be mutually exclusive. The investor would seek to blend both strategies to create a diversification that has the potential to give broad market exposure using low-cost passive solutions such as smart-beta ETFs and quantify funds that select the right combination of both active and passive investing strategies.