

Active Versus Passive: Which Investment Strategy Is Best For You?

The two rival camps make compelling arguments; understanding the pros and cons of each

Some money managers can and do outperform their benchmarks over time, even when costs are factored in.

The long-running debate between active and passive investing is a lively and sometimes heated one, played out in the pages of the financial press, in academia, and in the marketplace. Not too long ago, only a few index funds existed, tracking major market indexes such as the Standard & Poor's 500. Today, index funds track more specialized areas such as value stocks, emerging markets, or even industry sectors. Newer passive strategies include "Exchange Traded Funds" (ETFs), which are securities that trade on a stock exchange but mimic the performance of an index, much like index funds. Is passive investing all it's cracked up to be?

In passive investing, a portfolio manager attempts to simply match — not beat — the performance of an index or group of securities. Fans of passive investing cite its generally lower costs, which can have a significant impact on investment results. They can also point to statistical evidence that most portfolio managers do not outperform their benchmark indexes over the long term — hence, a passive strategy at least assures you will match the benchmark (minus costs). Nobel Prize winning economist William Sharpe has described passive investing as a "dull, boring way to be a better investor than many of your friends."¹

Active managers respond with a few simple facts: First, some money managers can and do outperform their benchmarks over time, even when costs are factored in. Also, just looking at performance potential overlooks the considerable benefits of active investing through a private account. Investors who have enough wealth to create a well-diversified portfolio of individual securities can enjoy an investment strategy that is tailored to their individual goals, income needs, risk tolerance and tax situation. For these investors, the benefits of customization may outweigh the case for passive investing.

Even those who praise the strengths of passive investing acknowledge it is not a panacea. In a speech last year, Nobelist Sharpe asked: "Should everyone index everything?" His answer: "Resoundingly no!"² Nonetheless, as passive investment strategies grow more prevalent and more sophisticated, it's worth taking another look at the debate between active and passive investing.

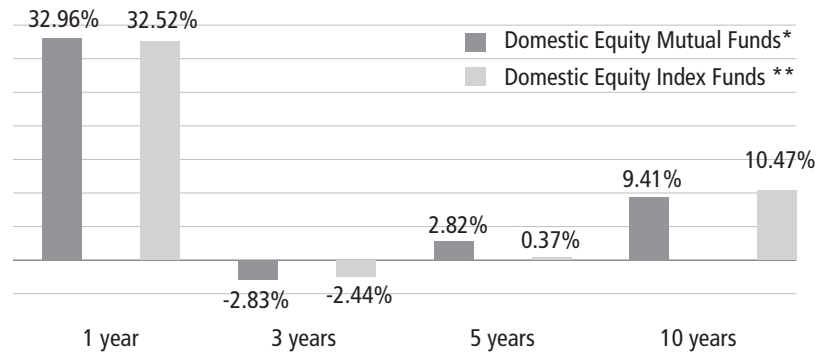
¹ Speech presented at the Monterey Institute of International Studies, May 1, 2002

² *ibid.*

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SHIFTING FORTUNES

Average annualized return of actively managed stock funds versus index stock funds (Period ending 12/31/2003)



Active managers, on average, outperformed index funds during the last one- and five-year periods, but index funds, in aggregate, outperformed over the three- and ten-year periods.

* Excludes ETFs, index funds, sector funds, balanced funds and bear-market funds

** Includes index funds for all market capitalizations and styles; excludes ETFs, index funds, sector funds, balanced funds and bear-market funds

Source: Morningstar

THE CASE FOR PASSIVE INVESTING

Passive investing is based on the controversial efficient market hypothesis (or efficient market theory), which asserts that in highly developed capital markets like those of the U.S., the prices of stocks embody all that can possibly be known about securities. Any news that affects a company is almost instantaneously translated into an appropriate adjustment in its stock price by alert investors.

Therefore, say efficient market supporters, you cannot consistently outsmart — or outperform — the market by picking out undervalued stocks that will produce gains when other investors come to appreciate their overlooked merits. Passive investing foregoes research and simply buys every stock in the market. When you buy an S&P 500 Index fund, for example, you're investing in all the stocks in that index — the good, the bad and the ugly. The Enrons as well as the General Electrics.

Common sense, however, suggests glaring flaws to the hypothesis. If the market “correctly” prices stocks, what explains the late 1990s’ technology stock bubble and subsequent spectacular bust? Can a dot-com stock be said to be fairly valued at \$100 in early April 2000 and also fairly valued at \$20 six months later? The field of behavioral finance is establishing a base of academic study that quantifies the ways in which human behavior can cause the markets to behave “inefficiently.”

On October 19, 1987, the efficient market hypothesis crashed along with the rest of the market.

The 1987 stock market crash is a classic example of the inefficient market. In one day—Black Monday, October 19—the Dow Jones Industrial Average tumbled 30 percent. Soon afterward, the Wall Street Journal editorialized that the efficient market hypothesis was “the most remarkable error in the history of economic theory.” Lawrence Summers, the economist who was Treasury Secretary under President Clinton and today is president of Harvard University, declared that the efficient market hypothesis “crashed along with the rest of the market.”

Efficient market theory aside, advocates of passive investing have some undeniable hard evidence on their side: Passive investing can be accomplished at very low costs, and these cost savings translate into bigger potential gains for investors over time. On average, the cost of a passively managed index fund is 0.80%, while the cost of the average actively managed mutual fund is 1.56%.³

Of course, comparing costs alone assumes that the investment results of the passively managed portfolio are equal to the investment results of the actively managed portfolio. And that’s where active managers beg to differ.

RATIONAL MARKET; IRRATIONAL INVESTORS

History is full of instances in which investors have appeared to take leave of their senses—from the overvalued Nifty 50 stocks of the early 1970s, to the 1987 stock market crash, to the tech bubble of the late 1990s. Here are some key behavioral traits that are common among non-professional investors:

Euphoria

Sometimes the past success of a stock colors our view of its future prospects. While it’s tempting to continue to ride a winning stock, many investors don’t know when to get off.

Panic

Investors commonly unload their shares at precisely the wrong time—after they have suffered serious declines and before they have had a chance to rebound.

Excessive Pessimism

Skepticism is a valuable trait, but not if leads you to avoid the calculated risk taking that’s necessary to generate returns.

Searching for Long Shots

Lottery tickets are appealing because of the possibility of a huge windfall. But the payoff, by definition, comes to only a few. Buying lottery tickets is not an investment plan.

Reacting, Not Acting

The markets always change. Strong companies may fade and miscreants may mend their ways. A good investment manager is proactive, seeking out opportunities ahead of the pack and shedding holdings as they stray from what made them attractive in the first place.

³ Morningstar, as of June 30, 2004

The potential for uncovering significant pieces of news that have not yet been discovered by the market may be greater today, thanks to new regulations that hinder the efficient flow of information.

THE CASE FOR ACTIVE INVESTING

Active investors don't dispute that major stock markets—in particular, the biggest one of all: America's—are efficient. But they argue that diligent, sophisticated research into company fundamentals can still uncover the kind of opportunities that can make for above-market returns. This is more likely when markets are relatively stable and not in the throes of a bubble mentality. Contrary to the passive investing doctrine, which maintains that stocks represent their "fair value" based on all the information available, active investing insists that stocks have an "intrinsic value"—one that tends to be either more, or less, than their market price.

One popular form of active investing, the "growth" variety, seeks out companies that are growing so quickly that their shares should outperform the market. The contrasting "value" approach relies on copious research to identify companies that are out of favor with investors yet have unrecognized potential and thus can legitimately be said to be underpriced: Their intrinsic value is substantially greater than their market value. The underlying companies may simply be out of fashion—the dot-com boom brought home how trend-conscious investors can be—or the companies may have suffered real setbacks, such as a loss of market share. However, nervous investors may have overreacted, and the companies' managers may be rectifying the problem. Astute research is critical to differentiate between truly undervalued stocks and those that are cheap for good reason.

Indeed, the potential for uncovering significant pieces of news that have not yet been discovered by the market may be greater today, thanks to new regulations that hinder the efficient flow of information. When the Securities and Exchange Commission passed Regulation Fair Disclosure in 2000, it intended to limit the *selective* dissemination of information by companies to large investors. It achieved its goal, but in doing so, lessened the overall flow of information from companies to the market. This creates opportunities for hard working analysts who can sniff out business trends through old-fashioned fundamental research.

The less "efficient" a market is, the more effective an active manager might be. Historical data has shown that some active fund managers can beat passive strategies when it comes to small-cap stocks and international stocks, markets that are not followed as closely by analysts as the U.S. large-cap stock universe. For the five years ending December 31, 2003, actively managed small-cap funds returned an annualized 11.63%, compared to an average annual return of 7.13% for the Russell 2000 Index. Similarly, all actively managed foreign stock funds returned 2.85% for the five-year period, compared to 0.26% for the benchmark MSCI EAFE Index.⁴

⁴ Morningstar

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THE CASE FOR...

Passive Investing	Active Management
Markets are efficient in the long term	In the short term, markets are not efficient
Stock prices reflect all known information	Stock prices often deviate from their intrinsic value
A low-cost investment strategy	Active management adds value
You can't beat the market	In-depth research can reveal opportunities
More effective in efficient markets	More effective in inefficient markets

THE SEPARATE ACCOUNT DIFFERENCE

Active investing shows its greatest strength when it is applied to separately managed accounts. Unlike mutual fund investors who must share year-end capital gains or losses regardless of their specific tax consequences, the manager of an individual's portfolio can choose specific losses to apply them against capital gains, thus reducing the annual tax bill. Managed accounts lend themselves to gifting strategies as well, making charitable contributions with appreciated stock for further tax savings.

Individual portfolio managers can also accommodate investment restrictions a client may have, or take into account a concentrated portfolio. For example, if you work for a technology company and have accumulated a large stake of its common stock, an active manager can limit your holdings of other tech stocks. Or if you have ethical or personal concerns about owning certain assets, such as tobacco stocks, for example, an active manager can accommodate your wish.

Last but not least, active management also provides a certain level of comfort that someone is in the cockpit when turbulence hits. While active and passive managers alike suffered in the bear market, many passive investors helplessly rode the S&P down almost 40 percent in 2000 through 2002. Moreover, broad index funds purport to provide comparative safety because they are diversified into many stocks, yet this can be deceptive: In early 2000, at the height of the tech boom, just 25 S&P 500 stocks accounted for 44 percent of the index's market capitalization.

THE BEST INDIVIDUAL SOLUTION

Now that passive investment strategies have become part of the mainstream, some of the lines between the passive and active camps are blurring. Some financial advisors use both passive and active strategies for their clients—using an index fund for a “core” portfolio and applying active strategies to “satellite” portfolios, in an effort to gain the best of both worlds: low costs with market-beating performance. Indexing itself is also evolving:

For individual investors, active portfolio management will always be able to provide the customization benefits that passive investing cannot.

some investment managers now provide “enhanced indexing,” which attempts to add just enough active management to outperform a pure indexing strategy.

Neuberger Berman believes that every individual is unique, and therefore every investor’s investment strategy should be determined on a case-by-case basis. But generally speaking, we believe that experienced portfolio managers, supported by strong analytical research, stand a much better chance of outperforming the market than does the “average” investor.

We also believe that investors who have enough assets to support a diversified portfolio of individual stocks are served best by active, professional portfolio management. For individual investors, active portfolio management will always be able to provide the customization benefits that passive investing cannot.

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