Active Vs Passive Investing

IFE Academy
Education Simplified

INVESTORS FINANCIAL EDUCATION ACADEMY

Phone : 044 - 2814 3044 email : bulletin@ifea.in www.ifea.in

What are our priorities?

Identifying your financial objectives and goals, at different stages of your Life.

Single
Set aside some savings for marriage or first home.

In your 20s

In your 30s and 40s

Family
Adequately protect your family financially.
Allocate your savings for children education and retirement funding.

Pre - Retirement
Review your Health Care Plan, Financial Assets to ensure a comfortable retirement.

In your 50s & above

At different stages of life, you will have different needs and challenges. By identifying your priorities you would be able to make realistic goals and efficient use of your financial resources.

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Introduction to Investing:

Investing is about setting yourself up for long-term financial success. It's the process of putting money to work over a long period, such as 10-60 years, by buying and holding assets that will grow from compound interest. In the investing world, the returns that are gained are linked to the perceived level of risk.

For example, holding onto cash is extremely low risk and as a result, it has a low rate of return. Maybe can earn 1% or 2% in a savings account, or using other short term cash like instruments. Likewise, in investing in stocks they come with a certain level of risk. It's possible the company invested in may run into problems but for taking this extra risk, return can be higher.

Investing is about taking advantage of higher rates of return and benefiting from the power of compound interest over long periods of time. It's also about finding the best ways to mitigate the risk.

Investment Strategies:

Investment strategies are strategies that help investors chose where and how to invest as per their expected return, risk appetite, corpus amount, long-term, short-term holdings, retirement age, choice of industry, etc. Investors can strategize their investment plans as per the objectives and goals they want to achieve.

The major strategies of investing are as follows:

❖ Active Investing Strategy:

An active investment strategy is a method in which individuals take more of an active role in buying and selling their shares. By taking this approach, investors attempt to own investments that look attractive and avoid anything that seems unattractive. Investors in this strategy of investments often manage their portfolios with value- or growth-oriented. Investing in these funds whose portfolio managers select investments based on an independent assessment of each investment's worth essentially, trying to choose the most attractive investments. Generally speaking, the goal of active managers is to “beat the market,” or outperform certain standard benchmarks. It is also called as Active Management.

Investment types:

- Actively managed mutual funds are the most common product for this investment strategy.
- There are also actively managed exchange-traded funds (ETFs).

What kind of investors invest in Active Investing strategy?

- Investors who invest in this kind of strategy is called as Active Investor.
- Investors can focus on undervalued sectors and have more control over the firms they own.
- Active investors have the opportunity to outperform the broader market.
- Individuals who embrace active investment take on more maintenance of their portfolios, face increased taxes if they trade frequently, and grapple with a major risk of active investing.

Benefits of Active Investing:

- **Risk management:** Active investing allows money managers to adjust investors' portfolios to align with prevailing market conditions.

- **Control –** Active investors can choose the stocks they believe in and that meet their criteria for a good investment. They can also exclude companies that don't stand up to their scrutiny.
- **Timing –** Active investors can change their approach based on market conditions. That could mean taking profits in an overheated market or doubling down when a stock is value-priced.
- **Performance –** A small number of active fund managers do have a lengthy track record of strong performance, consistently beating their benchmark for many years. These investing allows money managers to meet the specific needs of their clients, such as providing diversification, retirement income or a targeted investment return.
- **Alpha generating funds:** If the investor wants a bit extra than what the benchmarks are offering, then actively managed funds are better. The main objective of actively managed funds is to beat the returns of the Sensex and Nifty and generate 'alpha'. Here the fund manager uses his/her experience, knowledge and time for market research.

❖ Passive Investment Strategy:

Passive investing is a long-term strategy in which investors buy and hold a diversified mix of assets in an effort to match, not beat, the market. The most common passive investing approach is to buy an index fund, whose holdings mirror a particular or representative segment of the financial market.

This popular investment strategy doesn't try to outperform or "time" the stock market with a constant stream of trades, as other strategies do. Instead, passive investing believes the secret to boosting returns is by doing as little buying and selling as possible. It is also called as Passive Management.

Investment types:

- Passively managed ETFs are the most common product for this investment strategy.
- There are also passively managed mutual funds.

What kind of investors invest in Passive Investing strategy?

- Investors who invest in this passive investing are called as Passive Investor.
- The goal of a passive investor is not to beat the market but to closely mirror its returns, minus a small fee.
- These kind of investors execute a value or growth strategy described above by purchasing funds with that orientation.
- Investors passively hold the entire market using an exchange-traded fund (ETF) or index mutual fund.

Benefits of Passive Investing:

- **Optimistic outlook-** The core principle underlying passive investing strategies is that investors can count on the stock market going up over the long haul. By mirroring the market, a portfolio will appreciate along with it.

- **Low costs-** Thanks to its slow and steady approach and lack of frequent trading, transaction costs (commissions, etc.) are low with a passive strategy. While management fees charged by funds are unavoidable.

- **Diversified holdings-** Passive strategies also inherently provide investors with an efficient, inexpensive route to diversification. That's because index funds spread risk broadly by holding a wide array of securities from their target benchmarks.

- **Less risk-** By its very nature, diversification almost always brings with it less risk. Based on the funds they choose, Investors can also diversify their holdings further, within sectors and asset classes, with more targeted index funds.

Quick comparison between Active Investing vs Passive investing:

Feature	Active Investing	Passive Investing
Objective	To beat the market performance and focus on absolute returns.	To match the market performance, focus on relative returns.
Investor Perception of Market	Perceive markets to be insufficient.	Perceive markets to be efficient.
Transaction Frequency	Comparatively higher with lot of buying and selling	Comparatively lower, switching holding based on changes in index composition.
Performance	Provides the opportunity to outperform specific market indices.	Delivers returns that match the performance of specific market indices.
Fees	Active investing strategies tend to result in higher fees over time.	Passive investing strategies could result in lower fees over time.
Risk management	Higher returns but more risky	Lower returns but less risky.
Long Term Vs short Term	Takes advantages of short term price fluctuations.	Provides only Long Term investment focus.

Feature	Active Investing	Passive Investing
Diversification	Active fund managers can assemble diversified portfolios that spread the risk and reward among different asset classes.	Passive funds are a low cost way to be diversified within asset classes and market segments.
Expertise required	Superior skills needed to identify price discrepancies, arbitrage opportunities, fundamental and technical assessment of stocks.	Requires little decision making by manager. It is time savings due to less research and analysis involvement.
Portfolio Composition	More concentrated portfolios with fewer securities than broad market index.	All securities of market index held to match market performance.

Which investment strategies suites better?

In the end, it comes down to personal preference and what suits your investment goals.

- For Investors who don't have time to research active funds and don't have a financial advisor, passive funds may be a better choice.
- Investors who are willing to be at least somewhat involved with their investments, passive funds are a low-cost way to get exposure to individual sectors or regions without having to put in the time to research active funds or individual stocks.
- If investor prefers a more hands-on approach, active investing might be worth exploring.

- Investors should know that not all active funds are equal. Some might have lower fees and a better performance track record than their active peers. But remember that great performance over a year or two is no guarantee that the fund will continue to outperform.

Either way, having a clear strategy in place is a good first step in your investment journey. Or, if you've been investing for a while, it may be a good idea to review your strategy to ensure it still aligns with your goals and current circumstances.

Notes

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About IFE Academy

IFE Academy was established in 2011 as a Not-for-Profit entity to promote Financial Education. IFE Academy conducts Investor Awareness Programs across the country with the support of other market participants. www.ifea.in is a comprehensive website on Financial Education. It has various sections such as Videos, Puzzles & Games, Financial Calculators and Library. It gives a holistic view on financial education combining various aspects such as Savings, Investments, Credit, Insurance and Pension at a single place. IFE Academy periodically publishes Investor Educational materials and distributes it to general public.

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Regd. office : Park View, Basement, 85/17, G.N.Chetty Road, T.Nagar, Chennai - 600 017.
email : bulletin@ifea.in www.ifea.in