When Is It a Good Time To Be an Active Investor?

The financial media and investment gurus often try to sell investors on the "right time" to be an active investor. The following shows that it is never a good time to be an active investor.

Investment experts espouse all sorts of conventional wisdom. One assertion: There are times when active investing is a prudent strategy. Below are some examples:

- Peter Preiseler of T. Rowe Price Global Investment Services suggests the current "disconnection between long-term fundamentals and valuations has created investment opportunities — an ideal environment for active managers to demonstrate their abilities." He goes on to suggest, "One would expect an active manager to get the better of an environment where volatility was high."[1]
- Stephen Birch of investment consultant Hymans Robertson said, "Active managers will tend to find greater opportunities to add values when markets are inefficient."[2]
- In a June 2008 article in *Money*, personal finance guru Suze Orman was questioned on why it was the time to get into active management: "All the stats say that index funds outperform 80% of managed funds out there … But today I think you have to be more active."[3]

So, when is it a good time to be an active investor? We would argue that there is never a good time to be an active investor. When you take the valuated average of all active investors and the valuated average of all passive investors, the difference in their performance is simply the difference in the fees they pay. The average active investor will underperform the average passive investor due to fees and expenses.

This concept is what professor William Sharpe called "The Arithmetic of Active Management." It is perhaps best explained by an example. Let's say an investor holds a passive market portfolio. The investor knows the aggregate of everyone else holding a market portfolio and the return must equal the return of the market minus expenses. The investor also knows the aggregate of every other investor (including many active investors) must equal the return of the market minus the aggregate of their expenses. From Sharpe's paper, "costs of actively managing a given number of dollars will exceed those of passive management."[4] Simply because of fees and expenses, passive investing wins over active investing. This holds both in the long run and in the short run, and over any time period.

If an inefficient market made active investing less expensive than passive investing, then the arithmetic of active management would not hold. We know this is not the case.

Sources

The following sources were used by the author(s) to arrive at the above conclusions. You may wish to reference these sources to help you prepare to use the ideas presented in these talking points with prospects and clients.

1 Peter Preisler, **Why Active Management Outperforms Passive**. *Wealth Bulletin*, Available at http://www.wealth-bulletin.com/home/content/1054510458/. June 22, 2009.

2 **Asset Managers to Cut Investment Teams,** *Professional Pensions*. Available at http://www.professionalpensions.com/863510/print. Accessed June 24, 2009.

3 Eric Schurenberg, **If You Knew Suze Orman.** *Money*. July 19, 2008. Available at http://m.cnn.com/cnn/archive/archive/detail/128537/full%3Bjsessionid=7B1AEB70A8B424CAAF3316D4F56092C5.live7i

4 William Sharpe, **The Arithmetic of Active Management.** *Financial Analysts Journal*. Jan/Feb 1991.