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KayneInsights

September 2022

Active vs. Passive Investing Strategies

Should you invest your money in active or passive strategies? We discuss the benefits and differences between both investment approaches.

Perhaps the most basic question every investor asks is: Should I pay for a portfolio manager to actively manage my money to hopefully generate excess investment returns, or should I "buy the benchmark" through a lower-cost index fund?

The first is known as an active investing strategy, while the second is passive investing. Passive index funds or an actively managed portfolio — the choice isn't as simple as it might sound.

If you are trying to make a decision for yourself between passive index funds and actively managed strategies, it's essential to know the benefits and limitations of each.

What is Passive Investing?

Passive investors have a buy-and-hold mentality that focuses on benefitting from the overall increase in market prices over time. One of the major benefits of passive investing is that it minimizes the mistakes investors can make when they react emotionally to every move of the stock market.

The easiest way to implement a passive approach is to buy and hold an index fund that follows one of the major indices like the S&P 500, Dow Jones, or Russell 2000 (small-cap stocks). These funds pool money from multiple investors to buy the individual stocks, bonds, or securities that make up their market index. When the index changes its components, the index funds that follow it also switch up their holdings to match.

Other types of passive investment strategies that seek to track the performance of an index include:

- **Passive Mutual Funds:** pools money from investors to purchase stocks, bonds, and other assets. Minimum initial investments for mutual funds are normally a flat dollar amount and trades are executed once a day, at a single price.
- **Passive Exchange-traded Funds (ETFs):** a pooled investment vehicle that operates like a mutual fund. However, ETFs do not require a minimum initial investment and are purchased as whole shares. They are also traded similarly to individual stocks and can be bought and sold intraday at different prices.

What are the Potential Benefits of a Passive Investment Strategy?

Passive investing may offer the following potential benefits:

- **Easy to understand.** The strategy is simple — track the index.
- **Low cost.** A buy-and-hold strategy minimizes transaction costs. Since the index makes all the decisions on which companies to include, you don't pay for — or benefit from — expert individual stock analysis.
- **Long-term growth.** Over time, these indices have historically increased in value.

Passive investing can even make a compelling case for better fee- and tax-adjusted returns when compared to many active equity strategies. However, the benchmark does not provide the best returns in all cases. Also, investors need to look closely at the underlying holdings in a manager's portfolio when comparing returns. The quality of the underlying businesses is an important factor in the long-term consistency of investment performance and risk management.

On the downside, passive investing doesn't offer the flexibility of making portfolio changes to take advantage of or avoid the losses of short-term market changes. Plus, you are limited to the stock choices made by your index.

What Is Active Investing?

An active investment strategy involves using the information acquired by expert stock analysts to actively buy and sell stocks with specific characteristics. The goal is to beat the results of the indices and general stock market with higher returns and/or lower risk.

Quality investing, the investment strategy employed by KAR, is a type of active investing that focuses on creating a portfolio of businesses with strong fundamental characteristics, such as a high return on equity and invested capital, low debt-to-capital ratios, strong free cash flow, and consistent profitability. The strong financial characteristics of these companies are driven by the fact that they have a durable, competitive barrier.

What are the Potential Benefits of an Active Investment Strategy?

The potential benefits of an active investment strategy are:

- **A chance at bigger rewards.** An actively managed fund or portfolio has the potential to beat index returns. A quality investment strategy can be an important factor in capturing greater risk-adjusted returns relative to the market.

- **Flexibility.** Active managers can buy stocks that may be undervalued and underappreciated in the general market. They can quickly divest themselves of underperforming stocks when the risks become too high. They can choose not to invest during certain periods and wait for good opportunities to buy.

- **Tax management.** Although frequent buying and selling may trigger more capital gains and taxes, some strategies can help offset taxes for big winners.

When Markets are Volatile, and Investors Look for Safety, Quality Counts

When stocks are moving higher together in a bull market, individual stock picks may appear to be unimportant. The quality characteristics of individual companies may seem to matter little when markets move together, up or down, due to strong economic and political factors that dwarf the effects of individual company fundamentals.

However, when markets become more volatile and dispersion increases, quality companies tend to stand out and active managers who focus on quality have greater opportunities to create alpha. During these more challenging market environments— when investors are looking for safety—is when the potential benefits of quality become clear.

Market conditions change frequently and sometimes with little or no warning. It helps to have an expert investment manager to keep an informed eye on your portfolio.

Contact Kayne Anderson Rudnick today to speak with one of our Wealth Advisors about your investment strategy.

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