Karen Telleen-Lawton: Passive vs. Active Investing

By Karen Telleen-Lawton, Noozhawk Columnist | Published on 05.20.2013 6:03 p.m.

[Note: The following column on financial fortitude is one installment in a continuing series.]

Examining your finances takes fortitude. What are your goals and dreams? What can you afford? Here are more questions I've heard in my financial advising practice:

Dear Karen: My husband and I are retired and have rolled over our company 401(k)s to IRAs. A friend ("Rick") is advising us on investments, and seems to have some good ideas. At least I think he's done well for himself picking stocks. My husband says Rick is an active investor, and he would prefer passive investing. Isn't that just avoiding making decisions? I'd rather take the bull by the horns and ride it!

A: Every year, many investors beat the market. It can be done! However, there are few — think Warren Buffett — who can consistently outperform the average over a decade or two, or even more than a few years. If your friend Rick is Warren's confidante (and maybe a decade or two younger), you might consider listening to his advice for a portion of your investments.

If you want to stay with Rick, you need to understand and agree with how he chooses your investments. Technical investors use charts and graphs to analyze how the market (or a specific stock) has performed. They try to forecast future prices based on historical price and volume data, looking at the general direction of the market and the movement of market and certain securities. Many investors see this as the equivalent of reading tea leaves, but some advisors make their living this way.

Fundamental analysts study the economy, the industry, financial statements, and estimates of growth in earnings and dividends. These investors try to get a complete picture of the health of a company, an industry and an economy. They then attempt the best placement for an investment at any given time.

Both of these are active investment approaches. Active investing has the additional burden of transaction costs. Investors typically buy and sell frequently based on changing condition. These costs are charged against the investment. Most studies show that, over the long haul, active investing does not compensate for the extra cost except in very narrow areas such as emerging market stocks. Nevertheless, most advisors believe they can beat the market to some extent.

A passive approach is characterized by not attempting to outperform the market. Passive investors believe that capital markets are mostly efficient and reflect all or nearly all information in securities prices. A portfolio heavy in index funds and ETFs reflects implemented of a passive approach. A small percentage of advisors are totally passive investors, though somewhat more use a passive strategy for part of the portfolio.

For the bulk of your money, my bet is on your husband's passive strategy. Call the Rick funds your "play" money to reinforce the idea that they could either gain a lot — or disappear.

For whatever approach you choose, it is important to have a diversified portfolio in terms of stocks, bonds and cash. When the financial industry (or technologies, or whatever) hit the skids, consumer stocks or another industry is holding its own. When stocks tank, bonds are there to prop up one end of your portfolio. A fee-only financial advisor can help you build an appropriate asset allocation and make sure the rest of your life is in line with your goals.

— Karen Telleen-Lawton's column is a mélange of observations spanning sustainability from the environment to finance, economics and justice issues. She is a fee-only financial advisor (www.DecisivePath.com) and a freelance writer (www.CanyonVoices.com). Click here to read previous columns. The opinions expressed are her own.