WHAT IS PASSIVE AND ACTIVE INVESTING?

As an investor, it's important to give some thought to what strategy of investing is right in different situations. Choosing passive investing or active investing is about choosing an investing strategy.

What is Passive Investing?

Passive investing attempts to mimic the composition of a market. These investments follow the market through its ups and downs and produce returns similar to the market.

Index mutual funds and index ETFs are typical passive investments.

What is Active Investing?

Active investing selects certain investments while rejecting others, producing returns that will almost certainly differ from the overall market.

You can implement an active investing approach by investing in actively managed mutual funds or by selecting individual stocks.

Tailor your approach to the financial market

Is the market "smooth" or "lumpy"?

Passive investing is better suited to financial markets with certain characteristics and active investing to others.

When you select an investing style (or a combination of both passive and active styles), consider which markets you want exposure to—are those markets "smooth" or "lumpy" in terms of diversification?

Let's turn to the broadly diversified U.S. equity market to illustrate the concept of "smooth". An index mutual fund investment in the broad U.S. equity market provides an efficient route to portfolio diversification. This is because the large and heterogeneous U.S. stock market provides exposure to almost all industry sectors and inherently creates a mix of defensive and aggressive, growth and value stocks. For this kind of "smooth" market, an index fund or ETF can be the ideal way to gain exposure (see chart below).

Contrast this to the "lumpy" Canadian equity market, which has a high concentration of financial and resource stocks without much exposure to technology and healthcare companies. As a result, the relatively small Canadian market can be impacted by the "fortunes and misfortunes" of one sector or one large stock that rises dramatically until its bubble bursts. This occurred in 2015 with Valeant Pharmaceuticals and with Nortel during the technology boom and bust of the early 2000s. As these stocks soared and then plummeted, an index fund holder in a broad Canadian equity fund was along for the ride on both the upside and the downside.

The following shows the sector breakdown of both the U.S. (broadly-diversified) and Canadian (concentrated) equity markets.

The Case for Passive: S&P 500 (U.S. Equities)

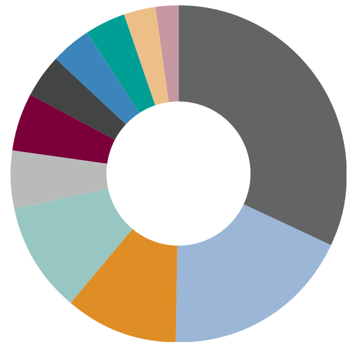
Broadly diversified or "smooth"

Information Technology	20.6%
Health Care	14.8%
Financials	13.3%
Telecommunication	10.1%
Consumer Discretionary	9.9%
Industrials	9.8%
Consumer Staples	7.1%
Energy	5.4%
Utilities	3.3%
Real Estate	3.0%
Materials	2.7%

Constituents	505
Weight of Largest Constituent:	3.7%
Top 10 Constituents:	20.7%
Top 3 Sectors:	48.7%
Largest to Smallest Sector Range:	17.9%

The Case for Active: S&P TSX (Canadian Equities)

Concentrated or "lumpy"



Financials	32.5%
Energy	18.4%
Materials	11.1%
Industrials	10.6%
Telecommunication	5.7%
Information Technology	5.4%
Consumer Discretionary	4.3%
Utilities	4.0%
Consumer Staples	3.8%
Real Estate	3.2%
Health Care	2.1%

Constituents	238
Weight of Largest Constituent:	6.6%
Top 10 Constituents:	38.0%
Top 3 Sectors:	62.0%
Largest to Smallest Sector Range:	30.4%

Totals may not add up to 100% due to rounding.
Source: S&P Dow Jones Indices, February 28, 2019.

Areas that can benefit from active selection

Broad, well diversified equity markets are good candidates for passive investments. Other markets and market sub-sectors may warrant a more active approach. Here are some examples:

Small cap stocks	This group of stocks, often early stage companies, can produce sensational winners but also a number of flops, including companies that will eventually disappear. Distinguishing between these groups can be very valuable and can warrant some active selection.
Specialized sub-sectors	As an example, Socially Responsible Investing (SRI) is a potential candidate for an active investing approach. Your definition of "socially responsible" may differ from the definition used to create the SRI index fund. Maybe you're comfortable investing in tobacco companies but you want to exclude weapons manufacturers. Researching and selecting SRI companies yourself or choosing a fund manager whose criteria match your thinking are possible solutions.
Emerging markets	In a manner somewhat similar to small cap stocks, emerging markets can produce some spectacular successes with robust returns. But growing pains are not uncommon for emerging economies and returns can suffer along the way. The group is much more subject to "outliers" than developed markets and discerning choices can make a difference.
Corporate bond markets, especially high yield bonds	High yield bonds have a higher yield than equivalent investment grade bonds, but not all high yield bonds are "worth" the risk. Research and active selection can steer you towards those that are, while an index fund will not distinguish.

In Summary

A passive investing strategy suits some financial markets, while an active approach may be better for others.

The market you choose to invest in, as well as your current objectives and resources, can help guide your investing style choice.

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