MARKET
INSIGHTS

PACIFIC LIFE

PACIFIC LIFE FUND ADVISORS | NOVEMBER 2023

The Active Approach to Passive Investing

These Insights Address:

- How to distinguish key differences between active and passive funds.
- The advantages and disadvantages of active and passive investing.
- Why the act of investing is always active.
- The importance of asset allocation decisions.
- A low-cost yet active option to multi-asset investing using Pacific Dynamix® Portfolios.

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The debate surrounding active and passive funds continues to circulate among investors and their financial professionals. Despite the contention, there are many benefits to both active and passive investing depending on a client's needs. This article simplifies the strategies behind active and passive investing, and reveals how investors can combine both worlds to pursue their investment goals.

Active vs. Passive Investing: Advantages and Disadvantages

From a broad perspective, active investing refers to managing a fund aimed to outperform a benchmark by allocating assets to attractive investment opportunities. Active managers seek to beat the market—or benchmark—by choosing what they think is the right investment at the right time based on a specific investing style and strategy. Some active managers focus on selecting individual stocks or bonds that are expected to contribute positively to performance. Others specialize in investing in certain sectors or industries as well as investment styles and asset classes that are expected to perform well depending on market conditions.

On the other hand, passive investing aims to mirror the performance of specific market indexes instead of trying to outperform them. Passive funds can achieve this by owning all the securities in a given benchmark and matching their respective weights in the index. Other passive strategies apply various methods such as stratified sampling to replicate characteristics of a certain index as closely as possible.

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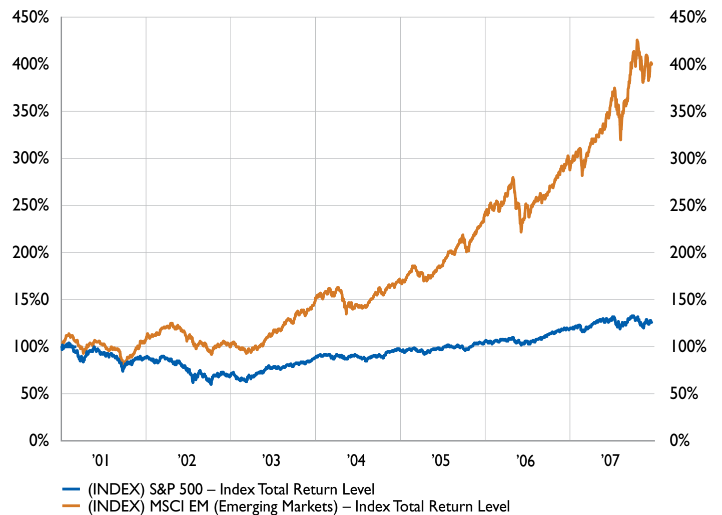
There are pros and cons to active and passive investing. Active strategies are more flexible, as they are not required to hold specific securities within an index. Additionally, active strategies allow for more hands-on risk management through allocation adjustment if risk becomes overwhelming. However, the higher expenses associated with the research and frequent trading of more involved portfolio management typically make active investing cost more than passive investing. These higher costs make it more challenging to outperform a benchmark after accounting for fees.

Conversely, pure passive strategies feature lower fees, as the process is significantly more automated. But while passive strategies get all the market upside when the index is rising, they also capture all the downside when that index falls. Furthermore, investors should recognize that passive and active results are cyclical because different environments usually favor one over the other.

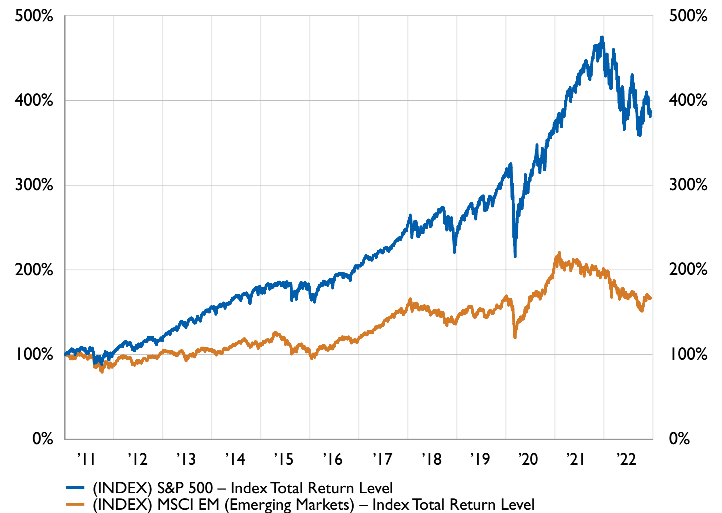


Source: FactSet

Asset Allocation Matters: Active vs. Static Asset Allocation

Regardless of strategy, investors consider many factors when investing their money. Some prioritize reducing fees, while others emphasize opportunistically weighing risk and return to generate alpha. In other words, one could argue that there is nothing passive about investing in any circumstance.

For example, the decision to invest at all is a concretely active decision. Even choosing a passive fund involves an active selection of the type of vehicle. Creating a portfolio of passive strategies becomes even more active when we factor in asset-allocation decisions. Throughout the lifespan of an investor, one will need to decide when to change the weight of an allocation to certain asset classes to align their risk-reward profile to their investment goals. While passive strategies are associated with buy-and-hold tendencies, this does not mean the investor should take a buy-and-ignore approach.



Source: FactSet

Many studies have shown that asset-allocation decisions can explain roughly 40% to 90% of the variance of a portfolio's performance.[1] This suggests strategic and active asset allocation is vital to overall portfolio performance. For instance, the decision between allocating to U.S. equities and emerging markets can have a significant impact on a portfolio's performance over time. Emerging markets outperformed U.S. equities by more than 315% between January 2001 and December 2007, cumulatively. On the other hand, U.S. equities outperformed emerging markets by more than 275% between January 2011 and December 2022, cumulatively.

While the underlying strategies within a portfolio may be passive, managing these portfolios involves a continuous process of identifying investment opportunities and avoiding asset classes facing challenges. As mentioned, this can be accomplished through timely allocation adjustments within a portfolio, which may be determined by the market environment and outlook. Active asset allocation entails managing a diverse portfolio that invests within predefined equity and fixed-income allocation ranges. Unlike static allocation portfolios, active asset-allocation portfolios can express overweight and underweight views on specific styles, regions, and asset classes.

These investment views can be developed by means of macro research and analysis from various resources as well as perspectives. Additionally, advisors can evaluate leading economic indicators and trends with both quantitative and fundamental lenses. Throughout the decision-making process, portfolio managers can add value by gauging macroeconomic, monetary policy, valuation, business, financial, sentimental, and technical indicators as well as fiscal policy and geopolitical issues.

Active asset allocation considerably differs from "model portfolios" that tend to be static, though some models may be adjusted—albeit at a slower pace. While these generic model portfolios may benefit from aspects of diversification, they fail to adapt to changing market conditions in a timely manner.

The best results may arise from combining active and passive strategies. For example, active strategies may benefit investors in certain environments, as managers can navigate market volatility on both upsides and downsides. In other cases, passive strategies may be preferable when markets move in tandem and security valuations are roughly even. It should also be noted that active may be better suited than passive for certain asset classes with inefficient markets such as small caps, emerging markets, and credit. Alternatively, passive may be better for efficient markets like large caps. Nonetheless, investors can benefit by blending both passive and active strategies in a way that leverages market insights, as market environments fluctuate all the time.

Pacific Dynamix Portfolios

Pacific Life offers Pacific Dynamix Portfolios as a low-cost option within our variable annuity products; however, this does not mean these funds are passive strategies. While they utilize passive and quantitative underlying strategies, managing them involves active asset-allocation decisions and selections of underlying strategies and their providers.

PLFA has designed the Pacific Dynamix Portfolios as risk-based products that opportunistically seek to capitalize on short- and long-term mispricing of assets and disequilibrium by overweighting asset classes we consider attractive and underweighting ones we consider unattractive. Our conservative fund strategically focuses on capital preservation with some emphasis on generating capital growth, while the aggressive fund mainly focuses on capital growth.

Active Management Involves More than Picking Individual Stocks and Bonds

In all, active management requires the optimization of various tools and resources to accomplish its objective for investors and generate alpha. Investors can opt for the upside potential of active investing as well as the lower-cost benefits of passive investing, but they come in various forms.

Some choose purely passive and stagnant options like model portfolios because of misconceptions between passive and active portfolios. And, while many investors may be attracted to the lower-cost aspects of passive strategies, they should also recognize the difference between static and active allocation decisions. Our Pacific Dynamix Portfolios offer a lower-cost option for multi-asset solutions, by actively managing different asset classes represented by passive strategies that seek to generate alpha.

[1] Determinants of Portfolio Performance and Does Asset Allocation Policy Explain 40, 90, or 100 Percent of Performance?

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Pacific Dynamix® Portfolios allow you to match the appropriate fund to your financial objectives, risk tolerance, and time horizon. Each fund is structured as a fund-of-funds (a fund that invests in other underlying funds) that has been diversified to achieve a specific target-risk level using a strategic mix of multiple asset classes, also known as target allocation. Each fund invests across a diversified blend of global equity and fixed-income asset classes, and PLFA adjusts the mix of investments based on the current economic environment, the portfolio manager's market outlook, and the fund's target allocation.

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