A NEW PARADIGM

Smart Passive Investing

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Active vs. passive investing is the age-old debate in investment management, and it's one that has garnered endless media coverage. While I'm not going to argue one way or the other – the debate really isn't black and white, after all – I would like to propose an alternative way of thinking about the topic: 'smart passive' investing.

First, it is important to understand the difference between active and passive investing. Active investing refers to buying and selling individual stocks and bonds. More recently, this approach might also include buying into a mutual fund that makes those types of decisions for you. Passive investing refers to investing in a product that tracks an index, such as an exchange-traded fund (ETF). As with anything, there are pros and cons to each strategy, and there are alternative strategies that offer a blended approach.

For example, smart beta is a blended approach that looks to actively invest in index funds. This approach takes into account volatility, liquidity, risk, and other factors, in order to invest in index funds that will perform well over time. Another alternative strategy, called smart passive investing, is used by investors following a small-cap index, and was highlighted in a Barron's article *"A Tale of Two Indexes"* earlier this year.

Before diving into what this strategy means, we need to examine how small-cap investors typically measure their performance.

According to Barron's:
"The most commonly used benchmark is the Russell 2000, and over 90% of investment funds focusing on U.S. small-cap stocks use it to peg their performance."

Many investors like to tout that they've beaten the Russell 2000 by 1-2 percent per year, but are they comparing their performance to the most appropriate benchmark? The Russell 2000 is made up of the 2000 small-cap stocks at the bottom of the FTSE Russell's top 3000 ranked investable companies in the U.S. stock market, as measured by market value.

Because this index is simply put together with a basic cap-weighted ranking, we don't believe it is the best index to measure investment returns against.

Using our smart passive approach, we compare our portfolios to the S&P SmallCap 600.

Barron's describes the factors required to be included in this index:
"Companies must show positive net income over the previous 12 months, including for the most recent quarter. At least 50% of the stock must be publicly traded. Companies can't be included until they've been on the stock market for at least a year. A committee continually looks at the member companies and updates the index as its members see fit."

The important distinction regarding the S&P SmallCap 600 is that a committee continually reviews member companies and updates the index accordingly – this is what makes it smart passive. As an allocator, you're asking what factors are valuable, and choosing an index based on these important variables, such as profitability, liquidity, and continual review of the companies.

Those screenings may potentially add quite a bit of alpha. The S&P SmallCap 600 has historically added roughly 2 percent annually above the Russell 2000. This means investors touting they beat the Russell 2000 by 1 percent may actually be underperforming the S&P SmallCap 600 by 1 percent per year. And over the long term, that can add up to a lot of money.

According to Barron's:
"Over 20 years, when you include reinvested dividends, the S&P index has outperformed its better-known Russell counterpart by an average of nearly two full percentage points annually, 10.2% to 8.3%. To put that more simply: Ignoring fees and taxes, an investment in the Russell would have grown by nearly 400% over that time. An investment in the S&P index: nearly 600%."

When it comes to the active vs. passive debate, Halite believes the choice is clear – using a smart passive approach can potentially grow your portfolio at a higher rate.