What is Active Investment Management?

"ACTIVE INVESTMENT MANAGMENT IS TAKING an active role in the ongoing process of investment selection and risk management with the objective of improving a portfolio's risk/reward relationship." another definition would be "the science of determining which asset class has statistically the best chance of providing positive returns as determined on a daily basis." Recently, it was suggested that a better definition is that "Active Investment Management is a discipline that has an exit strategy."

To clarify how active investment management differs from traditional investment disciplines, such as "buy and hold," it is necessary to explain those further.

Buy and hold is a discipline that when coupled with Modern Portfolio theory (MPT) constructs an investment portfolio that considers the risk and time horizon of the individual investor. The end result is typically comprised of several (if not all) assets classes, that is, stocks, bonds and cash. some portfolios also include real estate and precious metals. Most assuredly the more sophisticated portfolios will contain different classes of stocks (large, mid, and small cap, growth and value) and bonds (government, corporate, and municipal, investment grade and 'junk') to provide a fine-tuning of the risk/reward parameters. Typically, this is the method used by the average investor. Recent research has introduced probability testing based on history of varying market performances.

The problems with buy and hold are as follows:

1. Buy and hold is simply that. Hold on to the investments no matter what the market is doing. This means that if the market goes up, your portfolio should go up and vice versa. It's the vice versa that is the problem. As we all clearly and painfully have experienced twice in the last ten years, this provides a great opportunity to lose vast sums of money.
2. MPT taught us all to diversify. While in minor market corrections this mitigates the potential for loss, it cannot remove it completely. MPT was designed to take advantage of the history of the various markets to not all move in the same direction at the same time. When stocks may be on the rise and bonds on the decline, the overall effect on the portfolio is lessened. However, there is no provision that allows for making money (or at least breaking even) when either or both are falling.
3. Both buy and hold and MPT rely primarily on traditional fundamental research to select investments. Whether buying mutual funds or individual stocks, more often than not, decisions are based on the recommendations of individuals who have looked 'at the numbers,' economic forecasts, government statistics, and any and all subjective factors, and suggest that Company A is a buy, or mutual fund Z did well last year so....
4. Probability testing was born out of Monte Carlo simulations, which when simplified, means all the yearly performances of an index are thrown in a hat, pulled out randomly one by one and recorded consecutively so that you will have put together 70 years of returns in random order. Then the portfolio is tested to see how it performed over different time periods. And they do this thousands of times. The result will show the probability of the proposed portfolio's ability to provide a positive return over 1-, 2-, 5-, 10-year periods. The problem is that those years when the market does poorly still exist. They haven't been addressed in such a way that considers how a positive result can come from a negative time period. And the investor has bought and is still holding.

Active investment management differs in a number of ways:

1. By definition, selection. This, depending on the active manager's system, could be market segment, time period, and amount of portfolio invested. For example, a given manager may specialize in the S&P 500 index and on a regular basis will decide as to when and how much of the portfolio he believes his clients should be exposed. This of course includes the possibility of being invested in such a way that allows money to be made if the index falls.
2. The process is objective, that is, without emotional input. Most, if not all, active managers employ models that are based on strict mathematical rules that have been tested continuously and rigorously over long periods. Unlike fundamental research, in a quantitative approach, the formulae make the decision. And it is not just the decision to being in the market (exposed to risk); being without market exposure (in cash) is just as important.
3. The risk management in the active manager's approach can be twofold; as stated above by controlling dollars invested at any given time, and by when to be exposed to the market, either up or down. This is a key feature and the most important difference. Having the ability to be invested (up or down) or to be 100% in money market is not possible or, in some cases, not practical, with traditional investment disciplines.
4. All of these lead to the goal of improving the risk/reward relationship. If risk can be objectively and statistically managed then the reward should increase. The above are risk-controlling factors, and active managers base their theories on varying levels of risk exposure with respect to the expected reward.

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5. And most importantly, active management by its nature provides an exit strategy, a pre-determined point at which to reduce market exposure. This feature is missing in most traditional investment strategies available to individual investors. Granted, most proponents of MPT and buy and hold will agree that there are times when one should reduce one's exposure to risk, they just don't agree on when and how much. It's not that all active managers agree, but that they will do so on a regular basis, even when markets are going up. It is not unusual for an active manager to move to 100% cash several times a year, and in some cases, several times per month.

All mutual funds have some degree of active management in that securities are added or removed on a regular basis due to money flows in and out, or securities coming into or falling out of favor. Or perhaps the investment professional looks over the investor's account on a weekly or monthly basis. Some active managers typically decide on a daily basis how money should be invested for the next day. Not next week, or next month, but the next day and only the next day. Recent markets have shown us that trying to predict where the markets will be in the next month or year is less accurate than predicting the weather a week or so in advance. However, while not always correct, predicting the weather for the next day is much easier. It is not that easy with the market, but if wrong, the active manager won't be wrong for the whole year.

This may all sound like active managers are trying to time the market and in fact, that is largely true. Most investors have been conditioned to believe that timing the market doesn't work; that if you miss the 10 best days your return would be X% less. What they don't tell you is that if you missed the 10 worst days, your return would be Y% more. And in this case, Y is bigger than X. What is important to understand is that there exist hundreds of investment firms that were built around the theory of buy and hold. They have billions upon billions both invested and under management based on this theory. It is not being suggested that these firms are in cahoots or are pushing some kind of conspiracy. Quite the contrary. Buy and hold is a viable investment strategy if your time horizon is long term, meaning now-a-days 20 to 30 years. (It used to be 10 years but where were we 10 years ago?)

These same investment firms, in the late 1990's, banned the ability to exchange freely between funds on a daily basis because too many people were doing it. It only makes sense that if so many people were doing it, they were making money doing it, and therefore timing the market does work (if one knows what one is doing). Mutual funds changed their prospectuses to prohibit such practices saying it interfered with the ability of the fund manager's ability to manage the fund. Another reason for the ban on daily exchanging was that the "timers" were sharing in the gains of the fund and not the losses. Doesn't this sound like the timing was working?

For the period January 1990 through May 2013, there were 5901 trading days; 3218 were up, 2682 were down and 1 was unchanged for the S&P 500 index. That equates to 54.5% up and 45.5% down. We all know that Las Vegas was built on winning margins slimmer than this. And the S&P 500 index did go from 358 to 1630 at the end of May 2013. But if you didn't get in until 1996, 15 years later you were back where you started. The point is, so much of the success of the buy-and-hold theory is based on being invested long enough to weather the up and down cycles of the markets, and eventually a profit will be realized. The obvious flaw is that it depends a great deal on when an investor starts and when he needs to access the money. So is it a better theory that you plow all your money into the markets when they are down and some years down the road hopefully retire and put all your money in Cds when the markets are up? Probably, but if anyone could plan and read the markets that well they wouldn't need to work at all.

It is a much easier task to look at the markets on a daily basis and make an intelligent assessment as to what will likely happen the next day. It is a simple concept, one that everyone can appreciate and grasp. There is no guarantee that such a prediction will be correct, but the probability that the decision will be correct is higher than the probability of predicting where the markets will be in 10 years. This is not like flipping a coin. On any given day, the odds that the market will be up or down are not necessarily 50 – 50. Each coin flip is an independent event; the markets are influenced by many events on a daily basis.

Active management has several advantages over buy and hold, with the ability to still diversify over several market sectors. The practice has been in use and refined for more than two decades. The ability of active managers to be fully invested in such a way as to make money in an up or a down market or be completely risk free (in money market) on any given day is a feature that the mutual funds or buy and hold investment managers do not offer.

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