# The 3 Main Investment Styles: Pros and Cons

By Eve Kaplan, CFP®

There are pros and cons to investing in the three main investment styles: active, passive and "evidence-based investing." The benefits of "evidence-based investing" will be clearer after reviewing "active" vs. "passive" investing styles.

1. Active Investing through Mutual Funds: "Active" investors aim to "beat the market" (or a portion of a market) by investing in a large number of holdings through mutual funds and some Exchange Traded Funds (ETFs). The theory of doing better than the market sounds great but does it work well in practice? As a former active mutual fund manager, I can say: "not sufficiently." The very premise of "active" investing is making educated bets that some shares will do better than others. However, despite the best research in the world, stocks can disappoint. Having many holdings bundled together reduces some of the risk but some mutual funds do a better job than others. My particular beef is the plethora of "A," "B," and "C" shares of actively managed funds. Investors typically don't understand the cost of A, B and C shares and the insidious effect of eating away at performance.

Active Investing through Stock Picking: The investment manager researches companies and markets and assembles stocks or Exchange Traded Funds that he/she believes will outperform in the future as other investors join the bandwagon and drive these shares higher. I once was an equities analysts and I visited individual companies for years and wrote long reports with investment recommendations. Management fees for stock-picking can be comparable to actively managed mutual funds. Does this approach work? Data suggest this is a hit or miss approach. Yes, you could have become an Apple millionaire if you invested in Apple at the right time. And yes, you could have gone bankrupt if you had invested in Enron at the wrong time. If you want to mitigate some of the risk, add up all of the companies in an index – by weight – and invest that way. It's called passive investing.

2. Passive Investing: Passive investors don't believe it's possible to outperform markets consistently so they embrace mirroring a market or index. The "passive" approach has gained traction in recent years because it's clear to many that high fees for active management don't always translate into better net performance. Passive investment fees are far lower and the chances of growing money as greater than the "active" investing. This approach has been embraced by both mutual funds and most Exchange Traded Funds (ETFs).

Active and passive investors have their proponents and critics. Long term data underscore the relative benefits of passive investing since the majority of active investment managers do not outperform an underlying index for enough time to compensate for the higher fees charged: salaries, administrative fees and A, B and C commissions.

3. "Evidence-Based Investing": The third approach to investing, "evidence-based investing," has been developed and refined by Dimensional Fund Advisors (www.dfaus.com), a formidable powerhouse informed by Nobel laureates. Dimensional Fund Advisors (DFA) began in 1981 and it has nearly $500 billion in mutual fund investments under management. Exhaustive DFA data show there are consistent market anomalies over time that can be captured in DFA mutual funds. In other words, DFA mutual funds are constructed to help investors outperform over longer periods of time. These funds overweight smaller cap companies vs. larger companies, and they overweight "value" stocks (low book/market ratios) vs. "growth" stocks. This approach is consistent across US and international stock markets over longer periods of time. DFA

can and does deviate from indexes – as needed – to buy or sell "off market" to minimize affecting share prices; unlike passive investing, DFA does not need to mirror an index exactly.

The success of DFA "evidence-based" investing rests upon some important assumptions: 1. Market timing doesn't work. The investor needs to sit through the entire dinner – even the boring bits – to gain full advantage of long-term investment gains. 2. Investing with a "rear view mirror" (buying what's already done relatively well) doesn't work over the long term and 3. Keeping investment costs low means the investor gets more of the gain (the same approach as Vanguard).

Individual investors can access Dimensional Fund Advisors mutual funds through approved Fee-Only Advisors, through some 401k plans and in some 529 College Plans (e.g. State of Utah). Important note: There is no mark-up by Fee-Only advisors to clients who invest in these phenomenal funds. Please contact my office for more information about DFA funds.