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All Fund Management Is Active

ICI Explains

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Increasingly, investors have been directing assets toward index-based mutual funds and exchange-traded funds (ETFs).

In this short video, ICI Chief Economist Sean Collins explains why it's important to remember that active management is everywhere, whether money is flowing into—or out of—actively managed funds or index funds.

About Sean

This video is narrated by ICI Chief Economist Sean Collins, who oversees the Institute's statistical collections and its research on US and global funds, financial markets, the US retirement market, and investor demographics. His research and analysis focus on the flows, assets, fees, and industrial organization of registered investment companies; financial market issues; the costs and benefits of laws and regulations governing funds; money market funds; and financial stability. He has a PhD in economics from the University of California, Santa Barbara, and a BA in economics from Claremont McKenna College.

Transcript

Sean Collins: Hi. I'm Sean Collins, senior director for industry and financial research at ICI. I'm going to talk to you today about active management and, in particular, the notion that active management is everywhere.

A major development going on in mutual funds and exchange-traded funds is that much of the money coming into mutual funds and ETFs has been directed toward index-based mutual funds and ETFs. But what you may not know about this shift from actively managed to index-based funds is that active management is everywhere.

First, let's ask a basic question: what is an index fund? An index fund is a fund that invests in all of the securities in a particular market index. For example, the S&P 500 Index is an index of the stocks of 500 large companies that are listed and sold on US stock markets.

Let's now look at the question of active management. Suppose you decide to put all of the cash you have available for investing into an S&P 500 index fund. Even though you've invested solely in an index fund, that's an active decision, at least implicitly. It's active in the sense that you've decided to invest in a fund that holds only large-cap stocks that are US listed companies.

By investing solely in an S&P 500 index fund, you've decided not to hold any small-cap stocks; you've decided not to hold any foreign stocks; you've decided not to hold any bonds. You've made an active decision. So that's one sense in which active management is everywhere.

Let's talk about another factor affecting this issue. There's been a shift from active management inside funds, to active management outside of funds. This development also is part of the shift to index funds. What do I mean? I'll give you an example.

Let's look at an actively managed mutual fund—we'll call it Fund A. The fund has a portfolio manager who buys and sells securities for the fund—let's say Stock X and Stock Y—and who decides how to allocate the fund's assets between stocks X and Y. She might put 80 percent here and 20 percent here, or she might do something a little bit different. As portfolio manager of an actively managed fund, she has the ability to make choices and to change her decisions. She might also at some point decide that she wants to add another stock—Stock Z. And she might decide that she wants to add a bond—let's call it Bond Q. To do this, she might sell some combination of Stock X or Stock Y. That's active management inside of a mutual fund.

Now suppose we have three index funds—they could be mutual funds or exchange-traded funds—also known as ETFs. Let's call them Funds E, F, and G. Let's say you decide to invest all of your cash in those index funds, in some proportion. Suppose you decide, like many people, to hire a financial professional to help you manage the assets in your portfolio of index funds. The financial professional, who doesn't have anything to do with the management of those index funds, is in effect providing active management for you, by helping you build and manage your portfolio.

This person, for example, might help you choose an initial asset allocation. If you had $100,000 that you wanted to invest, this financial professional might help you choose an allocation between index funds E, F, and G, based on your long-term goals and your personal circumstances, including your income, whether or not you're married and have children, how close you are to retirement, etc.

This financial professional might also help you reallocate assets. What does that mean? Well, for example, as you grow older, it's generally considered a good idea to add fixed-income investments—bonds, generally—to your portfolio. So as you grew older, the financial professional might suggest adding a bond index fund—Fund H—to your portfolio.

In addition, the professional may give you advice on how to adjust your portfolio in response to changing market conditions. Throughout this process, and over time, the professional is providing active management of a portfolio of index funds. If you do this without the help of a financial professional, this simply means that you yourself are actively managing your portfolio.

So though you'll see lots of debate in the media about active versus index investing, it's wise to remember that active management is everywhere, whether money is flowing into, or out of, actively managed funds or index funds.

I hope you found this brief overview of active management helpful. For more information and resources, please visit ICI's website at www.ici.org.

Additional Resources

- ICI Statistics: Weekly Estimated Flow Report
- ICI's Investment Company Fact Book
- Frequently Asked Questions About Mutual Fund Shareholders