Passive Investing

In the broadest sense, there are two approaches to investing: active and passive. For over 20 years, this site has focused on active investing, based on a momentum framework known as Decisionmoose. Index Moose was extremely successful at beating the benchmark S&P 500 for 15 of those 20 years, but the Moose has struggled in the last five.

Investors who visit this site are looking for a practical investment strategy. If our active momentum strategy isn't optimal at the moment, what's the next best option?

Pure Passive Equity

While the S&P is the benchmark against which all strategies are measured, investing one's entire portfolio in the S&P and leaving it there for all time— the Pure Passive Equity approach— isn't really a viable long term strategy. It isn't considered prudent. There are always bears lurking in the woods, even though we may not have seen one in the US in eight years. Portfolio managers avoid the Pure Passive Equity approach in order to limit the likelihood of being sued by their clients for mismanagement. Individual investors not keen on portfolio suicide should probably avoid it as well.

Passive Diversification

The traditional passive investment strategy is known as passive diversification. A portfolio is built comprised of several non-correlated equity and income assets. The percentage attributed to each asset in the portfolio is static and is determined by the investor's willingness and ability to accept risk. Aggressive portfolios, for example, have a higher percentage of equities and other more volatile assets than risk-averse portfolios-- an "aggressive" growth portfolio may be 80% equities (and other) and 20% income, while, a "growth" portfolio might be 60% equities, 40% income. A conservative portfolio might be 20% stocks and 80% cash and bonds.

Lately, the passive diversification strategy has begun to compare favorably with the momentum model *over certain time periods*. I use italics because timing is everything when it comes to measuring performance. It is also everything when it comes to picking a strategy. To illustrate, I've created two basic passive diversified portfolios— aggressive, and growth-- using the nine exchange traded funds on this site. (I'm omitting the conservative portfolio option since this site is not normally targeted at risk averse investors.)

Portfolio	SPY	IWM	IEV	EWJ	AXJL	ILF	GLD	EDV	CASH
Growth—60-40	20%	15%	5%	5%	5%	5%	5%	30%	10%
Aggressive—80-20	15%	15%	10%	10%	10%	10%	10%	15%	5%

Rather than go through all the boring mathematical steps here, I'm going to cut to the chase. Plugging in the model ETF data, calculating performance according to each diversification schedule, and comparing that with Index Moose and the benchmark, leads to a number of observations. (Notice I don't say "conclusions", since these calculations are theoretical in that they don't reflect a true account, and don't include dividends earned or trading expenses paid.)

Portfolio (12/30/16)	1 year	5 year	10 year	15 year	3-year Sharpe
S&P (SPY)	+10%	+73%	+59%	+94%	1.98
Index Moose	-6%	-12%	+39%	+576%	-1.85
Growth—60-40	+7%	+21%	+60%	+161%	1.86
Aggressive—80-20	+9%	+17%	+44%	+165%	1.29

The overarching observation is that the economic and financial environment has a deep impact on the effectiveness of one's investment strategy. Until the current environment-- in effect for 8 years and essentially known as Fed financial engineering—ends, passive diversification provides a reasonable alternative to traditional momentum strategies. The trick, of course, is knowing when the "current" environment has passed. (More on that later.)