Canadian ETF Association

Active, Passive and Factor – what's the difference?

Too often, the discussion surrounding ETFs revolves around how they compare and contrast with mutual funds. That consideration is essentially a matter of structure and differs from the more purposeful question of the methodology used. While there are numerous alternatives to be considered, the basic consideration comes down to three primary choices – active, passive and factor-based.

Many readers would be broadly familiar with the first two options, but in the interest of completeness and clarity, let's take a moment to review all three. To begin, there is no single "right" way or even "best" way to invest. The three options laid out here are simply that – options. As with our children, we can love them all, but treat them differently as circumstances warrant. Here's the summary:

Active: This is the most traditional option in use today. As it pertains to ETFS, it is also the most expensive, with many actively managed strategies costing between 50 and 100 basis points (i.e. between 0.5% and 1.0%). Active management could come in various forms, but often include equal-weighted and covered call methodology options. These products use some degree of human intervention (hence the higher cost) to attempt to enhance return, lower risk or some combination of the two.

Passive: This is the format that is perhaps most associated with ETFs. Passive products aim to replicate the returns of a benchmark, but are bound to lag by the fees they charge and are also likely to deviate slightly due to modest difficulties in getting the performance to be the same – something called tracking error. You're looking to get the performance of a benchmark (something like the S&P 500 or the TSX) minus the product cost, which is often between 5 and 25 basis points (0.05% and 0.25%).

Factor: The concept of factor investing has been around for decades, but has only reached the mainstream in the past five or six years. Marketing types have sometimes referred to the concept as "smart beta", but that's a bit of a misnomer. Some people have even quipped that the word 'smart' could be an acronym that means: Silly Moniker About Rules-based Trading'. Essentially, factor-based investing occupies a middle ground between traditional active and traditional passive investing. Managers typically use unambiguous rules to overweight securities that have desirable risk-return characteristics, such as small cap stocks or value stocks. Unsurprisingly, the cost is often between the two traditional approaches and usually clocks in at between 30 and 60 basis points (0.3% and 0.6%).

There is simply no reason to be dogmatic. People may have their own preferences for various reasons, but the basic consideration here is value for money. The question you'll need to ask yourself before you invest is: "is the cost of the product worth it"? Taking the approximate mid-point of the ranges provided, you're looking at the following general costs:

Active:	75 bps
Factor:	45 bps
Passive:	15 bps

Actual costs will vary on a product by product basis, but this should give you a general sense of how much cost the people who manufacture the products need to overcome in order to add value. I have used all three types of ETFs over the years and I know many other advisors and portfolio managers would agree that there's no reason why one should be expected to use one or two formats exclusively. One phrase that I am particularly fond of is attributed to the late founder of Vanguard, John Bogle. Bogle was quipped that "you get what you don't pay for". In simple terms, there's a clear correlation between cost and performance in aggregate. While there always have been and likely always will be exceptions, the generally accepted relationship between cost and performance is negative. Investment products might be the only products on earth where, as a rule, the products that cost the least offer the best value for money.

Since there's no obvious and incontrovertible reason why you should use one methodology exclusively, many people elect to mix and match products and strategies as part of their portfolio construction. In general, I use actively managed ETF products only where there are no viable passive or factor based alternatives available. The more intervention involved, the higher the cost. Think of it as a continuum where trade-offs need to be considered.

Start with a passive option. Are you happy with what you're getting? If so, buy a passive product and be done with it. Think you can do better? The next question you might ask yourself is: "is it worth paying an additional 30 bps to get a factor-based product to seek a superior risk-adjusted return"? Repeat the decision-making. If the answer is 'yes', buy a factor product. I the answer is 'no', then do the exercise a third time: "is it worth paying an additional 30 bps (as compared to factor) in cost to attempt to get a better risk/ return outcome"? If the answer is yes, buy an active product.

Using the methodology laid out above, there are several variations that one might come up with in building a diversified and balanced portfolio. Reasonable people may differ. Since cost is a certain constraint, many people (myself included) have a slight preference for lower-cost options. If you had a portfolio that was 60% passive; 30% factor and 10% active, that might be a reasonable trade-off in managing costs while still having a fair amount of style diversification built in. That's just an example, though. The final decision is up to you.

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