THE BAM ALLIANCE
A Community of Independent Advisors

The True Spirit of "Passive"
There's a lot going on in a passive portfolio

Passive management represents perhaps the most important investment development since the introduction of mutual funds. This patient, disciplined investment philosophy eschews stock picking and market timing in favor of a long-term, buy-hold-rebalance strategy.

Academic research has shown that a passively invested portfolio will outperform a prediction-based, actively managed one simply because of fees and expenses. But sometimes, investors hear the word "passive" and get the wrong idea.

Passive investing typically involves far less trading than active management. It is an approach built on patience and persistence. But don't mistake all this patience and discipline for set-it-and-forget-it. Behind the calm exterior of the passive portfolio is a beehive of activity. The passive advisor proactively orchestrates a wide range of decisions and actions that keep the portfolio aligned with the interests and goals of the investor.

Among these activities are:

Developing a roadmap — The Investment Policy Statement (IPS) serves as the roadmap for the management of a client's portfolio, setting parameters for how assets will be invested. This roadmap maintains intentional focus on long-term outcomes, not on daily market fluctuations and economic headlines.

Asset allocation — The distribution of money to different kinds of investments is the primary determinant of investment results. This critical step matches the portfolio's expected risk and return characteristics to long-term goals for capital preservation, growth and income.

Monte Carlo analysis — This computer simulation determines the statistical likelihood that a given asset allocation will meet goals, such as funding 30 years of retirement. By running thousands of possible performance scenarios, it helps establish reasonable expectations for investment outcomes.

Security selection — Once the asset allocation is determined, the advisor chooses mutual funds or other securities that faithfully represent the desired asset classes. Choices are based on expense control, tax-efficiency and other factors.

Asset location — Asset allocation determines return characteristics; asset location determines how much the investor retains after taxes. To minimize tax exposure, the most tax-efficient investments are assigned to taxable accounts, when possible.

Rebalancing — As different asset classes appreciate at different rates, periodic rebalancing keeps asset allocation within target ranges. Efficient rebalancing considers not just allocation targets but also transaction costs and tax impacts.

Managing bond portfolio — Bonds are managed for geographical diversification, in-state tax benefits, callability features and to minimize broker markups.

Tax-loss harvesting — Capital losses can be used to offset gains and reduce tax exposure. Harvesting losses throughout the year instead of just at year-end often increases the harvest and diminishes the tax bill.

Adjusting the IPS — Periodically reviewing the IPS ensures that it remains aligned with personal and family developments such as births, deaths, marriage or divorce, career changes or the sale of a business.

Retirement planning — Careful planning ensures that 401(k), IRA, Roth and other accounts meant for long-term asset accumulation are utilized to their full advantage.

Charitable giving — Strategic use of charitable trusts and other tools helps maximize the impact of philanthropic giving while managing tax impacts.

Estate planning and wealth transfer — The advisor, working with attorneys, CPAs or other trusted advisors, develops and implements strategies for efficiently transferring wealth to loved ones before and after death.

Controlling emotions — An essential element of passive investing is finding the emotional resolve to not make portfolio changes when markets are turbulent. Often, the advisor acts as a buffer between investors' portfolios and their emotions.

It is important to point out how much analysis, planning and interaction goes into the management of a passive portfolio. Don't let semantics distract you from the benefits of this sound investment approach.

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