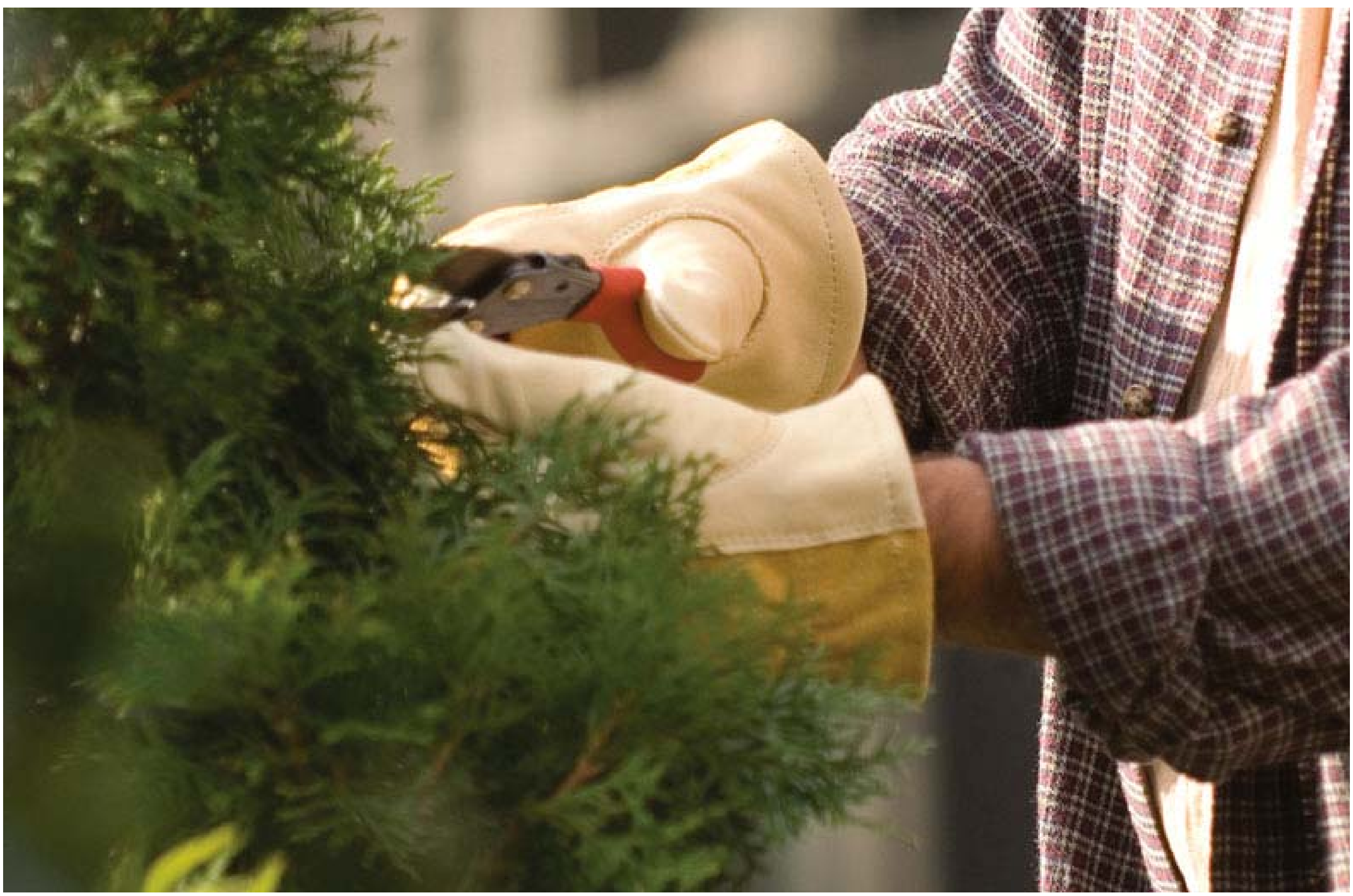
Client Education Library

Learn About Active and Passive Investing



Portfolios can be built using actively managed and index mutual funds either individually or in combination. This brief guide will help you understand the importance of both investment strategies so you can better appreciate how your financial advisor approaches investing your assets.

How actively managed funds work

Managers of actively managed funds attempt to beat the market by picking and choosing among specific investments. Managers employing an indexing—or passive—strategy, on the other hand, simply try to mimic the return of a certain index by buying and holding all, or a representative sample, of the securities in the index.

Actively managed stock mutual funds have the advantage of in-depth analysis of securities by fund managers. An actively managed stock fund also gives you the chance to earn higher-than-market returns.

Whatever a fund's objective, there are several techniques active stock fund managers use to try to beat the market. One is to be a smart stock picker. Typically, this is done by using either a top-down or a bottom-up approach.

Top-down managers start by looking at economic trends to help them predict which industries will prosper in the future. Once they've identified promising industries, they look within them to find the best companies.

Bottom-up managers look for outstanding companies in any industry, assuming that a great company will do well even if it's in an industry that's not thriving at the moment.

What about actively managed bond investing?

Active bond fund managers are a lot like active stock fund managers in that they must sift through the market to find the companies that offer the best odds of delivering positive returns. However, active bond managers must also consider other factors.

Active bond managers can try to beat the market through careful analysis of bonds' creditworthiness or by anticipating changes in interest rates and adjusting the maturities of the securities held in the portfolios they manage.

While bond prices move in the opposite direction from interest rates, the prices of shorter-term bonds are usually less sensitive to interest rate changes than those of longer-term bonds. A fund manager who expects interest rates to rise may buy shorter-term bonds—within the fund's stated maturity range. And a manager who expects interest rates to drop may buy longer-term bonds.

It's not easy to pick a winner

While actively managed funds offer the opportunity for higher returns, finding an active manager who can identify tomorrow's successful stocks—let alone pick stocks that will perform well consistently—can be a difficult proposition.

Don't forget about investment costs

The true value of active management depends on a manager's talent and on competitive costs. It's important that an active fund manager be able to implement a sound investment strategy and not lose too much potential return to costs such as management fees and transaction costs.

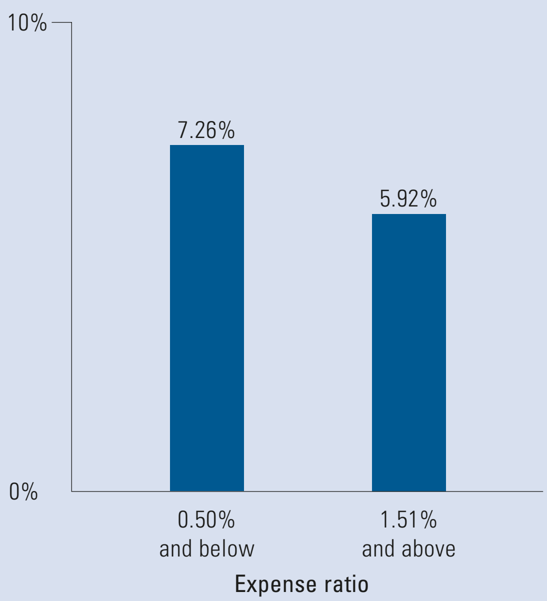
Costs are a critical factor in determining fund performance. In fact, the underperformance of an actively managed fund relative to its benchmark can often be the result of higher costs, rather than a manager's inability to pick

Investments in bond funds are subject to interest rate, credit, and inflation risk. Bond funds will tend to experience smaller fluctuations in value than stock funds. However, investors in any bond fund should anticipate fluctuations in price, especially for longer-term issues and in environments of rising interest rates.

strong-performing stocks. The chart below illustrates the effect that costs can have on the average actively managed equity fund's performance.

Average actively managed equity fund returns by expense ratio

Average annual returns
Ten years ended December 31, 2007



Past performance is not a guarantee of future results.
Source: Lipper Inc.

Look for these qualities when evaluating an active manager

- How much experience does the manager have? As with any profession, experience counts.
- Does the manager have a straightforward investment philosophy and does he or she consistently follow that philosophy? Knowing a manager's investment philosophy is the best way to avoid surprises.
- What is the manager's track record? Look for managers whose funds have outperformed their benchmarks over the long term.

How index funds work

Index funds are straightforward investments designed to match the returns of their target markets. To do this their managers use one of two indexing techniques—replication or sampling.

The replication approach

The managers of many stock index funds—but not of bond index funds—use the replication method to track the performance of their funds' target indexes. This method means that a fund holds every security in its target index in the same proportion as the index. For example, if a company's stock made up 1% of the value of the Standard & Poor's 500 Index, then the manager of an S&P 500 Index fund would invest 1% of fund assets in that stock.

The sampling approach

Managers of index funds that use the sampling method select a representative sample of securities from the target index that resembles the index in terms of key risk factors and other characteristics. For instance, if a particular industry makes up 10% of the target index, the manager of a stock index fund might invest 10% of fund assets in that industry—even though the fund might not hold every one of the index's underlying stocks.

Managers of stock index funds use sampling when the target index is so large that it's too expensive and inefficient to buy all of the stocks in the index, while managers of bond index funds typically use sampling to track bonds in a broad index that are not traded often enough to be obtained at a fair price.

Understanding indexes

An index is a collection of stocks or bonds chosen to represent a portion of the market. Investors use indexes to track market performance. In fact, a change in the price of an index should represent an identical change in the prices of stocks or bonds held in the index.

Most indexes measure companies based on market capitalization. For example, if a company's market cap is $1 million and the value of all the stocks in the index is $100 million, then the company would be worth 1% of the index.

Here are some common indexes

Dow Jones Industrial Average—The oldest barometer of the U.S. stock market and the one most often quoted in the media. The Dow tracks the stocks of 30 major companies from a variety of industries.

S&P 500 Index—Synonymous with the "U.S. stock market," the S&P 500 tracks the stocks of 500 leading U.S. companies.

Dow Jones Wilshire 5000 Index—A measure of the entire U.S. stock market, the Dow Jones Wilshire 5000 Index includes large, midsize, and small companies.

Russell 2000 Index—The Russell 2000 represents the smallest two-thirds of the 3,000 largest U.S. companies.

Nasdaq Composite Index—The Nasdaq Composite Index includes the stocks of more than 3,000 companies listed on the Nasdaq Stock Market, including the stocks of many widely followed technology companies.

Morgan Stanley Capital International Europe, Australasia, Far East Index—Designed to measure developed markets equity performance outside North America, the MSCI EAFE Index tracks more than 1,000 stocks traded on 21 exchanges in Europe, Australia, and Asia.

Lehman Brothers U.S. Aggregate Bond Index—A measure of the taxable, investment-grade U.S. bond market—including U.S. Treasury and corporate bonds—the Lehman U.S. Aggregate Bond Index excludes low-quality bonds whose issuers are considered more likely to default.

Prices of mid- and small-cap stocks often fluctuate more than those of large-company stocks. Foreign investing involves additional risks including currency fluctuations and political uncertainty. Diversification does not ensure a profit or protect against a loss in a declining market.

> There are many ways to construct portfolios using active and index funds. Work closely with your financial advisor to learn more about indexing and active management strategies and the ways in which they may fit in your portfolio.

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Investors cannot invest directly in an index.

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