Investment Styles

Estimated time: 3 minutes / Difficulty: Basic

At this point you might not be sure exactly how you are going to be as an investor. This doesn't just mean whether you're going to be successful or not, but more broadly, what your style will be.

Just as there are almost limitless types of investments and companies to purchase shares in, there are a multitude of approaches to investing, dependent on the personality, the needs, and the experience of the investor themselves, as well as external economic and sociopolitical factors.

Your style will be anything but black and white.

It's a good practice to think about what will likely work for you, and what fits with the amount of time, energy, and money you're able to commit, ahead of time. However, as with most things in life, you may find that it takes time to develop your own approach, and you may choose to change it in ways both large and small.

Common Investment Styles

One of the central debates in investing surrounds **passive management** versus **active management.** It's essentially an argument surrounding whether or not experts can outperform the market.

To define it more clearly, **active management** is an approach used by *experts* who believe that, through research, analysis, excellent judgement and timing, they can exceed the overall market's ~7% average return. Many people with large investment accounts or pension funds rely on professional investment managers to perform this work for them, in return for significant fees. The fees result from the staff of expert analysts and portfolio managers that are required to constantly adjust the investments.

On the other end of the spectrum is **passive management**, wherein an investor believes that by investing in index or exchange traded funds, stable stocks, and building a diversified portfolio for little or no fees, they will be better off than the active investors. They are essentially relying on the idea that if they can invest in a way that more or less represents the whole market, their investments will rise and fall with the market, growing over time.

One famous test of these competing approaches was recently carried out by Warren Buffett, one of the foremost investing minds, and a hedge fund called Protégé Partners. In 2007, they bet $1M USD that an investment in an S&P 500 index fund would outperform a basket of investments in actively managed hedge funds. In 2018, after 10 years, Buffett won the bet with an average annual return of over 7%, while the funds averaged a little over 2%.

While the bet doesn't necessarily prove anything, as so many other factors, such as the timing, the index, and the individual decisions taken by the funds, went into the outcome, it certainly makes a point. The experts aren't always right.

As an individual, these approaches differ in the amount of time and patience required. As an active investor with your own portfolio, you will need to watch companies and specific equities very closely, and frequently make decisions to buy, sell, or hold. As a passive investor, this means choosing the right investments on the front end and having the patience to ignore the daily news of the market going up or down.

Related to this last point are the investment approaches of **buy and hold** and **indexing.** Whereas **indexing** refers specifically to the strategy of mimicking an index of choice by creating a replica portfolio or buying into an index fund, **buy and hold** is simply applying the **passive** view to specific stocks. By choosing large, steady companies, oftentimes *blue chips*, an investor chooses to hold onto the company for the long term, believing it will move upward along with the overall market.

Two competing approaches related to passive and active management are **fundamental analysis** and **technical analysis.** While both rely on extended analysis of a stock, they differ in their goals and the information they rely on. In **fundamental analysis**, and investor is looking for companies with a positive long term outlook, and is based on the trends and information available in a company's financial statements. They pay attention to changes in strategy, management, or mergers and acquisitions activity, but do not expect immediate results. However a **technical analyst** would look for short term opportunities, analyzing the company's stock performance and how it relates to the greater stock market.

Another spectrum of investment styles involves the differences between **growth** and **value** investing. Investors pursuing a **growth** strategy look for companies that show potential for a rapid increase in value, such as recent startups with great potential. These are usually innovative companies or companies in an underdeveloped industry, and are identified by high earnings growth, return on equity and profit margins, and low dividend payouts, as they reinvest profits in further growth.

Value investors, which incidentally include the aforementioned Warren Buffett, look for strong or stable firms that are underpriced. To establish that an investment is underpriced, they will likely look for a low **price to earnings (PE) and price to sales** ratios, as well as a high dividend payout. (See the lesson on "How to pick a stock for more on these terms.")

Within these other investment styles, one can have a preference for **small capitalization** or **large capitalization** companies. As you recall, **market capitalization** refers is a measure of total value of a company, calculated by the price of a share multiplied by the number of shares.

Choosing between large or small can rest on many factors, but can be reduced to matters of risk and growth. An investor favoring **small caps**, which includes companies with a capitalization of between $300MM and $2B USD, oftentimes believe that as more agile and adaptable companies, they will provide greater returns. However, some believe that because such companies have fewer business lines, or different products and revenue sources, and fewer management resources, they are at greater risk of making mistakes or failing altogether. This can lead investors to favor **large caps**, or companies with a capitalization of over $10B, as they are likely to be industry leaders with long and profitable histories and therefore are likely to be lower risk.

A Mix of Styles

While these different approaches may seem to differ widely, in reality, many investors pursue a mix of strategies. In reality, it is less a question of which single style or strategy you should *choose*, and more about which you will *favor* to begin with. Someone who wants to try value investing could benefit from making a few growth investments, both as a strategy for diversification and learning. Likewise, a large cap approach can be balanced by investing in some small caps, and you can set aside a portion of your portfolio for passive investments while actively managing a few select stocks.

As you start, you will probably gravitate towards stocks that you know, such as products you are familiar with, from computers and cars to fashion brands. This is okay, as many popular companies are also profitable. After all, a consumer oriented company like Apple depends on people like us to buy its products, and if we do so, its stock generally performs. However, this should not be the only factor in creating your style, as it wouldn't be well diversified or thought through. Instead, you should take a balanced approach to begin with.