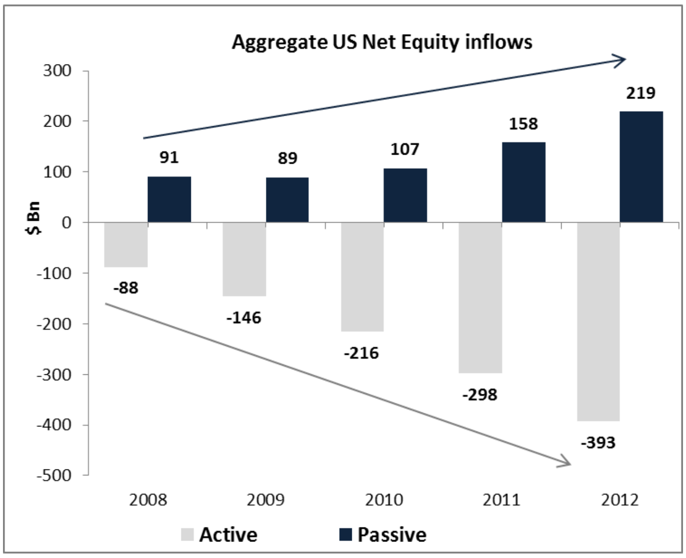
"Active" Versus "Passive" Investment – fact and fiction

"All active fund managers are expensive and most of them don't even beat their index". The money section of most newspapers these days carries at least one article about the excessive costs of the fund management industry and how an index tracker would do the same job better and of course cheaper than the average managed fund.



This month we examine the **pros and cons of passive investments** (index trackers) compared with their managed brethren and ask whether active managers still have a role to play in our increasingly cost-conscious marketplace. As you can see from the chart (right), investors in the US are increasingly using passive investments and we believe that the UK is heading in the same direction.

But first some definitions of "Active" and Passive":

ACTIVE management is the use of a human element, such as a single person, co-managers or a team, to actively manage a fund or portfolio. Active investors rely on analytical research, forecasts, and their own judgment and experience in making investment decisions on what securities to buy, hold and sell.

PASSIVE management is investment into a portfolio consisting of investments that exactly mirror the components of a market index. For example, the Vanguard 500 Index fund invests into all 500 of the shares in the S&P 500 Index so that investors can participate directly in the returns of the index as a whole, rather than rely on the skill of a particular manager or team.

According to Vanguard's *Case for Indexing* research, over the last 15 years only **17% of active equity funds** and **4% of active fixed income funds** have outperformed their prospectus benchmark over the last 15 years and there has been similar underperformance over 5 and 10 years too.

To demonstrate this point we show a chart that demonstrates the performance of the **average UK Equity Income Fund** (pink line) compared with a comparable **index tracker** that we use in our clients' portfolios (blue line). This shows clear outperformance in a relatively short space of time.

Costs of commissions, taxes and administrative charges all combine to erode returns of active funds over time and clearly the major advantage of the tracker fund is therefore relatively low cost. After all, flying on autopilot only requires a good computer whereas human pilots with large pension funds and high annual salaries are far more expensive.

So, seemingly passive investments outperform their active rivals and cost less as well. So why even consider buying any actively managed investments? Well, passive funds are not always the panacea:

1) Passive (tracker) funds track the market up, but they **also track the market down**, so even if you are convinced that the market will fall, a tracker can't position itself to be more defensive because the computer will say "no".

2) Tracker funds aren't perfect because they cost you something therefore **you suffer** what is known as "**tracking error**". If the FTSE 100 is up 10% but you buy a tracker that costs you 0.5% a year, you will only see 9.5% out of 10% of that return. This can make a material difference to performance over many years.

3) Not many people know that there are two different ways to design tracker funds. They are either "**fully replicated**" or they are "**sampled**". Fully replicated is safest because the provider physically buys all of the holdings that go into the fund and holds them on your behalf until you want to sell, so that £1 invested = £1 of physical stock bought. This reduces risk because investments are held as "collateral" on your behalf. However with "sampled" trackers, the

issuer buys derivatives (the instruments that helped precipitate the banking crisis in 2008) instead of buying all of the constituents of the index. In other words they promise to repay you £1 when you need it but they don't actually hold £1 of assets as "collateral**". "Sampled" trackers are cheaper** because there is less work for the bank to do and more profit, but they **carry more risk** because you are relying on a "promise" from the bank.

4) **Not every investment or asset class can be tracked**. The FTSE 100 (UK) and S&P 500 (US) investments are huge, liquid stock markets and easy to buy and sell (and therefore easy to replicate). But what about a fine art index tracker? Try and find an index that fully replicates that market – you won't. It's too small, too risky, impossible to buy all of the constituents (e.g you can't buy 1.2% of a Rembrandt), difficult to price and therefore impossible to sensibly "replicate".

5) You may not know that most tracker providers will be happy to take your money, buy your investments and then lend out the assets that they buy for you to other investors, in order to make some profit and reduce costs in the process. This is called **"stock lending**". In other words you put in £1, they buy you assets worth a £1 but they then lend those assets to other investors. If that investor goes bust, they may not be able to pay you back the money that you don't know they have lent! (A bit like a bank really except without the £85,000 protection level).

So, yes, they are cheap, but clearly trackers are far from perfect.

All of that said, if you know what you are buying, from whom and as long as you understand the structure of each fund **we believe that passive investments have a major role to play in clients' portfolios**. Ideally you want to buy a "fully replicated" fund that accurately and cheaply tracks a big market like the FTSE 100 and with a provider that does not lend stock to other investors. These are the trackers that we invest into for our clients. We believe that they are the "cleanest" and most efficient way of expressing a particular viewpoint about the markets and in our opinion the "purest" form of exposure to equities other than buying each stock direct in the market place.

We think that an investor should use **both passive and active funds together in a balanced portfolio.** Using trackers reduces the costs to our clients of running their portfolios and also allows us to express our own views about the potential direction of these equity markets quickly and cheaply. Therefore if we need to we can quickly change the mix of assets in a client's portfolio to reflect changes in the ebbs and flows of the markets. However **we also use actively managed funds** where we believe that an active manager will really add value for the fees that they are charging. In more esoteric investment areas, as above (see point 4), selecting an expert manager who knows their market inside out is more valuable and in most cases less risky than tracking an index that is not easy to re-create. For example we would buy an active manager who specialises in the small "Global Healthcare" sector, rather than try to find a tracker that does the same job. You can't use an autopilot to fly a 2-Seater plane.

The key then is to find some balance. The right tracker can lower costs and enhance performance when used alongside other active investments. The skill then comes in using this passive exposure to sensibly manoeuvre in and out of equities in order to enhance performance through good timing. This is called "active asset allocation", a completely different concept altogether and one that is a key pillar of our investment process that is best covered another time.

Market "Stance" - the chart on the right illustrates our current general "market stance".

Each of the dots on this chart represents a change in this market stance over time.

Our current stance is still:
NEUTRAL

Positive (bullish)

Neutral

Negative (bearish)