Active versus passive investing:

the decision is not binary

Alex Baily, Portfolio Director, investigates...

The passive market has grown exponentially over the past decade and in recent years, many investment columns have been devoted to the so-called 'active versus passive' debate.

Those in favour of actively-managed funds highlight that fund managers can take advantage of investment opportunities as they arise, in addition to those created by market volatility. In contrast, they claim passive funds have little flexibility to 'swim against the tide' and therefore guarantee underperformance (after fees).

The passive cohort, however, highlight the reams of academic studies that show a large portion of active managers underperform the market and there is the perennial question of fees.

In our opinion, it is not about choosing one side over the other. We believe the active versus passive debate is outdated because it is not a binary decision to invest in an actively-managed fund over a tracker fund, or vice versa. For us, it is simply about selecting the most appropriate investment vehicle that will achieve the best outcome for our clients.

Initially, we make an asset allocation decision such as increasing exposure to a specific part of the market because it looks attractive. We then assess both the active and passive opportunities and carefully analyse the most suitable one for the client depending on their risk profile and objectives.

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Investigation

As an experiment, we created a 'passive-only' portfolio in line with our asset allocation views. We wanted to explore how this control portfolio would compare to the typical portfolios we manage for clients (which include both active and passive funds) in terms of cost, performance and investment outcomes.

Outcome

Although our research is ongoing, an important caveat is that there are some parts of our typical client portfolios that cannot be replicated passively. As soon as you move away from traditional asset classes, you run into challenges. For example, it is difficult to replicate commercial property indices as you cannot buy a bit of every building in the benchmark, just as it is very difficult to buy a small share of a series of infrastructure projects.

Likewise, hedge funds and absolute return funds provide investors with the prospect of some protection when markets fall, however it is difficult to find a passive equivalent, although there are funds that use algorithms to replicate successful hedge fund strategies that could be classified as passive.

Evaluation

Even in more conventional areas, we have concerns about the passive options available. The bond market is likely to face numerous challenges, as central bank monetary policy starts to normalise, and we are concerned that liquidity could be a problem.

The growing use of passives has also unwittingly created investment opportunities for savvy active managers as they understand how passive fund flows behave if markets come under pressure. This creates opportunities for managers to go against the crowd and react quickly to market inefficiencies. Each market comes with its own set of dynamics, which means that active managers have historically performed better in some markets than others. In UK equities, when reviewing peer group performance of rolling three year periods over the last ten years, the middle of the second quartile return outperformed the index for 73% of the monthly observations. ▶

Definitions

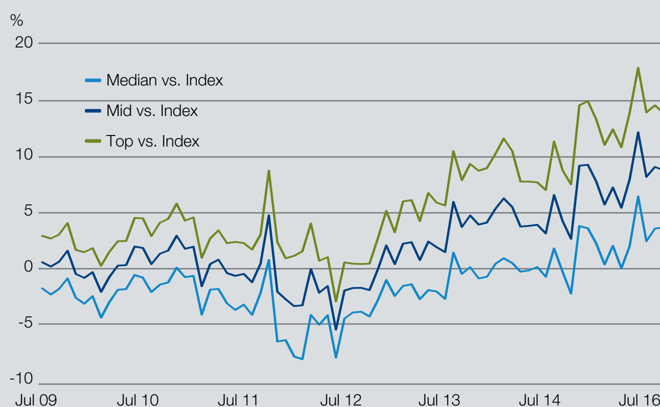
Index Tracker Fund An index tracker fund is a type of mutual fund with a portfolio constructed to match or track the components of a specific market index, for example the FTSE 100 Index.
Exchange Traded Fund (ETF) An ETF is a marketable security that tracks an index/a commodity/bonds or a basket of assets like an index tracker fund. Unlike mutual funds, an ETF trades like a common stock on a stock exchange. ETFs experience price changes throughout the day as they are bought and sold.

▶ In the US, this percentage fell to 26% and fell further to 21% in emerging markets.

The good news is that when using the top of the second quartile peer group return, the percentage of observations that outperform the index significantly increases. In the UK it amounts to 99%, 96% in the US and 82% in emerging markets.

Whilst these figures do support the merits of active management, they also do highlight the importance of selecting a good manager.

Peer group: UK (rolling 3y relative cumulative performance)



Source: Lipper/Cazenove Capital to August 2016. Index: FTSE All-Share TR.

Selectivity and thorough research is crucial when it comes to deciding whether to invest with active managers, and the same is true for passives. Investors must develop a comprehensive understanding of where it makes sense to own both passive and active funds in a portfolio because both may have a place.

We will watch with interest to see how our passive-only portfolio performs from here. We are keeping an open mind and anticipate further developments in the world of passives. After all, nothing stands still in the world of investment. d

IMPORTANT THINGS TO CONSIDER WHEN DECIDING TO INVEST IN A PASSIVE OR TRACKER FUND

FINDING THE RIGHT TRACKER

Making a decision to simply ‘buy the market’ via an Index Tracker Fund or an Exchange Traded Fund (ETF) is not as simple as you might expect.

Like actively-managed funds, passive funds have their intricacies so it is important to look under the bonnet to ensure you understand what you are buying. Here are a few pointers to help with the process:

Fund or ETF?

In a particular quarter or year, passives will not completely replicate the performance of an index. This is down to the fact that they have different costs and structures, and are priced at different times of the day, so you can expect some degree of performance drift. An ETF is a listed security that can be traded through the day. In contrast, an index tracker is a mutual fund that is priced once a day, normally at noon. Fees can differ amongst providers.

What is being tracked?

When investing in a collection of markets, it is important to understand how the different exposures break down and be able to identify what is actually being tracked. This is especially true for emerging markets and Asia-focused ETFs or index trackers, offering exposure to broad regions. The breakdown of how much is allocated to each country can vary from product to product, so it is important to make sure that the underlying exposures are appropriate and acceptable. In addition, it is worthwhile confirming how often the portfolio is rebalanced to ensure that it does not drift too far away from the index.

Tracking bond markets passively can also prove challenging. If the aim is simply to track a bond index via a mainstream market cap-weighted product, the highest allocations will be to those countries and companies with the greatest amount of debt issuance. This may not necessarily be a sensible decision. In the high yield asset class the performance of the passive offerings has diverged significantly from the index at times.

How does it work?

It is important to distinguish whether a fund or ETF is physically backed by the underlying index it is tracking, or replicates the index using ‘synthetics’:

1. If it takes the physical route it means the fund buys all (or most) of the underlying shares in the index.
2. Synthetic replication works completely differently in so far as you are effectively buying a contract with a third party, normally an investment bank, to provide you with the same return offered by the index. The third party does not need to hold all of the shares within the index, but they should hold some collateral. This can be in the form of shares, although these may not necessarily be in line with the index you are seeking to track. It is important to monitor what shares are held.