Active & passive investing

Your guide

PENSION & INVESTMENT ADVISERS

PLANNING FOR THE PEOPLE

Introduction

It is generally accepted that asset allocation has the biggest impact on the variability of returns within an investment portfolio. However, even after establishing your asset allocation, an important decision remains. Which investment style should you adopt when investing in each asset class?

You can choose between two styles: active and passive. There is a significant amount of information on both, however, in these pages we do not refer directly to particular papers and publications. Instead, we outline the consensus view on both approaches. Before doing so, it is important to identify the key components of risk.

The components of risk

Investment theory separates risk into two components, market risk and company risk. The sum of these provides the aggregate risk of an investment.

Market risk comes from investing in a particular asset class, such as the UK stock market. For example, if the UK stock market declines, an investor in that market is likely to see the value of that portion of their portfolio fall. Company risk arises where a specific security's performance differs to that of the wider market.

Active & passive investing

What is passive investing?

Passive investing is an investment approach that aims to reduce aggregate risk by eliminating all security risk, leaving only market risk. This involves a buy and hold investment approach that will match the performance of the chosen index.

For example, the Vanguard FTSE UK All Share Index fund aims to replicate the returns of the FTSE All Share Index, by investing in a representative sample of the underlying companies. The total investment returns of the fund should equate to gains or losses in the underlying index with small adjustments for tracking error and fund charges.

What is active investing?

Active investing is an approach that embraces company risk. Active fund managers build portfolios that seek to outperform a benchmark. They believe that markets do not always correctly price the value of a company, providing opportunities to profit from buying companies below their true worth. Active investors hope the fund manager will produce a higher net return (after paying higher fees) than can be achieved by passive investment.

Which strategy is best?

Both approaches offer value to investors. However, they generate intense debates among their supporters. The main argument is whether active funds produce the long-term returns required to justify the additional risk and higher costs.

There is no simple answer

Most academic research suggests that, on average, active fund managers underperform compared to their benchmark. For example, of the active funds invested in US equity markets – only around 30% outperform their comparable index.

Whilst the precise figures vary by asset group, there is little evidence of consistency. Those managers that outperform over one period do not necessarily have a greater statistical probability of doing so in subsequent years. This is where the strongest arguments in favour of passive investing come in.

Supporters of active investing however present two counter-arguments:

1. It is unlikely that all fund managers have only a random chance of success. Logically, some fund managers must have greater ongoing abilities than their peer group. A few fund managers are seemingly superior in their aggregate performance than statistical flukes would allow. The most likely explanation of their success is superior ability.
2. A more compelling argument is that active investment has greater investment flexibility than passive and is better able to respond to changing market conditions. Active managers can avoid sectors or companies they believe will underperform the market and overweight where they believe the converse is true. A passive fund has no choice, it will invest in both the winners and losers.

The Efficient Market Hypothesis?

The active versus passive debate centres upon the question of whether markets are efficient.

The Efficient Market Hypothesis (EMH) proposes that company share prices will always incorporate all of the available information and therefore share prices will always reflect what a company is truly worth. Therefore it is not possible to "beat" the market as it is not possible to buy undervalued shares or sell overvalued ones.

An active manager believes markets are not efficient and that this provides opportunities. A believer in EMH would just buy a passive fund, as there is no need to pay the extra costs for no advantage.

The evidence for EMH

Academia has for a long time debated whether the EMH holds true in reality.

Markets are not wholly efficient. Over the past 20 years or so, academics themselves have repeatedly identified inconsistent patterns of returns. These patterns would not exist if EMH represented the complete picture.

Inefficient markets

Many recognise some specific investment markets as being inefficient. Active managers' arguments become more powerful with evidence of inefficiency. This at least brings the possibility of gains exceeding the market as a whole. Such inefficiencies may exist in some areas such as smaller companies stocks, poorly researched markets and illiquid investments.

Behavioural finance

Behavioural finance is one hypothesis that seeks to explain these patterns. It does this by extrapolating the repetitive habits of individual investors which sometimes leads to irrational investment decisions being made. Anecdotally, some funds using behavioural finance techniques, particularly in the hedge fund industry, have achieved some success. Behavioural finance aims to explain occasions when inefficiency is evident.

Indices and trading

Many indices are created by reference to market capitalisation, where each company has an allocation in the index in proportion to its size in the market. Some investors may question the suitability of this process, particularly in the case of corporate bond investment where it involves allocating more money to the more highly indebted companies.

In addition, when a security is added to or removed from an index, it can cause a cluster of trades as passive funds seek to replicate these changes. Passive investors in these instances are obliged to trade, no matter what the price, offering the potential for active investors to exploit these opportunities by buying ahead of a security being added to an index or selling before they are removed.

Cost

Typically, actively managed funds are more expensive than their passive counterparts. The greater costs need to be justified by returns in excess of a passive equivalent. Passive funds are cheaper to manage as the underlying construction of a portfolio and the buying and selling can be largely automated. Plus with the growth of passive funds, the fund providers have begun to compete on cost. In the UK, investors can purchase funds tracking major indices for less than 0.15%. Active funds in the same areas would typically charge between 0.8% - 1.0%. Active funds may also include performance fees, which can have a particularly damaging effect on an investor's overall return.

Choosing the right style

For diversification purposes, today's modern portfolios are generally invested across a range of asset classes.

Variations between portfolios then tend to arise as a result of the chosen investment style, which vary depending on the individual investor's personal requirements. An active investment approach may be more suitable in certain asset classes where market inefficiencies arise through illiquidity or lack of information. This provides scope for active managers to add value even after costs are taken into consideration. In well-researched, heavily traded markets, a passive approach may offer a useful alternative, as it is likely to provide a return only a little lower than the market.

Whether you select active, passive or a combination of both, is a personal decision. Many independent investment houses strive to identify funds that are likely to outperform in the future. It's true that some active funds do outperform passive funds. However, passive investing may not always be an option in certain markets or asset classes, as there may not be a relevant index to track.

This document provides information about investing and explains some of the different investment styles available to you. It is a statement of opinion, not advice, and you should not take it as an indication of likely future returns. Seeking professional advice will help you make informed decisions that are right for you.

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