FINANCE UPDATES

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ACTIVE V PASSIVE: WHAT'S BEST FOR YOU?

Can you benefit from the best of both approaches?

Whether the terms are new to you or you already hold an opinion, we will look at the respective pros and cons of active and passive fund investing, and find out if it is possible to get the best of both by taking a hybrid approach to investing.

THE ROLE OF INVESTMENT FUND

Before we talk about the difference between passive and active funds, let's remind ourselves about the role of funds as a whole in a personal investment portfolio.

Funds are investment products which invest in a group of shares (or other types of investments, like bonds), as opposed to you individually stock picking yourself.

You pay an annual management fee and possibly transactional costs in return for a mix of investments – usually selected from a certain sector, think FTSE 100 companies or European bonds.

Fund investing is an efficient way of diversifying your portfolio which, as you probably know, is regarded as good practice.

This is because your one investment in a fund will expose you to 30, 50, or even 100 different holdings in one fell swoop. It would then be common to invest in several funds, achieving much more diversification still.

More experienced or confident investors may enjoy the challenge of individually picking stock, and back themselves to make the returns without incurring management fees.

ACTIVE & PASSIVE FUND INVESTING

Within the fund universe, the terms "active" and "passive" refer to the investment processes of funds.

Passive funds, sometimes called trackers or index-linked funds, simply track a chosen investment sector with no outside human judgement on the buying and selling decisions made.

Active funds, on the other hand, rely on the stock-picking skills and judgement of a fund manager within a particular sector.

To give you a basic example, a FTSE-100 tracker may at all times seek to have a proportionate holding of each company's shares within the FTSE-100 index; whereas an actively-managed UK large cap fund might have only the FTSE-100 companies which the manager believes will deliver the best performance.

The debate around the two investment processes centres around cost and return.

Passive funds are lower cost and if they do what they should do, they will very marginally underperform whatever it is they are tracking as the costs are always deducted from the return.

Active funds cost more (the range can vary considerably), but their aim will typically be to outperform whatever benchmark they are set against. Great in principle, but if they do not meet their targets, you are paying more for less when compared to an equivalent passive fund.

Active and passive funds will have their own sectors that dictate what they invest in. These could be based around geography, company size, asset class, risk profile or something else.

PASSIVE FUNDS

A benefit of investing in passive funds is the cost savings. The annual fees are much lower than their active counterparts. This is achieved by the high degree of automation in the trading process, little analytical cost and, often, fewer trades.

This means that if investment performance was equal over a given time period between an active and passive fund, the passive fund would deliver the greater return because less money would be deducted in expenses.

Over time there could be a significant difference, so the cost angle should be taken seriously.

In a rising market, passive funds will deliver a return pegged to the overall market. So if a market rises 20% in a year, that is near what you should get from your passive fund which tracks it (less the minor cost deduction).

You can't beat the market but 20% growth would feel pretty good to most investors, although a downside to passive fund investing comes when markets fall.

Because no human input is mandated, there is no protection against market volatility, and no jumping ship from a company that is obviously going under. You should only fall as far as the market does, but a bit of intervention from an active fund may have lessened the fall.

ACTIVE FUNDS

With an active fund, you are getting a fund manager's insight, backed up by research and analysis. They will apply theory, experience and the human touch – sometimes the courage of their conviction – to their stock picking and have a stated aim of outperforming their benchmark.

The very best will do so, and this is worth paying for. However, most won't outperform so you may end up actually paying more for less growth than a passive fund. Active funds will always cost more than passive ones regardless of performance.

The problem is nobody can predict with certainty how fund managers will perform in the future. Sometimes it can even go wrong for stellar fund managers. However, advisers may be able to recommend who is well placed to succeed.

Because active funds are not confined to tracking, another advantage is you might find one more tightly matches the parameters in which you are seeking to invest, making an absolute return for instance.

And while passive funds are sufficiently attractive in a rising market, the human intervention of a fund manager may be appealing when markets are struggling.

THE MIDDLE GROUND

You may be starting to draw a conclusion on the approach you'd prefer: is it all about cutting cost or seeking overperformance? As with many things in life, a middle ground may be best.

The financial markets of many economically developed countries are highly regulated and efficient, meaning that the majority of the pertinent information is available uniformly.

This suits a passive approach, or at the very least makes it more difficult for an active manager to find points of differentiation which would allow them to overperform.

In contrast, emerging markets tend not to be as efficient, and regulation not as tight. Here is where an expert stock picker has more opportunity to make a big difference.

Therefore, one way to consider using the cost-effectiveness of passive funds and the potential for outperformance of an active manager might be to use passive funds for investment in developed markets and active funds for emerging markets.

Of course, it's not as black and white as that. Research would still be required to choose the right funds for the right markets, but the general approach has its merits.

Another way in which the two investing styles could work together is one based upon market conditions.

We have already observed it's hard for active funds to outperform passive funds in strong rising markets, especially when their extra fees are taken into account. But they can also fare better in falling markets as they are not tied into the worst performers in an index.

So rebalancing the active and passive elements of your portfolio in line with the financial outlook is another broad idea to consider. Albeit this is an approach that would require a greater degree of nimbleness.

Get in touch for a portfolio review.

IMPORTANT INFORMATION

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