Active vs. passive investing – the great investment debate

Rathbones
Look forward

Background

In our last investment report for charity trustees, we explored the choice between absolute return and relative return investing. This time we look at the choice between active or passive investment management. This debate has run for many years and remains one of the most fundamental and divisive issues in the world of investing. We examine the advantages and disadvantages of each approach, and the factors that trustees will need to consider in deciding which strategy to adopt.

Any questions?

This booklet contains material extracted from our latest charity investment report. If you have any questions, or would like a copy of the full report, please contact our charity team on 020 7965 7103 or by email at james.brennan@rathbones.com

The value of investments and income arising from them may fall as well as rise and you might get back less than you originally invested.

Active vs. passive investment management – a debate that can't be ignored

Can active managers beat their benchmarks, or should investors abandon active strategies for passive investments?

Active investors attempt to outperform the returns of a specific benchmark, while passive investors track a specific index. If you believe that market prices incorporate all the factors that could impact an investment's price, then passive investing may be the approach for you.

While active management has been around for many years, passive investing is a relatively new phenomenon. Yet its growth has been rapid, particularly over the last decade. In 2015, exchange traded funds (ETFs) attracted nearly $200 billion in the US, while actively managed equity funds saw outflows of $124 billion.

The rise of the passive investing can best be demonstrated by the fact that passive funds now account for circa 25% of all US fund assets.

Weighing up the evidence

Aside from academic research, if the number of quotes in support of passive management is considered, active management would be a thing of the past. Here's one from the *Wall Street Journal's* Jonathan Clements:

"Santa Claus and the Easter Bunny should take a few pointers from the mutual fund industry. All three are trying to pull off elaborate hoaxes. But while Santa and the bunny suffer the derision of 8-year olds, actively managed stock funds still have an ardent following among adults."

Defining an active manager

To explore this issue, Invesco conducted a study focusing on 'active share', which measures the difference between a fund's active holdings and those of the index that it's trying to outperform. A fund has a higher active share when it:

- holds stocks not in the benchmark
- omits stocks that are in the benchmark
- holds the same companies as the benchmark, but in different weights.

The study showed that across multiple market cycles, active management posted a history of benchmark-beating results based on excess returns, downside capture and risk-adjusted returns. The benefits weren't limited to smaller companies or emerging markets, which are regarded as 'less efficient' and where returns can be generated more easily.

So, active wins, passive loses? Unfortunately, it's not that simple and comes down to time frames. For example, the S&P 500 Index outperformed 95% of all managers investing in larger companies from 1992 to 1998. From 1984 to 2008, evidence suggests that 70% of large cap mutual funds fell short of their benchmarks.

Pros and cons of active management

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Pros

- the active manager's remit is to outperform the market
- active funds can invest more freely, they're not tied to an index meaning ethical or other requirements can be accommodated
- active managers can minimise potential losses by avoiding certain sectors or regions.

Cons

- performance depends on the manager's skills – an actively-managed fund can underperform
- fees tend to be higher because good active management involves more costs
- 'key man' risk – if the fund manager leaves, the replacement may not be as talented.

Pros and cons of passive management

Pros and cons of passive management

Pros

— a passive fund is unlikely to underperform the market index by a material margin

— management fees are usually lower than for an actively-managed fund

— passive funds can also offer a quick and easy way to gain access to a market

— no 'key man' risk.

Cons

— the costs of running passive strategies can be underestimated — the 'headline' fee rate can be misleading

— asset allocation decisions can't be passive

— there's no chance of outperformance

— the investor is required to accept an index, emphasising larger companies or sectors that are in vogue: examples include technology stocks in the S&P 500 Index when the bubble burst in 2000 and financial stocks held prior to the 2008 financial crisis

— investors in corporate bonds have recently faced falling market liquidity — in this scenario, passive funds run the risk of either being forced buyers or sellers, regardless of market conditions.

Looking forward – is active investing about to make a comeback?

Before dismissing active management, it may be wise to look at the economy. When interest rates fall, equity markets typically do well. When rates rise, there is often a higher dispersion between the best and worst performing stocks. In this situation, active managers can outperform their benchmarks more easily.

Passive funds may lead to less efficient markets, creating opportunities for active investors. As passive management increases, there are fewer managers analysing a company's fundamentals, providing opportunities for those who do their research.

Interest rates have started to rise in the US, albeit at a measured pace. As rates rise and markets mature, it's harder to make money simply through investing in passive funds.

Which approach is right for you?

To answer this, investors should first consider asset allocation. While ‘strategic’ asset allocation aligns the portfolio to longer-term goals, ‘tactical’ asset allocation exploits shorter-term opportunities, which can only be taken on an active basis.

The next step is investment selection to ensure the portfolio meets your needs, both from a return and risk perspective. Trustees should ask themselves these questions before deciding on their approach:

- given our charity’s requirements, which approach offers the most choice?
- are both approaches compatible with our income target?
- can a passive approach accommodate our ethical policy and restrictions?
- we’re cost-sensitive, but what about value for money?
- will we still get investment advice, safe custody of assets, first-rate administration and investment training?

Passive investing can be cheaper; the dilemma can be price over service. The lower fees earned by passive managers typically mean that value-added services are not provided.

Few indexed funds offer an ethical overlay. Income generation is another area of contention.

What's our suggested investment strategy?

Perhaps it isn't a case of either/or, but rather how active and passive investing can be blended together.

The merits of each strategy depend on the market in question. It can be hard to find active managers that consistently outperform their passive counterparts, a good example being US equities. While US equity active managers have struggled to outperform the S&P 500 Index at certain times, some funds have added value over a variety of market cycles. The challenge is finding the 'best of breed' managers; high-quality research is essential.

Evidence in less efficient markets still supports active management. In Europe, Asia and emerging markets, where economic and political factors change quickly, active managers can exploit the resultant volatility. Passive funds do not have this luxury.

We also believe the smaller companies market offers opportunities for active managers to exploit market inefficiencies through fundamental analysis and stock picking.

In summary, as a firm, we believe in being open-minded. It would be foolish to dismiss passive funds altogether, although we believe that skilful active managers have the edge.

For this reason, a hybrid approach, where active investing is supported by targeted passive investing can offer the best of both worlds.

So which approach should your charity choose: active or passive investing?

Our team would be delighted to explain the pros and cons of active and passive investing, and explain how a hybrid approach can be the best option. We have considerable experience in helping charities to understand complex choices like these.

Contact us today to discuss your charity's investment options:

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