Active & Passive Investing

Your guide

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Introduction

It is generally accepted that asset allocation has the biggest impact on returns within an investment portfolio. However, even after establishing your asset allocation, an important decision remains. What 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 these two investment styles. However, in these pages, we do not refer directly to particular papers and publications. Instead, we outline the consensus view on both approaches.

The components of risk

Long-term investment returns relate closely to the possibility of loss. The greater the possibility of loss, the greater the expected return needed to make your investment worthwhile.

Investment theory defines two components of risk: specific risk and non-specific risk. The sum of these provides the aggregate risk of an investment. Non-specific risk – sometimes called market risk – comes with investing in a particular asset class, such as the UK stock market. Specific risk is associated with investing in a particular security rather than a stock market.

Investors experience the losses of non-specific risk when, for example, the UK stock market declines, reducing their portfolio values. They suffer the effects of specific risk when, for example, the stock market rises but their share values decline.

Active & Passive Investing

What is 'Passive' Investing?

Passive investing is an investment approach that aims to reduce aggregate risk by eliminating specific risk.

This involves investing each asset class in a portfolio to match, as closely as possible, the movements of a particular index. A typical modern example is an Exchange Traded Fund based around the MSCI United Kingdom Index. Investors in these types of fund will experience no specific risk. Instead, they participate in gains or losses in the underlying index.

What is 'Active' Investing?

Active investing is an approach that embraces non-specific risk. It does this by building a portfolio of securities that will diverge from movements in the underlying market. Active managers aim to identify baskets of securities that, in aggregate, will behave differently from the whole market – looking to perform better over the long term.

Which strategy is right?

Both methods 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 costs.

There is no simple answer to this

Most academic research suggests that, on average, fund managers underperform compared to the index in which they invest. For example, of the active funds invested into typical large markets – such as large capitalisation Equities in the UK or US markets – only around 20% outperform their comparable indices in any period.

There is also little evidence to suggest that those that outperform have a greater statistical probability of doing so in subsequent years. This is where the strongest arguments in favour of passive investing come in.

However, supporters of active investing have two counter arguments:

1. It's unlikely that every fund manager has no more than 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? Superior ability.

2. Possibly the more compelling argument is that active investment is lower risk than passive. That's because, during difficult markets, active managers can mitigate losses by carefully selecting securities. Passive managers can do nothing but watch their portfolios decline. If true, this is a powerful point. However, even with vast research and marketing resources, the active investment industry cannot prove it can achieve this consistently and predictably.

Efficient market theory

Active managers base their arguments on two presumptions:

1. An investment manager can select portfolios of securities that will collectively outperform the market. This means the market mispriced those securities – and that the mispricing will correct itself over a reasonable time period – giving the active manager a better-than-market gain.

2. The manager has the foresight to anticipate broad future movements in and between asset classes - which the market as a whole hasn't yet recognised.

How likely are these presumptions to be true?

At an individual security level, there are two theories regarding the possibility of mispricing shares. The first is the established Efficient Market Hypothesis (EMH). EMH states that a share price always represents the available information and that new information will instantly be reflected in a price change. As the market is efficient, it always prices a share at the optimum level, based on the available information.

This theory dismisses the possibility of active investing ever delivering gains by carefully selecting securities. Indeed, the passive investment industry uses EMH to justify their practices. However, EMH doesn't tell the whole story. Markets are not wholly efficient. Over the past 20 years or so, academics have repeatedly identified consistencies in patterns of returns. These patterns would not exist if EMH presented the complete picture.

Behavioural Finance

Behavioural Finance is a fairly new hypothesis that seeks to explain these patterns. It does this by extrapolating the repetitive habits of flawed people making investment decisions. 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.

Inefficient Markets

A more important fact is that many recognise some 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 capitalisation stocks, currencies and many liquid investments.

Cost

One factor beyond argument is the effect of charges on medium to long-term returns.

Passive investments are usually much cheaper than active. This is because passive fund charges benefit from two factors:

1. The underlying investment management can become mechanical and automated.

2. As a largely homogenous product, market pressures force charges to extremely low levels.

For example, in the UK, investors can purchase funds tracking major indices for around 0.15%. Active funds in the same areas would typically charge over 0.75%.

Choosing the right style

All modern portfolios are invested across a range of asset classes. An active investment approach may be more suitable for certain asset classes and in some cases, a passive approach is not an option as there is not a relevant index to track.

Whether you select active, passive or a combination of both is a personal decision. It's true that some active funds do outperform. In fact, many independent investment houses strive to identify funds that are likely to outperform in the future. So while the rewards of active investing are elusive, they may be attainable.

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

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