Active & Passive

The Great Debate

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Introduction

The current view, held by a number of investors, is that active and passive are polarised. Investors need to 'pick a team' and go entirely active or entirely passive. At Square Mile, we believe that a portfolio should consist of a combination of the best funds to meet the clients' objectives, at a cost that represents value for money. That may be active, passive or a blend of both.

What are the key considerations in fund selection?

- Asset class
- Region
- Costs
- Investment size
- Funds available
- Time horizon
- Performance objective

The debate is active v passive, not active v Index

Currently, the majority of investors compare a fund's performance against its benchmark, which is usually an Index or a sector. However, it is impossible for an investor to obtain the exact exposure and performance profile of a sector or an Index, due to factors such as trading, platform costs and liquidity.

Square Mile believes that it is more appropriate to compare an active fund to an equivalent passive fund, for example a UK Equity fund benchmarked against the FTSE All Share Index should be compared against an equivalent passive fund that tracks the FTSE All Share Index. This can be difficult given the shortage of passive funds tracking a number of specific indices, but it ultimately gives a fairer assessment of the relative merits of active and passive funds.

Why choose active funds?

- The ability to provide superior returns over the Index.
- The ability to generate an income, preserve capital and protect against inflation.
- The ability to provide investors with a "smoother" journey.
- The ability to avoid significant drawdowns during periods of market stress.
- Managers have greater flexibility in where they can invest, so do not blindly invest in specific regions/industries and stocks.
- Investors have greater choice, allowing them to invest in a fund that best suits their needs.
- Investments can be made on a forward-looking view.
- Sometimes there are few or no passive options. This is particularly true in esoteric asset classes, such as mortgage backed securities, or difficult to replicate assets, such as private equity or commercial property.

Why choose passive funds?

- They are usually cheaper. (There are exceptions: In the UK All Companies sector the OCFs range from 0.06% to 1.51% for passive funds, while the range for active funds in the same sector is 0.22% to 2.69%).
- Passive funds often have greater transparency, allowing investors to have greater insight into their portfolio's risk characteristics, although this may change as active managers are being pushed (quite rightly) to improve disclosure.

- Passive funds are exposed to minor active risk (the risk associated with not performing in line with the Index), however, they do remain exposed to the same overall risks as the market.
- Simple, straightforward and easy-to-understand.
- Lighter touch monitoring and maintenance required.

Do you get the Index?

This is an important question for those investing in passive funds because comparisons are often made between the performance of active funds and the Index, but there are a number of reasons why passive investors don't provide the same return as the Index.

- Fees, trading costs and other expenses all have a negative drag on a fund's performance.
- Timing differences will also impact relative performance.
  If a fund is priced at 12.00pm but the Index closes at 4.30pm, then any deviation in the Index price between these periods will lead to a deviation in performance.
- Tax. Asset managers can't avoid paying taxes such as stamp duty and dividend tax. If the benchmark tracked does not reflect these taxes, then there will be a mismatch between returns.
- Passive funds do have the ability, albeit limited, to add alpha above the Index through stock lending and by making subtle changes to the fund before or after an Index change/rebalance takes place.
- For many passive funds, the managers will not fully replicate the Index but instead adopt an approach called stratified sampling, where the fund will be constructed to have very similar risk characteristics to the Index but not identical. The mismatch between the portfolio and the Index can lead to differences in performance.

Performance analysis

We compared the returns of active and passive funds in five popular sectors up to 31st July 2017.

1. ***UK All Companies:*** As expected, the average passive fund has consistently underperformed its respective Index. However, in the 17 years covered, active funds have only underperformed their respective indices in five calendar years. Overall the average active UK equity fund has outperformed its benchmark when considered over rolling three-year periods. On average over the period in question, the top 73% of active funds would have either matched or outperformed the average passive fund.

2. ***Sterling Corporate Bond:*** Active funds have not been able to outperform their benchmarks in the corporate bond arena consistently over rolling three year periods. From May 2010, where we have sufficient data on passive funds in this sector, 31% of active funds have, on average, outperformed passive funds.

3. ***Global Equity:*** Broadly speaking, active global equity funds have underpeformed their benchmarks over rolling three year periods. However, during specific periods over the last 10 years, the difference has been marginal. Over the period covered, active funds have, on average, outperformed passive funds 58% of the time.

4. ***North America:*** The period in question may be short, however over all rolling three-year periods, active funds, on average, have, been unable to outperform their equivalent passive funds. In the 11 calendar years analysed, North American active funds have only outperformed passive funds in three of those years. Since September 2007, 39% of active funds have on average outperformed the average passive fund.

5. ***Sterling UK Gilt:*** Even though the difference has been minimal, passive funds have been able to outperform their equivalent active funds over rolling three year periods from July 2005 to July 2017. Since September 2010 active gilt funds have consistently underperformed their benchmarks. Since September 2007, 32% of active funds have on average outperformed the average passive fund.

Conclusion

Active management has 'worked' in the IA UK All Companies and Global sectors, where the majority of active funds have been able to outperform their passive equivalents. However, passive funds have outperformed in the IA North American, IA Sterling Corporate and IA Sterling UK Gilts sectors.

Active v passive is not a binary call. A portfolio that carefully blends active and passive funds can provide investors with the best potential outcome.

*This document is a summary of a full report produced by our research team. To view the extended analysis, please click **here***

Data source: FE Analytics

Thank you

Important information