Active or Passive?

A MISGUIDED QUESTION?

The role of technology in the modern development of stock markets has given fuel to an important debate between two very different investment philosophies. There is an increasing appetite for passively managed funds and Irish investment managers have responded by offering an increasing array funds in this category.

Investors and their advisors must now consider whether they want their investments and pensions actively or passively managed.

Active fund managers believe that stock markets are inefficient, i.e. individual stock prices can be incorrect, being over or undervalued at any given time. They believe they can exploit these inefficiencies and therefore make a return over and above the average stock market return. This approach is still the dominant investment approach in the world today. These funds rely heavily on market research and analysis and as a result generate higher trading costs relative to passively managed funds.

Consistent outperformance of the market by the likes of Warren Buffet in the US and Neil Woodford in the UK prove that a skilful active investment manager can take advantage of stock-market inefficiencies and generate a return over and above the market average.

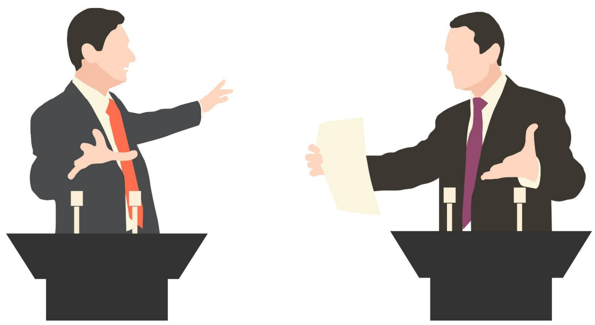
Nevertheless, these consistent outperformers are the exception and not the rule. A recent study of actively managed funds in the US showed that of the top performing funds in 2012, only 4% was still in the top quartile in 2014[1].

So, while many fund managers have proven that there are market inefficiencies, the problem for investors is identifying those top performers.

The alternative approach is if you can't beat the market, why not track it? Passive management is perhaps a misleading term, the more accurate one being index tracking. It is like investment management on autopilot. The portfolio of stocks within an index tracking fund usually mirrors that of a particular market index like the FTSE 100 or S&P 500. A typical index tracking fund would be weighted based upon the market capitalisation of the companies in that index. So, if say, Royal Dutch Shell makes up 5% of the FTSE 100, a FTSE 100 index tracking fund would be 5% weighted to Royal Dutch Shell stock, and as Shell's stock price increases or decreases, so too will its weighting within the fund.

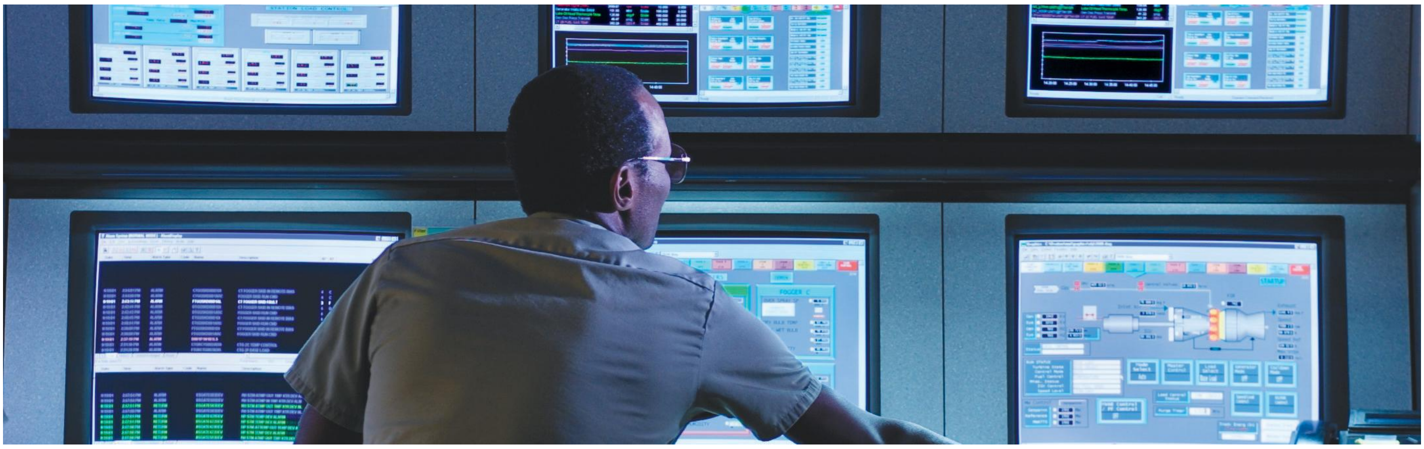
Due to the exponential advance of financial technology, index tracking funds tend to have much lower overall management costs due to their simplicity of function. Most of the trading is done by complex computer systems and algorithms, this leads to lower manpower and trading costs, translating into higher returns and most importantly, more money in your pocket.

On the other hand, whereas a typical index tracking fund may show bias towards the largest company on that index, active managers argue that they can take advantage of investing in small but growing companies. In addition, some actively managed funds can offer investors significant protection in a falling market by utilising alternative investment strategies such as absolute or total return funds.



Nevertheless, the debate around active vs passive is somewhat misguided and given too much importance. The returns between similar active and passive funds in many cases only differ very slightly. In fact, the best portfolios often include a mix of the two styles, giving an added level of diversification.

The most important decision any investor and advisor needs to make when they invest is not whether they should go 'active' or 'passive'. The most significant determinants of how your money will perform in any given fund are the length of time you are invested and the allocation to the different assets classes within the fund.



This is where good advice can be invaluable. Your MoneyCoach advisor will guide you through the process of identifying your investment objectives and take you through your options to ensure that our recommendation matches these objectives and your attitude to risk.

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[1] Business Insider 'The Past Performance of a Mutual Fund is not an Indicator of Future Outcomes ... 96% of the Time' by Sam Ro 14/07/2017