

Active versus Passive fund management

There has been a long and heated debate within financial services about whether active management really works. Should we back an individual's stock picking skills, or rely on passive 'tracker' funds?

I have recently attended two very interesting fund manager seminars and listened to two compelling yet contradictory arguments on the subject.

In favour of passive management ...

The key argument for passive fund management is that, hampered by costs, most fund managers are unlikely to outperform the market.

I recently attended a presentation by Charles Ellis, author of "Winning the Loser's Game". Ellis argued that on average 85% of institutional investors underperform the market in the long term.

Ellis believes that this is partly because investing has become so competitive that even the smallest of the top 50 institutions spend \$100m a year buying services from brokers. Ellis asks the question "how much better must an active fund manager have to be to even recover the costs associated with active management?"

By passive management we generally mean index tracking funds.

This view is in line with the "costs matter hypothesis" (CMH), first circulated by Jack Bogle, one of the founders of Vanguard (who we use for our tracker funds). The CMH argues that the only element of fund performance of which we can be absolutely certain, is fees. As a result the key factor to consider in selecting a fund should be cost, an area where passive funds hold the advantage.

The true cost associated with active management is actually higher than a fund's published Total Expense Ratio. Every time a fund manager buys or sells they incur transaction costs, therefore the more active a fund the higher the cost. This is never stated in fund literature but is reflected in performance.

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In addition, there is the issue about getting "best price". If you are selling your holdings in a company, there will be various different buyers out there quoting the price they are willing to pay. If an individual sells £1,000 of stock then they may well get "best price" for all of it. However, if you are a fund manager selling £100 million of stock, you will only get a small part of that amount at best price. For the rest, you may receive a lower price. Again, this impacts on performance.

From this it therefore seems obvious that in the long term the wise investor would use passive or indexing funds.

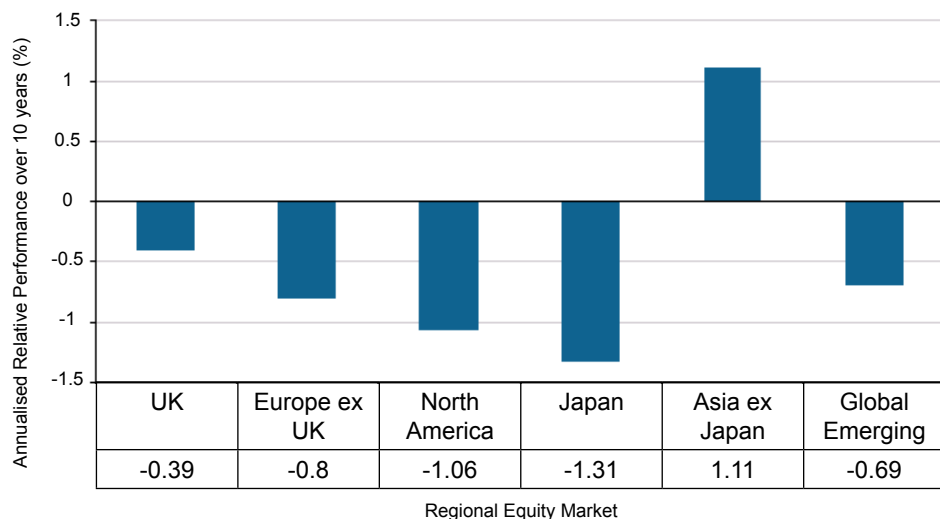
For active management...

The key argument in favour of active fund management (where a manager is employed to select stocks he believes will do better than the market) is that managers will be able to pick stocks that limit damage during market down turns.

The manager should also be able to identify stocks that outperform when there is a "stock pickers' market", i.e. a market where there is a wide dispersion of returns among stocks.

The following chart illustrates how the average active fund manager underperforms the benchmark over a 10 year period:

Average Fund Manager Performance: 10 years relative to benchmark



Source Lipper. IMA Sector relative to index at 30/04/2010 (Cazenove)

Where the bar is below the line on the above chart, this means the average fund in that sector has underperformed the index.

This initially seems to support the argument for passive funds. The only region where the average active fund manager has outperformed the benchmark over 10 years is Asia (excluding Japan). However, don't forget that this is just the average of funds within a particular sector, including all the absolutely terrible ones!

What must be considered however is that passive funds do not perfectly follow an index. There are costs associated with all fund management.

Even passive funds have to buy or sell occasionally. For example, the companies that make up the FTSE 100 regularly change. These changes must be reflected by a passive fund. Not only does this mean dealing costs, but the effect on performance is magnified as every FTSE 100 tracker fund has to sell on the same day, depressing the share prices.

Finally, the active fund manager performance shown above is subject to typically a 1.5% annual management charge. Here at Equilibrium we generally pay half of this for an equity fund (0.75%), or even less.

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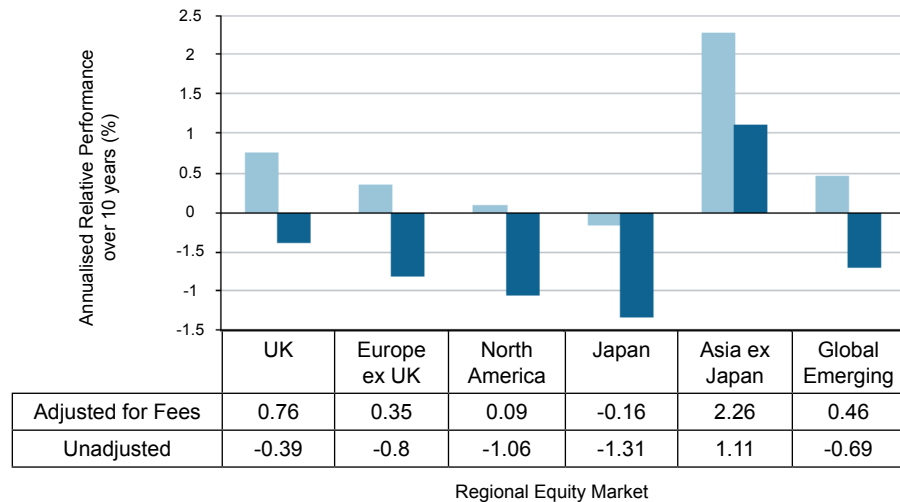
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If we adjust the previous chart to reflect the discounted charges we pay on active funds, and the inevitable underperformance of tracker funds compared to the index, we get a very different result:

Average Fund Manager Performance: 10 years relative to benchmark

(Adjusted +0.75% IMA and -0.4% Index)



Source Lipper. IMA Sector relative to index at 30/04/2010 (Cazenove)

This chart now shows that the average 'active' manager outperforms, except in Japan.

What is also worth noting is that these graphs are looking at the 'average' fund manager. It is our job to identify the best funds and fund managers, those that outperform consistently.

Conclusion...

We are relatively agnostic about the whole argument. Both active and passive funds have merits.

Only the best fund managers consistently outperform. If we can't find one that does so in a certain sector we'll just use a passive fund.

We also recommend using a core of passive funds combined with active funds. We will change our recommended weightings depending on market conditions in order to hopefully outperform.

For example, in the last 6 months we've increased weightings to 'UK Large' funds which we felt would do well in difficult market conditions. This has paid off to date, although we will look to change it if we anticipate that more aggressive funds will do better.

Andy Baker
Investment Analyst

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Market Views | 15 September 2010

General Economic Overview

GDP growth is expected to be muted, but we believe we will probably avoid a double dip recession.

Core inflation is expected to fall but the headline numbers may increase when the VAT changes take effect in January. Inflation could become more of a concern in the long term. We believe interest rates will remain low throughout most of 2011.

Asset class key

+ positive

- negative

= neutral (normal behaviour)

+5 strongly positive

-5 strongly negative

Equity Markets

Equities still look good value but less so after recent growth. The FTSE Allshare Index was trading on a price/earnings ratio of 13.7x at the end of August compared to the long term average of 14x. However, based on forecasts for next year's earnings the FTSE 100 is on a ratio of more like 10x, which looks very attractive.

We remain positive on equities, particularly large, quality companies which have not seen the same growth as poorer quality stocks.

Outlook

+3

Fixed Interest

Gilt yields remain very low, making corporate bonds look attractive in relative terms. Although we believe gilt yields will have to rise at some point (meaning capital values will fall), we do not think this will be a sharp move. In a low growth, low interest rate environment, corporate bonds continue to offer good relative value.

+1

Commercial Property

The rental yields on the commercial property index remains very attractive being around 6.3% pa. However, we expect returns to cool after a decent recovery phase and expect little capital growth over the next 12 months.

Property funds are sitting on high cash levels which is a drag on returns. This will gradually reduce as fund managers look to buy properties, but this too has a cost.

=

Residential Property

We have introduced a new structure to produce our outlook scores. We believe residential property should grow by around 5% pa on average over the long term, roughly in line with average earnings. We believe prices could fall or remain flat over 18 months, leading us to a -5 outlook score.

-5

Cash

With interest rates remaining at record lows, returns on cash are as low as they have ever been, and we expect them to remain low for some time.

-5

These represent Equilibrium's collective views. There are no guarantees, although we hope to be right more often than wrong. We usually recommend holding at least some funds in all asset classes at all times and adjust weightings to reflect the above views. These are not personal recommendations so please do not take action without speaking to your adviser.