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Active Verses Passive Investing ?

The argument between the proponents of active and passive fund management has raged for 30 years of more, ever since the savage bear market of the 1970s prompted a rethink of then dominant investment methods. Back then, everyone was an active investor. Being in the stock market meant trying to beat it. All fund managers aimed to out-perform both the market index and fund managers from competing firms by picking better stocks. Then indexing came along and some investors decided that they would prefer to give up the chance of beating the market in exchange for lower costs.

THE CASE FOR PASSIVE INVESTING

Deciding to invest through a passive manager necessarily accepts an average performance as they simply copy the performance of the relevant index by buying all the securities listed in it. Of course, this performance comes at a lower cost than active stockpicking.

Exchange Traded Funds also look to track the performance of a market index or underlying asset class, but unlike passive funds can be traded intra-day on exchanges such as the London Stock Exchange.

Both passive funds and ETFs have become increasingly popular in recent years and have one thing in common – investors are buying the market and not the services of an active fund manager.

There are two main arguments for passive investing.

1. although the benefit of lower costs might not seem much in any given year, over time the power of compounding can make a big difference to your eventual return.
2. most fund managers find it difficult to out-perform the market consistently year after year and that in aggregate the winners must be offset by the losers. In other words, active investment is a zero-sum game.

NOBODY SAID IT WAS EASY

The counter argument from active investors is that the market can be beaten, if not all the time then consistently enough to make the effort worthwhile. This is principally because financial markets are not efficient. At any time most shares are either under or over-priced and a skilful and experienced investor can spot these anomalies often enough to beat the market and to justify the higher costs involved.

Successful investors are not always right but they are right more than they are wrong because they stack the odds in their favour. They do this by picking companies with the soundest balance sheets or those with the most appealing valuations or the most efficient operations or highest barriers to entry, (such companies tend to have few competitors and so generally have higher profit margins). In all sorts of ways, they make it more likely that they will pick winners and avoid losers.

Despite this, many studies over the years have seemed to make the case for passive investing. They show that relatively few active managers beat the market and, more to the point, they suggest that it is impossible on the basis of past performance to spot the winners of the future. Maybe this is true but, if so, it merely says that successful investing is hard, not that the search for successful investors is futile.

UNCOMFORTABLE TRUTHS ABOUT PASSIVE INVESTING

While the argument against active investment is often made, the case against passives is heard less often. There are, however, some uncomfortable truths about passive investing too.

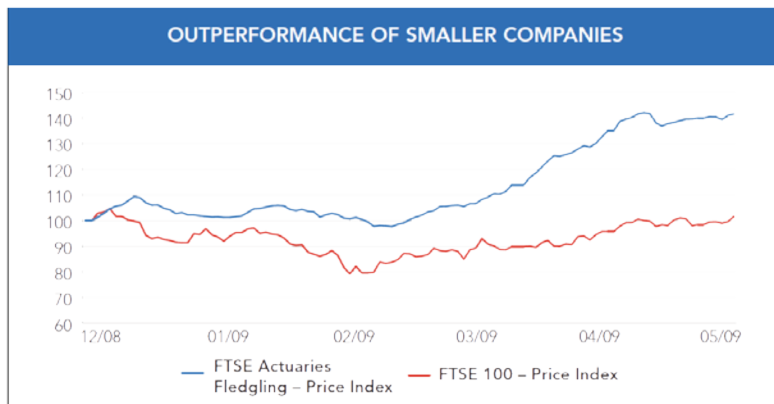
When passive investing takes the form of tracking a market capitalisation-weighted index such as the S&P 500 or FTSE 100 (as it usually does) it leads to investors buying more of a share as its price rises because it accounts for a growing proportion of its index.

An obvious example of this was Vodafone at the height of the dot.com boom or, more recently, RBS just before the credit crunch. Investors end up buying shares precisely when common sense tells them they should be reducing their exposure.

By the same token, smaller and mid-cap stocks are de-emphasised by a passive approach despite the fact that these less well-known companies are probably less effectively researched and so more likely to be mis-priced by the market.

It is impossible for a passive investor to take a meaningful position in a small, under valued share.

This is a particular handicap during a period of market turmoil such as we experienced in the second half of 2008.



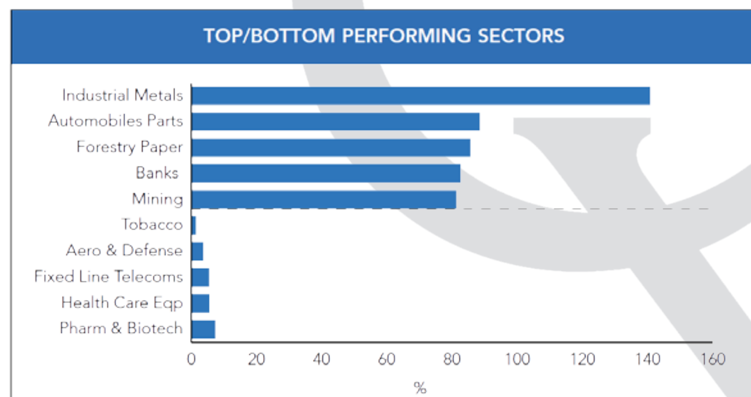
Source: Datastream 31.05.09

As the chart to above shows, smaller companies have outperformed significantly since December 2008 but most passive investors would not have been able to benefit from this.

IT'S A STOCKPICKERS ENVIRONMENT

In the first 100 days since the market low on 3rd March, the FTSE All Share Index rose 30.1%. What this overall figure masks, however, is the huge disparity of returns that occurred between sectors and stocks over that time.

During the period, 62 stocks saw their share prices rise by more than 100%. Of particular note were car dealership Pendragon up 768% (not bad considering the perilous state of the global car market!), Avis Europe up 536% and Punch Taverns which rose 311%. Conversely, 53 stocks saw their share prices fall over the same time frame.



Source: Bloomberg 03.03.09 – 11.03.09, FTSE All Share Sectors

Looking at a sector level, we see a similar divergence of returns. Industrial Metals rose 141%, Automobile Parts were up 89%, Forestry and Paper 86% and Banks rose 83% – helped by Barclays which rose 272%. The worst performing sectors, although still in positive territory, were Tobacco up just 1.5%, Aero & Defence 3.8% and Fixed Line Telecoms up 5.5%.

An active manager, particularly one with an unconstrained approach, could have successfully navigated these highs and lows.

Furthermore, when you consider that 67% of the revenue of FTSE 100 companies is derived from overseas operations, it is clear that an active manager with access to global company-level research capabilities, has the potential to add significant value to a fund.

By definition, an index-tracking fund is obliged to buy every stock in the index it follows. It will buy the good, the bad and the ugly – a disastrous approach during a period when a particular sector or industry falls out of favour such as during the financial crisis last year.

As an active investor you might have chosen to steer well clear of the banks in the eye of the storm or you might, on the contrary, have trawled for value in the sector when you thought the crisis was over. What you would have certainly not chosen to do was to own all the banks in the FTSE 100 because you had no choice.

The argument over active and passive investing isn't going away soon. The emergence of hybrid portfolio approaches such as a passive core with more active satellite funds or, conversely, an actively managed core with passive satellites in more exotic markets, will ensure that the debate continues. Anyone hoping that passive investing offers an easy solution is likely to be disappointed. Talent and natural ability vary in every profession, and active fund management is no exception – why should it be? But if you accept the middle ground, over the long term, you could be missing out on some exceptional active returns.

**Source: Datastream and Bloomberg 03.03.09 - 11.03.09, FTSE All Share Sectors*
**Source: Revenue Figures for FTSE 100 companies based upon research collated in 2008*

Source Fidelity International Global Watch – June 2009

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Please remember that past performance is not necessarily a guide to future returns.
The value of units and the income from them may fall, as well as rise. Investors may not get back the amount originally invested

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