WhatInvestment

Have your cake and eat it

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ACTIVE VS PASSIVE

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By combining trackers in generalist sectors with more specialist active funds, pragmatic investors can benefit from a 'best of both' approach

One debate in fund management circles never seems to end: whether an active or passive approach is best.

Many industry professionals are staunch advocates of active investing, claiming a selective approach leads to better risk-adjusted returns. They also make the point that passive strategies are effectively getting a 'free ride' on markets.

Price discovery is achieved through the research of active investors, while passive investors simply buy the market paying no heed to valuation or prospects.

Meanwhile, passive enthusiasts point to the high failure rate of active strategies, and urge investors to maximise returns by minimising costs, which is easy to do with inexpensive tracker funds.

Rob Morgan
Pensions and investment analyst, Charles Stanley Direct

Best of both worlds

My own view is nuanced. I believe there is a place for both types of investment in portfolios and there is no need to wed yourself to one approach or the other.

Passives should generally be considered the default option in the absence of a genuinely strong reason to use an active fund. Trackers represent a particularly good strategy for areas where managers consistently struggle to beat the index – often large, well-researched markets such as the US sector. Here, investors will have done well in recent years simply to buy an S&P 500 tracker.

It is worth noting the inexorable rise of a cluster of large tech and e-commerce businesses has overwhelmingly driven the US market, and should these have a tougher time then a standard passive fund could struggle.

However, in recognition that it's difficult for an active manager to consistently have an edge over Wall Street, passive funds remain a strong option for this market.

Stock markets don't have the monopoly on investment opportunities

Yet in an area such as UK smaller companies I would hesitate to take a passive route.

Over the past decade, the average fund in the Investment Association UK Smaller Companies sector has turned £1,000 into £3,685, whereas hugging the widely used benchmark index, the Numis Smaller Companies ex Investment Companies, would have resulted in £3,066.

Why is this? Quite simply it's the inefficiency of the market. Relatively little proprietary research is taking place compared with the multitude of analysts poring over US behemoths. Fund managers getting under the bonnet of these businesses are more likely to discover anomalies and opportunities missed by others.

Uncovering stocks or areas the wider market doesn't fully appreciate is where active management works best and cost, though important, may be a secondary consideration. Often more pivotal to returns is the expertise of the manager and their team.

Beyond frontiers

At Charles Stanley our managers building portfolios can cherry-pick active or passive strategies for particular needs.

Presently, portfolios are positioned about 60/40 passive to active, but this ratio changes over time. If they think there are more inefficiencies for active managers to exploit, they allocate more towards active.

We are currently investing in active funds in Asian and emerging markets where we believe there is more opportunity for active managers to add value, whereas in developed markets we are more biased towards low-cost passive funds outside some more thematic strategies.

Private investors populating their own portfolios can take a similar approach.

There are also investment frontiers beyond the reach of passives that are well worth considering for diversification. For instance, illiquid areas such as physical property and infrastructure can be accessed through specialist investment trusts.

The 'closed-ended' structure of an investment trust is often most appropriate for accessing esoteric asset classes, and the only credible option when liquidity is a problem.

Genuinely diverse

Private equity is also a major area where active management is largely the only route, and in my view this could be an Achilles' heel of passive-only portfolios.

Stock markets don't have the monopoly on investment opportunities. Some of the fastest-growing companies and investments with exciting potential are in the hands of private holders, often founders and early investors in the case of relatively new companies.

Private equity investment trusts buy into unlisted companies and other areas that would otherwise be very difficult to access.

Although it can be higher-risk, its potentially a source of decent returns as sometimes the growth a company enjoys is strongest in its pre-stock market life – if it ever lists on a market at all.

There are also some broader trusts that include an element of private equity in their portfolios, including Scottish Mortgage, an adventurous global growth trust, and RIT Capital Partners, a more diversified multi-asset trust.

By combining passive funds in more generalist areas with specialist active funds, pragmatic investors can take a 'best of both' approach. This should result in diversified portfolios that maximise opportunity as well as control cost.

There is no need to wed yourself to one side of the active versus passive debate.