Lync Wealth Management

A guide to active and passive investment approaches

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Introduction

The terms active and passive, used in relation to collective funds such as unit trusts or OEICs, describe the manager's approach to selecting the investments that make up a particular fund.

An active manager will select investments based on their opinion of the prospects for the shares of particular companies. They might consider the management of a company, the sector that it's in, the impact of the economy on the company's prospects, the political backdrop, etc. Their objective is to outperform a given benchmark, such as, for example, the FTSE 100, through their skill at identifying investments that will deliver this.

A passive approach to fund management, however, will simply replicate the make-up of a given index. So, in the case of a FTSE 100 based passive fund, you might expect to see all 100 company shares that make up that index in your fund.

In contrast to the active manager, the passive fund will only aim to deliver the return of that index, minus fees, not to outperform it. In addition, whilst active funds are generally bought and sold via the fund manager, passive funds may either be bought and sold in that way, or else traded on a stock exchange. With the first method, such passive funds are called Trackers and with the second method, they are known generally as Exchange Traded Funds (ETFs).

As a general rule of thumb, active managers charge more for their services, as they need to employ many resources in order to deliver their objective of outperforming a given index. In contrast, all passive managers need to do is replicate the constituents of a given index in the most efficient way as possible. This means that passive funds are often significantly cheaper than their active counterparts.

Why the difference in this approach?

It is widely accepted that relatively few active managers have been able to outperform the market over the longer term and equally as few of those can do so on a consistent basis. Evidence suggests that the higher costs associated with active funds tend to be one of the main reasons for this.

The chart below demonstrates active fund performance consistency through the percentage of funds outperforming their benchmark over one, two and three years.

	1 Year	2 Years	3 Years
US Equity Funds	40%	20%	21%
European Equity Funds	17%	7%	10%
European Fixed Income	47%	51%	40%

Source: SPIVA, May 2024

Passive investors are often believers in the efficient market hypothesis, which suggests that, as all information about stocks is freely available to everyone, stocks are always correctly priced, so there is no point in trying to be selective i.e. active, because you can't beat the market.

However, there are active managers who do manage to outperform the market and can dispute this argument, pointing to factors that can make markets inefficient, such as lack of research in certain market sectors or behavioural biases that can cause prices to swing erratically (such as market crashes), which creates opportunities through mispricing.

It should be pointed out, that whilst the majority of active managers don't outperform, those that do in any given year, can outperform significantly.

Aside from cost and performance considerations, investors in passive Exchange Traded Funds (ETFs) will point to the fact that these types of funds can be traded in real time on an exchange, whereas unit trusts and OEICs only trade at a single point and price during the day.

Whilst real time trading might be useful for an investor who is actively buying and selling funds, the advantages of this feature do not really apply to most private investors, who tend to be long term in their outlook.

Indeed, certain ETFs can trade at a wide bid/offer spread (the difference between the buying and selling price) during certain times of the day, so investors who are unaware of this fact can suffer a reduction in return if they trade at the wrong time, or in a fund with a permanently widespread.

Active funds and market risk

A significant difference between active and passive funds is that active funds can reduce risk relative to their benchmark So, for example, if the manager has a negative view on the market, they may choose to hold a higher proportion of lower risk stocks or cash.

Passive funds cannot do this. Likewise, if an active manager is feeling confident about the market's prospects, they may increase the risk compared to their benchmark. Again, passive funds cannot do this.

In these circumstances, an investor would be advised to measure the success of an active fund on a risk adjusted performance basis, not just the return versus the index.

The changing nature of passive funds

Historically, active managers might have delivered success because they like to target stocks in a particular segment of the market. This segment might be based on the size of the company, which is called market capitalisation, or how the market currently views the stock, which is known as style e.g. value (cheap relative to the market).

These and other factors may be combined e.g. small capitalisation and value. This could have given them the edge over other fund managers. However, in recent years, managers of passive ETFs have worked with index providers to target these areas of 'style' and offer them at a lower cost, thus removing another advantage of an active approach.

Added to this, we have recently seen the introduction of a small number of active ETFs, but the range is currently quite limited in terms of the asset classes they cover.

The limitations of ETFS

If a fund is traded on an exchange, as it is with an ETF, the fund needs to be able to reflect the flows of money in and out of the fund on its portfolio i.e. be freely able to buy and sell the stocks in that portfolio.

Therefore, the underlying assets need to be liquid enough to reflect active buying and selling activity in the fund. As a result, there are certain asset classes which cannot be accessed through an ETF, which can be held by an active fund.

Physical property is a good example of this. If you imagine flows of £millions in and out on a minute-by-minute basis, it is impossible for a manger to buy and sell, say, entire office blocks with that frequency.

The case for combining strategies

The debate between active and passive management often overlooks the potential benefits of integrating both strategies within a single portfolio, but here's why a hybrid approach can be the ultimate solution.

By combining active and passive strategies, fund managers can diversify the sources of risk and return. Passive investments provide broad market exposure and stability, while active investments offer the potential for higher returns through strategic selection and timing.

A hybrid approach also provides greater flexibility in responding to market conditions. Active management can be utilised in sectors or asset classes where the manager has a competitive edge, while passive strategies can be employed in more efficient markets where active management is less likely to add value.

Furthermore, incorporating passive strategies can significantly reduce the overall expense ratio of a fund. This allows more capital to be allocated to active strategies where the potential for outperformance justifies the higher costs.

Utilising a blend of both strategies enables fund managers to optimise performance across different market cycles. Passive investments can serve as the core holdings, providing steady returns, while active investments can be used to capture alpha during periods of market dislocation.

Personal preference matters

Ultimately, whether to adopt a hybrid approach comes down to personal preference and financial goals. Some investors appreciate the simplicity and lower costs of an all-passive strategy, while others are drawn to the potential for outperformance through active management. A hybrid strategy can offer the best of both worlds, but it requires careful consideration of costs, complexity, and individual comfort with risk.

Investors should assess their risk tolerance, investment objectives, and willingness to pay for potential outperformance before deciding on the right mix of active and passive investments. Seeking advice from a financial professional can also help in making an informed decision that aligns with your long-term goals.

Investments carry risk. The value of your investments (and income from them) can go down as well as up, and you may get back less than you invested. Past performance is not a reliable indicator of future results. Investments should be considered over the longer term and should fit in with your overall attitude to risk and financial circumstances.

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