BreedElliott

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Active and Passive Fund Management

As investors, we can choose from two main strategies to generate returns from our portfolio: active and passive fund management.

In general, active management aims to outperform the market over time, compared to a specific benchmark, while passive management mirrors the investment holdings of an index and its performance. However, with around 4,000 actively managed funds and 150 passive funds listed by the Investment Association, it can be tricky to choose which is right for our portfolio. We might decide to consider investing in both types of fund as a way of diversifying our portfolio.

In this newsletter, we explain the main differences between active and passive fund management with the aim of helping you to understand which is best and right for you.

How they are managed

When we invest in either an actively managed or a passively managed fund, our money is pooled with that of other investors across a range of investments.

For both investment strategies, there is a fund manager but it is the role of the fund manager which differentiates active from passive fund management.

With an actively managed fund, the fund manager actively chooses what the fund invests in. The manager aims to make investments which deliver returns that beat the fund's particular benchmark, with a team of researchers and analysts to support them in achieving this aim.

By contrast, passively managed funds (often called 'trackers') aim to deliver a return that is in line with a benchmark, mirroring the movements of the particular index they are tracking.

For example, among the most popular type of passive funds are those that track the FTSE 100 index of Britain's largest 100 companies, or the FTSE 250, tracking the next 250 largest firms.

Passive funds may also be stock market listed exchange traded funds (ETFs), as well as Unit Trusts and open ended investment companies (OEICs).

Underlying investments

Passive funds will aim to invest as closely as possible in the underlying assets of the index they are mirroring or tracking.

For example, a fund tracking the FTSE 250 will ideally buy shares in all the companies listed on the FTSE 250 Index in the same proportion as their market value and, in this way, the fund's performance moves more or less exactly in line with the Index.

However, many passively managed funds will choose to invest in a sample of the companies listed on the chosen Index, with the aim of mirroring the performance of the Index as closely as possible.

The difference between the performance of the Index and the performance of the passive fund which is tracking the Index is often referred to as 'tracking error' which is always there as a result of the fund charges and sometimes there if the fund does not exactly mirror the assets held in the Index.

Some sectors, such as commercial property, for example simply cannot be mirrored by a simple tracker fund as they buy commercial properties and pay returns based on rental income and capital value increases. If an investor wants to put money into an area of investment that is considered specialist, they will often have to choose an active fund.

Managers of active funds will select an Index to act as the fund's benchmark. For example, the manager of a UK equity fund may select the FTSE All Share Index as the fund's benchmark and their aim will then be to beat the benchmark's performance.

This fund manager can then choose which UK equities to hold within the fund, making careful decisions over which equities to buy and sell to generate the best returns.

As another example, an active fund investing in emerging markets could potentially invest in a vast universe of stocks that fall within this geographical region.

The costs involved

Investors will typically pay a higher annual fee for the expertise of an active fund manager, often amounting to between 0.6% and 1.5% per annum. However, the cost will depend on the particular fund they choose.

Some specialist funds may be more expensive than, for example, a UK equity fund. Whether it is worth paying these higher costs will depend on whether the fund manager outperforms its market benchmark; the higher charges will tend to reduce the net return more than the passive manager's lower charges.

Lower charges are one of the major reasons why people choose passive funds over active funds. Charges can be as low as 0.1% per annum and still provide access to the world's largest financial markets.

As passive funds are operated automatically, rather than relying on the expertise of a fund manager, their running costs are low. Over time the impact of charges can have a significant effect on investor returns, so they are a key factor when deciding which fund to choose.

Their goals

An active fund manager will aim to outperform a particular benchmark, whereas a passive fund typically aims to match the performance of its benchmark.

It is impossible to predict exactly the way that a particular fund may perform, whether it is passive or active. The performance of the market depends on a wide range of factors, including political and economic conditions, inflation, deflation, and issues that may particularly impact specific companies and sectors. Whilst an active fund's objective is to outperform a benchmark it may not achieve that aim, performing less well and may experience greater losses or smaller gains.

While the aims of passive and active funds are different, both may produce returns or losses for investors. Active funds may fail to beat their particular market, with the underlying investments not performing as hoped. In this case, passive funds may deliver higher returns, but remember that if the index receives a shock and falls, so will your investment.

Some people claim that passive investments cannot protect investors from periods of volatility, unlike active investment where a manager can keep a close eye on wider economic conditions and tailor a portfolio to weather a potential storm.

However, it is also argued that the majority of active fund managers fail to consistently beat their benchmark Index over the longer term.

Whichever approach you choose, remember that past performance is not a reliable indicator of future performance, and the fortunes of any passive or active fund may change direction.

What might be right for you?

The right investment choice for you will depend on a number of factors, including your investment goals and risk tolerance, and whether you are confident the active manager can beat a benchmark and make the higher charges worthwhile.

Given that developed markets such as the US and the UK are so widely researched, it can be particularly difficult for managers to spot opportunities that others have missed, so you might consider that opting for a passive fund may make more sense in this case.

In comparison, regions that are considered greater risk and are subject to less analysis, such as emerging markets, may benefit from the expertise of a fund manager. Markets such as these are typically less efficient, and the specialist knowledge and experience of a fund manager could potentially produce greater returns by tracking down the best assets, although there are no guarantees.

Other examples of more specialised areas of investment that may possibly benefit from an active approach include smaller companies and commodities.

Whichever option you choose, or whether you decide to invest in both active and passive funds, you have to accept that your investments can still fall in value as well as rise and you might get back less than you invest.

If you would like to review the investment strategy you are currently adopting, please raise this with your Breed Elliott financial planner at your next review meeting.

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Market	Value at the start of 2018	Current situation	Comments
Interest Rates (BOE base rate)	0.25%	0.75% at 30.11.18	The official bank rate is 0.75%
House Prices (Nationwide)	House prices increased by 2.6% in 2017	House prices up by 1.9% at 30.11.18	UK annual house prices up 0.3% month-on-month
UK Share Prices (FTSE 100)	7142.83	7038.95 at the close on 30.11.18	The FTSE 100 has fallen by 89 points since the beginning of last month

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Registered Office:
1 Linfield Copse, Thakeham, Pulborough, West Sussex, RH20 3EU

Visit our website: www.breedelliott.co.uk