Active v passive investing

Neither's better, and here's why, argues **Craig Palfrey**, a financial planner at Penguin Wealth, Cardiff

The IFA Magazine soapbox feature invites individuals who have a strong opinion on a particular topic which is relevant to the world of financial advice, to air their views.

Before we get down to some detail, let's just take a step back and clarify what it is that I'll be talking about here.

Looking at Wikipedia, I find the following definition: "Active management (also called active investing) refers to a portfolio management strategy where the manager makes specific investments with the goal of outperforming an investment benchmark index. In passive management (or passive investing), investors expect a return that closely replicates the investment weighting and returns of a benchmark index and will often invest in an index fund."

The ongoing debate about whether active or passive investing is the best approach is one of the most misguided within the investment world. That's because, in my view, the debate itself is based on a completely false premise and the fanatics on either side need to wise up. The fact that there is even a debate on this topic at all is a bit like the magician tricking you by deceiving you into seeing what he wants you to see for the purposes of his trick.

Does passive mean passive?

Firstly, and just to position this, the whole passive argument is completely undermined straight away because the word 'passive' is a misnomer in this context.

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Any adviser proposing a passive investment approach, or any investor following such an approach, is not acting 'passively'. The decisions being taken – at outset and all the way through the period of investment – are, in so many ways 'active'.

As advisers, we have to make active decisions about matters such as which assets to use, which markets we may wish to track. If, for example, an adviser decides to put some of a client's invested monies into the UK Equity market, decisions still needs to be taken around what proportion of the portfolio (as a percentage of the overall portfolio), what product to recommend, which extends to whether we use an All Share, FTSE 100 or FTSE 250 tracker, or an OEIC, an investment trust or ETF. Then, as time goes on and the portfolio builds, we need to review whether to keep the same percentage originally invested into those assets, and decide when to switch and rebalance, if at all.

All in all, investing in passive funds still requires a lot of active decisions to be made.

What passive investing really means is index tracking. Using market tracking funds instead of active funds. So the debate terminology needs to be "active or tracking?"

The "average" return

This leads to my second point; one which can sometimes take a little time to get one's head around.

The average return of all active funds in a market is exactly the same as the average return of all tracking funds in that market, all other things being equal (which they are not, but more of this in a moment).

So the two alternative methods revert back to the same average return?

Take the market in UK shares for example; the active funds, totalled up, make up a large proportion of the total market. Therefore the market index, say the All Share index, is a factor of this total. The performance is therefore averaged to produce the index performance. This average is the average of the active investments in that sector. Trackers follow this average.

The above is ever so slightly over-simplified, but academic research shows this to be the broad case in virtually all markets, all of the time.

On the average point, ignoring costs, tracker funds do not out-perform active funds, but this is just as true the other way round. Neither one is better than the other. However that assumes all other things are equal but, of course, they are not.

The impact of charges

One thing we can say for sure is that tracker funds tend to be cheaper than actively managed funds. This cost differential does produce a swing in favour of trackers. Let's assume the gross return (before costs are factored in) from the UK stock market index will be 5% per year in a particular period.

A typical tracker fund might charge, say, 0.5% per year, whereas a typical active fund is higher at say, 1.5% per year. Let us assume these are the average costs, across the sector. Now the comparison swings, because the average tracker returns 4.5% net per year, the average active fund 3.5% per year.

In this simple example, that means tracking wins. But, does it? If you work on the basis

that you will only ever get an average return from an active fund, then, yes, you should use trackers. Full stop.

However, if by using a solid due diligence process, you can find active funds which have performed better than the average (and there are some which have track records over long periods which suggest this may be feasible), in theory you can swing the balance back in the other direction.

The debate is really, ultimately, this: neither approach is a better way of investing; what needs to be determined is whether we, as advisers, can find active funds which are consistently better than 'average' – and will continue to be better by enough to wipe out and pay off the cost difference?

At Penguin, we think the answer to this question is 'yes' this can be done. But care needs to be taken. This is why we prefer to look in some detail at investors' own positions, discuss their views and then create a fund portfolio accordingly around those. Sometimes that means using trackers, sometimes using active funds, sometimes both.

We take the difficult quest very seriously, when we advise on the inclusion of active funds in client portfolios, to try and identify the long term winners. But the results of the fund strategy that we advocate and use prove that with diligence and effort this can be achieved.

Asset allocation

There is one more thing which ultimately trumps (sorry to use that word!) everything else above, something which I believe all of us as advisers need to remember. It is asset allocation, not fund selection, which is the most relevant factor in determining optimum portfolio returns.

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The decisions we make on how to allocate a portfolio into different asset areas will be something like 70% relevant to the outcome. So, whichever funds are selected, whether active or trackers, will be much less significant than the asset allocation strategy that is pursued.

On that basis, the time that we spend arguing whether active funds are better or worse than index funds, is to a large extent wasted. This is because as advisers we should be focusing mainly on the asset allocation strategy we use within our clients' portfolios, and that's taking a long term view, which includes when and how to rebalance.

Anything one can do to improve results by pursuing a better overall strategy is going to make a lot more difference to clients' portfolios, than the marginal differences achieved by decisions around an active or tracking approach.

I believe therefore that the debate about active or passive is superfluous or a distraction; don't be deceived by where "the magician wants you to look" and be careful of getting sucked into one camp or the other. Neither is right, neither is wrong. An adviser's job, and the effective impact we make on our clients' position, will be determined by broader aspects than this.

The opinions expressed in this article are the views of the author

About Craig Palfrey

Craig is a Certified Financial Planner, Chartered Wealth Manager and founder of Penguin Wealth, a financial planning business based in Cardiff. He began his financial services career back in 2000 and considers himself extremely fortunate that he's found his vocation in financial planning. Craig really enjoys presenting at seminars as he is passionate about sharing his knowledge with people who need it. This is evidenced further by Craig authoring a book that will be featured on Amazon upon its release. On a personal note, Craig has always lived in Cardiff and considers himself lucky to be blessed with 2 children and 3 step children. He loves playing and reading with his little ones and sharing as much time as he can with his family.