ACTIVE VS PASSIVE INVESTING

WHICH IS BETTER?

The debate about which is better – active or passive funds – has been raging for years among investment professionals.

Actively managed funds are still the most popular overall, but tracker funds have been steadily eating into the market share - and investors often favour passive investing for new investments.

The latest data shows that in the UK, investors poured £991 million into tracker funds during September alone, taking their overall share of industry funds under management to 22%[1].

Meanwhile, investors withdrew £2 billion from active funds in the first nine months of the year[2].

Both active and passive strategies have their strengths and weaknesses:

ACTIVE FUNDS

As a reminder, active funds are run by fund managers and their research teams, who dedicate their time to analysing companies they wish to invest in and, crucially, deciding on when to buy them.

They must understand the inner workings of a company and not just what the accounts show. It's also essential for them to constantly monitor the companies, economies, and markets they already invest in.

An increasingly significant part of a fund manager's job is engagement with companies about their social and environmental challenges.

PROS AND CONS OF ACTIVE FUNDS

Pros

- You get the opportunity to outperform the market – that's the fund's objective.
- They offer flexibility to invest more freely than their passive counterparts as they're not tied to an index.
- Active managers can minimise potential losses by avoiding specific sectors or regions with extra risk.
- Active fund management will appeal to those keen to use their money to encourage change in the world for the better because managers can use their clout as large shareholders to drive change.

Cons

- There is a risk of underperformance as the fund's success depends on the skill of the manager and analysts.
- Investors pay higher costs to cover the expertise and resources required for active fund management.

PASSIVE FUNDS

Passive or tracker funds generally invest in all the same stocks as an index – a basket of shares or bonds like the FTSE 100 or the S&P 500.

They are typically cheap to run because the investment process is completely automated using algorithms - there is no expertise to pay for.

Tracker funds are different, offering the chance to invest in various global markets and sectors. Some will buy shares in all the companies that make up a particular index, while others will track an index by buying a cross-section of companies.

For those who want their money to back companies with a solid approach to environmental, social and governance (ESG) issues, some funds track ethical indices such as the MSCI Global Environment Index.

Another type of passive fund is an exchange-traded fund (ETF), which tracks many other investing areas and major markets like the FTSE100 and major US indices. You will find many that track niche industry benchmarks and let you invest in all kinds of specialist areas. ETFs are listed on a stock market, allowing investors to buy and sell at any time, unlike a tracker fund, which is priced and dealt once a day.

PROS AND CONS OF PASSIVE FUNDS

Pros

- You know what you're getting with a passive fund – it's going to track the market, which means it reduces the risk that a portfolio manager makes the wrong call.
- The fees are ultra-low - the cheapest UK tracker fund costs just 0.05%, so you keep more of the returns.
- When you want quick and easy exposure to an efficient market, it can make sense to do this through a low-cost index tracking passive investment.
- Passive funds have proved popular in finding cross-market exposure when making a tactical call is tough.

Cons

- There's no chance of outperformance - you get the market return rather than aiming to beat it.
- These funds capture the performance of all the stocks in an index - good and bad. They cannot reallocate their portfolio to protect against potential losses.
- Passive funds can miss opportunities as there's no way to intervene, capitalise, or adapt to certain market conditions.
- There's no control over the individual holdings in the fund. If you dislike certain companies for moral or other personal reasons, you can do nothing.

THE VERDICT

There's no one-size-fits-all when it comes to investing. Active and passive funds have an important role in an investment portfolio.

A common strategy is to blend different elements of active and passive to get the best out of both worlds - the low costs offered by passives and the outperformance and risk management provided by a good active manager.

You can speak to your financial adviser about the right blend to help you reach your goals.

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[1]https://www.theia.org/news/press-releases/third-quarter-2023-closes-ps12-billion-net-inflows-despite-challenging

[2]https://ifamagazine.com/six-tips-for-building-a-passive-portfolio/