Summary
- Active investment involves higher charges and has not always produced higher returns.
- Passive funds track markets and work well in bull markets.
- When times are tough, an active, bottom-up approach can help improve performance.
- Fixed income can be passive or active too.
- Passive bond funds give a broad spread of access at low cost.
- Active bond funds can navigate the very complicated waters around the bond market.
- All investment – equity, fixed income, active or passive, involves an active decision-making process on the part of investors.

Active versus passive investment: Is there a clear winner?

The debate around active and passive investment continues within pension investment. Sandra Haurant finds out where the experts think the smart money should go

Every now and again research comes out that makes investors stop and think. In January, the *Financial Times* published the results of one such report: according to analysis carried out by CEM Benchmarking for the *FT*, active funds had only beaten the markets by 16 pence for every £100 invested.

The results naturally challenge received wisdom – if active managers cost more and don't make more money, then where is the value in using them? Indeed, the *FT* quoted CEM principal John Simmonds, saying: "A lot of value that is being created has been returned to the asset management industry rather than to the pension funds and their members."

It is a familiar argument. By and large, active fund managers charge more than passive funds because. Which, of course, makes sense: while passive funds follow a market benchmark, actively-managed funds employ teams of people who make, as the title suggests, active decisions about the investments that are held within their fund. But for pensions, as for all other investors, it is important to get what you pay for – and when performance on higher-fee funds is all but equivalent to those lower-cost passive funds, it becomes hard to justify the choice.

"In a world of low expected nominal returns, in theory the 'alpha' from active equity should be more valuable to pension schemes compared to earlier periods when equity market beta was expected to be higher," explains PiRho Investment Consulting's director Phil Irvine. "However, the reality is that 'alpha' from active equity investing in mainstream markets has been difficult to access in any consistent manner."

The place for passive

Indeed, there are certain areas in which passive investment delivers fairly consistently for pension investors, says Irvine, creating that necessary imbalance between charges and returns. "Within equities, investing in large, efficient markets such as mainstream US equities, which can be accessed very cheaply and are highly liquid, is highly suitable to pension schemes," he says.

Indeed, says JLT Employee Benefits senior investment consultant, Aniket Bhaduri, there is plenty of evidence to suggest that passive investment should and can deliver returns at a lower cost and therefore with greater efficiency than active funds: "There has been a lot of research and empirical evidence to suggest that developed equity markets are generally efficient in most cases. It is therefore difficult to add value through active management in these markets," he says. "This has been evidenced in the current bull market where tracker funds have provided robust returns, and often, higher than average actively-managed funds on a net of fee basis."

Nonetheless, there are, as ever, caveats. While Bhaduri agrees that this view holds up in so-called 'normal conditions', there are other matters to take into consideration, he argues: "For instance, we prefer active management in emerging markets as we see opportunities in country, sector and stock selection away from the traditional benchmark."

Indeed, the capacity that active managers have to zoom in on specific markets and sectors, and then to stock pick within that focused scope in response to whatever political or economic conditions are in the wider atmosphere is, arguably, what should give active investment an edge. And it is this that strengthens arguments in favour of an active approach.

A hands-on approach

For Cardano's senior investment strategist Tom Rivers, the current conditions point towards a renewed need for just the kind of bottom-up approach that active management can deliver: "Market conditions over the past five years or so have been characterised by ever-lower volatility and asset price reflation. During this period, passive investors have been able to harvest solid risk-adjusted returns, at low cost," he says. "We believe we are entering a phase of likely increased divergence between economies, asset classes and bottom-up corporate fundamentals; all of which can drive an increase in volatility. This provides an attractive landscape for active management."

What's more, while cost and underwhelming performance are often highlighted as weaknesses for active funds in today's landscape, there are other factors to take into account in passive investment. "It has been difficult to outperform indices in the current bull market," says Bhaduri. "However, exposure to passive funds can result in a different type of risk. As more and more allocation to passive funds are being made, it is driving up the prices of the benchmark components and hence may result in taking overvalued positions."

The bond question

And of course, equities are only part of the story. A similar debate is also taking place within the fixed income space, too. Passive fixed income funds are often seen as a way to gain access to this important sphere at relatively low costs. However, there are limitations to this strategy, argues Irvine: "One of the main purposes of investing in fixed income, for a pension scheme, is to match liabilities – but bond indices are by definition not tailored to the individual scheme," he says. What's more, Irvine adds: "For fixed income, generally, companies or countries that are doing poorly have more need to issue debt. As a result, the country weightings in global equity indices are very different to global bond indices."

For Payden & Rygel (London)'s managing principal Robin Creswell, the differences between equity and bond indices makes this a very different decision: "Bond indices can typically have 2,000 or more bonds in their composition, compared to 100 to 500 stocks in a typical stock index," he explains. "A petroleum company with one class of stock can have 100 bonds outstanding to its name." As such, a hands-on approach in expert understanding of the sector is crucial to navigating the waters of the bond market. "An active fixed income manager must weigh the value and characteristics of each of 100 bonds of an issuer versus the single analysis of the single share classes. Within an institution's guidelines, duration, maturity, credit quality, convexity, position in the capital structure must be weighed, and availability of bonds is also an issue when selecting."

For equities, it does appear that the markets, to an extent, dictate whether the time is right for active or passive funds. But in all cases, there are choices to be made. Selecting a manager – equity or fixed income, passive or active – will always involve a level of active engagement on the part of the investor. So how do you make the choice?

Creswell says: "Pension funds are best served identifying managers and manager style, expertise and process that most closely match their needs. Managers should be able to demonstrate best fit through an evidence-based due diligence process." What's more, he adds, needs can change and when that happens, so might relationships with managers. "It is our experience that an institution's requirements flex over time as liabilities, the environment, equity valuations, the interest rate environment and many other factors change. An active relationship reflects these changes to a client with opportunities to increase or decrease risk and portfolio sensitivity in line with need and appetite."

So while debate continues over the whether active or passive investment is the best fit for pension funds in today's economic environment, there is perhaps a wider and more philosophical matter to ponder. As Rivers points out: "Passive investing still requires you to make an active choice, for example on index and whether you want to take currency risk or not. These can lead to quite different outcomes." Which begs the question, is there really such a thing as passive investment?

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