Summary
- Passive funds – index funds or ETFs – follow the highs and lows of the markets. Over time, the highs tend to win out.
- With active investments, managers or management teams aim to outperform the markets by making investment decisions allowing them to avoid low points and capitalise on upturns.
- Passive strategies require fewer resources and are cheaper to run.
- Active strategies have higher costs, in general.
- A combination of active and passive strategies can be used to create a well-balanced portfolio for pension funds.

Active or passive investment – a role for both

While a long-running debate seeks to compare and contrast passive and active investment strategies, both have an important role to play. We take a look at how these strategies work, how performance can be gauged, and why there is space for both in pension scheme portfolios

Perhaps the prime example of a passive fund is an index fund, a portfolio designed and composed to mimic performance of a specific index – such as the FTSE 100 or S&P's 500. When the index rises, so does the portfolio's value. And of course, the same happens when it falls.

ETFs, created in the 1990s, frequently (but not always) track benchmarks, too. ETFs are effectively bundles of stocks that can be traded on the market in the same way that stocks and shares can be bought and sold. The value of ETFs can rise and fall all day, just like the price of a share, and, like shares, they can be traded at any time.

An ETF might follow a stock market index, specific bond market, commodities, specialist market, or almost anything else, for that matter. There are an awful lot of them – more than 8,000 different funds. And thanks to this simplicity, flexibility and diversity, the ETF market is huge, with around $10 trillion assets under management, up from $2 billion in 2002, according to analysts EPFR.

Passive positives

One of the key advantages that passive funds have is the simplicity of their structure. As Northern Trust Asset Management EMEA CEO, Marie Dzanis, says: "Passive strategies typically have greater transparency to fund holdings relative to active, meaning less complexity and monitoring required on the part of the pension fund manager."

Passive funds can also play a part when a pension fund needs to move out of one active fund and into another, Dzanis adds: "They can be implemented as tactical exposures to play market events or take a view, and can act as a transition vehicle to equitise cash and remain invested while due diligence is conducted on the desired end destination."

But the primary advantage is low costs. Morningstar associate director of passive strategies, manager research, Jose Garcia Zarate, says: "Given the long-term investment horizon on which pension funds work, and their need to carefully balance assets and liabilities, having a tight rein on ongoing expenses seems like a very good idea."

It's not surprising costs are lower; with no need for the stock-picking, research and analysis resources required for actively managed funds, fees can be kept to a minimum. What's more, says Zarate: "The issue of costs is also relevant when considering turnover, which is typically low for many passive funds." After all, they tend to 'buy and hold' stocks in a given index.

Going down

Dzanis says: "With exposure to market downturns, passives will fully participate in line with the index, meaning pension funds may have to engage in complimentary asset allocation or other risk management techniques and strategies to quickly adapt to changing market conditions or capitalise on opportunities." Active investment strategies, on the other hand, aim to produce better outcomes. Here, a manager, or a management team, works to manage investments so that the fund can beat its benchmark.

Cardano client portfolio manager, Nigel Sillis, says: "Active strategies are generally more expensive to implement than passive strategies, so it is important to be sure that you are getting what you are paying for." But, he argues: "Properly selected and structured active strategies can enhance portfolio diversification and improve portfolio risk/reward."

When selecting active strategies, says Sillis: "We look for return attributes that are differentiated, have a high tracking error and that cannot be produced by the market; a manager with an identifiable edge, a repeatable process and, where the manager's interests are strongly aligned with those of investors; and funds where the area of investment focus is sustainable, associated with inefficient market segments and exploits long-lasting thematic opportunities."

Market-beating managers

"The allure of alpha, compelling story and a star manager could be why active strategies can appear as attractive," says Dzanis, who adds. "The flexibility of active strategies potentially offers better management of interest rate risks and credit risks, which appeals to pension fund managers."

And there are certain asset classes that, traditionally, have been considered better suited to an active approach. "Compared to equity, fixed income is a more complex asset class," says Zarate. "Multiple pricing sources, and liquidity streams, and so on – all these make bonds a trickier asset class to understand, and this is why it is routinely highlighted as the asset class where active managers may have an edge."

But fund performance does not always bear this out, he says. Morningstar produces a semi-annual 'Passive/Active Barometer' which monitors and compares the performance of funds, effectively focussing on whether active managers are succeeding in beating passive strategies. "Technology and the wider availability of information is bringing a lot of light into the bond market," says Zarate. "The results of the active/passive barometer do not scream in favour of active bond managers, although as is the case for equity, there are some bond market exposures where they may still have an edge."

Active involvement

Some active funds place emphasis not just on the returns, but on the long-term effects for the companies on the receiving end of that investment. Baillie Gifford investment manager, Marina Record, says: "The emphasis that we have on the long term is important to the companies that we back. It frames their ambitions. It changes their notion of risk. The ability to plan over the long term empowers companies to go after the hardest problems and reduce risk by investing in teams, technology and science. This increases their chances of success and builds resilience to setbacks. Crucially, it also increases the scale of the opportunity and with it, the chances of becoming one of those rare and valuable companies that generate extraordinary, outlier returns."

Winning formulas?

Passive and active funds diverge in terms of fundamental strategies and costs, but how far do their returns differ? Do active managers manager to beat the markets? The Morningstar global equity index and global bond index both declined by 17 per cent during the 2022 calendar year. However, according to Morningstar's barometer, only 29 per cent of active equity manager survived and outperformed their passive equivalents in 2022.

Indeed, says Zarate: "For some market exposures, the case in favour of passive management is overwhelming and it makes little sense to try to find active managers who may beat the market, particularly over long periods."

In the balance

While it might be possible to compare the fortunes of active and passive strategies in a general sense, it's not always useful to attempt to draw clear conclusions – after all, not all asset classes require the same treatment. Sillis says: "There are large parts of the fixed income universe that are not suitable for active strategies (e.g. global government bonds, investment grade credit). Conversely, emerging markets, high-yield credit and loans offer more potential," he says. "Inappropriate use of active strategies in asset classes to which they are not well suited can have adverse cost/benefit effects."

Pitting active and passive against one another in a direct way has limited benefits, says Sillis. "For a pension fund, active and passive strategies can be complementary. They can be implemented alongside each other in a fund's portfolio."

Indeed, says Columbia Threadneedle Investments head of pensions and investment education, Chris Wagstaff: "The long running active versus passive debate has been poorly framed, with the two approaches to asset management having been incorrectly treated as being mutually exclusive." Instead, he says, we need "a focus on the ability to sustainably generate net value added; delivering sustained outperformance after fees and meeting desired investment outcomes is how the active/passive debate should be positioned".

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