ACTIVE V PASSIVE INVESTMENT MANAGEMENT

Introduction

The debate about the relative merits of Active versus Passive Investment Management is ongoing and widely reported in the financial press. The argument for Passive Management is that a tracker fund will, as the name indicates track a sector up and down. Because the fund is not actively managed, the charges are lower. The Active Investment Manager will seek to justify higher charges claiming they add value.

At Forrester-Hyde Ltd we do not see conflict but instead see the two methods complementing each other and both are incorporated in the portfolios that we design, install and manage for our investment clients. The Passive Fund is the blunt instrument delivering a core strategy at a lower charge, complemented by Actively Managed Funds, which focus on specific markets and investment strategies. The additional level of expertise required warrants a higher charge, but there is a place for both strategies in a diversified portfolio.

Looking at each in turn.

- **Active Fund Management**

Active Fund managers believe there is a degree of market inefficiency and a combination of experience, in depth research and skill will enable them out-perform both the benchmark and their rivals. Out-performance is achieved by a combination of stock selection, sector weighting and market timing.

Advantages

- The best Active Funds have out-performed the market index hugely over the long term.
- Active Funds are not tied to the stock or sector weightings of an index.
- An Active Investor can choose from many management styles and strategies to best suit their investment goals and attitude to risk.
- Active managers can take a broader perspective when investing looking at key trends that may affect companies' prospects.
- They are able to target specific aims such as income, growth or fundamental value.
- Can react quickly to specific company risk.
- Some managers have demonstrated they have a repeatable process that will seek out strong Companies and preserve value for unit holders compared to market benchmark.
- These funds do not have to subscribe strictly to a mandate and have the ability to change strategy in variable market conditions.
- The Fixed Income sector is more sensitive to economic change and pricing can be more subjective.
- Over ten years approximately 57% of Active Fund managers in the UK All Companies Sector produced total returns in excess of the FTSE100 Index and over three years 76%.

Disadvantages

- Actively managed funds attract higher Annual Management Charges.
- They may also incur higher transactional costs as the manager is likely to make more trades than a Passive Fund manager.
- Research demonstrates that developed Equity markets are highly efficient and difficult to out-perform in the short term. For an active strategy to work the manager must consistently beat the benchmark. Over one year only 39% of Active Fund managers in the UK All Companies sector produced total returns in excess of the FTSE100 Index.

ACTIVE V PASSIVE INVESTMENT MANAGEMENT

- **Passive Fund Management**

The manager of a Passive Fund subscribes to the theory that markets are efficient, which is to say that all information is available to all participants and is priced in accordingly. Passive or "index" investing is a strategy that aims simply to match the returns from the stock market, as measured by an index such as the FTSE 100. The Passive manager does not, therefore, seek to gain an advantage by actively selecting mis-priced stock, nor do they seek to time the market. Perhaps the main attraction of Passive Funds is that charges tend to be lower. The measure of success is how closely they track their target index.

Advantages

- Lower charges, the total expense ratio of Passive funds can be as low as 0.09%.
- Timing risks will not affect performance and Passive funds are unlikely to under-perform the market index by a significant margin.
- You know what stocks will be in your fund.
- Performance will not be disrupted by a change in management.

Disadvantages

- You are restricted to investing in a near replication of a market index and hence only have potential to earn the average rate of return.
- There is little or no potential for a Passive Fund to out-perform the market.
- Lack of diversification can have a negative impact. For example, in April 2008 40% of the FTSE 100 comprised just two sectors, Oils and Financials. If either sector performed badly this would have had a negative impact on the Fund.
- A Passive Fund manager is required to rebalance in line with the index and maybe forced to sell shares which may be at their cheapest when dropping out of the index and buy shares at their most expensive when they are admitted to the index.
- In practise not all markets are efficient and efficiency will vary at different times.

Summary

At Forrester-Hyde Limited we follow a four step approach to advising, installing and maintaining an actively managed portfolio for our investors, see:-

http://www.forrester-hyde.co.uk/mm_uploads/GUIDE_TO_MAKING_INVESTMENT_DECISIONS1.pdf

Our fee model is designed to treat our customers fairly and is entirely transparent and investments are purchased on wholesale terms. Further, we register investment on an electronic back office platform to facilitate online trading which reduces time out the market and speeds transactions. We design, install and maintain portfolios to match an investor's appetite for risk and volatility.

Our portfolios include Passive Funds where appropriate and these serve to lower the average Annual Management Charge. We see a clear advantage for choosing Actively Managed Funds when investing in markets that are not efficient, such as Emerging Economies, Smaller Companies and in Fixed Interest Securities. These are markets with lower transparency and experience is needed to navigate the pitfalls, however, there is opportunity for specialists with market knowledge to secure returns above the benchmark.

In conclusion, we believe that Active and Passively Managed Funds complement each other and there is a place for both in a diversified portfolio. Forrester-Hyde Limited Investment Committee meets at least monthly and more frequently when circumstance dictates. The group is chaired by Rob Marek, Investment Director and the Committee embrace both Active and Passively Managed Funds, believing there is a place for both strategies in the portfolios we maintain for our clients.