Active and passive investment

Understanding the differences between active and passive investment funds.

If you're thinking of incorporating unit trusts or open-ended investment companies (OEICs) into your investment strategy, a key decision you will need to make is whether you opt for **active management funds, passive management funds** or both.

These two funds both carry financial risks and benefits, depending on the underlying assets and the investment strategy.

This guide will provide an in-depth examination of active and passive funds, and offer advice on how to incorporate investment funds into your portfolio.

Active fund management

Active investment funds are administered by the companies managing the fund. The manager in control of the fund will act on behalf of its investors and use their expertise to buy and sell different assets. They are responsible for analysing the market and researching listed companies.

The main objective of an actively-managed fund is to outperform an investment benchmark index. This means delivering higher returns during positive market conditions and mitigating capital losses during market downturns.

To achieve this, fund managers will buy assets (such as equities and bonds) which they believe will be profitable and sell assets they believe may lose value in the future. Investing into an active fund therefore has the potential to limit the risks if managed properly.

Advantages

Returns: Active funds can generate higher returns than passives, which are commonly referred to as trackers. Continuously selling underperforming assets and buying potentially profitable assets increases the chances of the fund outperforming the market.

Protection: Active fund managers attempt to anticipate future losses on assets held by the fund and will sell if necessary. They can also reduce the fund's risk by avoiding certain asset classes, countries and sectors.

Expertise: Fund managers use their financial expertise to decide which companies may generate good returns. The better the manager, the more likely you will earn a high return.

Disadvantages

Cost: The costs associated with active fund investment can be high. Firstly, active funds pay more in tax and transaction fees due to frequently buying and selling assets. Secondly, active fund managers will charge for the time and expertise needed to conduct research.

Risk: It is implausible to expect fund managers to always make the right call. Sometimes managers will buy securities that do not perform as expected; either producing a low return or making a loss.

Are active funds still popular?

Since the turn of the millennium there has been a substantial increase in demand for low-cost passive investment funds and a dip in the popularity of active funds. This has happened for two reasons.

Firstly, many active funds have underperformed during recent years. In fact, the average return over the past seven years has been only 7%.

Secondly, the cost of investing into an active fund far exceeds that of a passive fund. Active fund investors face higher annual management charges, trading fees and ongoing charges. The high cost of investing into active funds coupled with their lacklustre performance explains

Active and passive investment

the rapidly rising popularity of passive funds, despite their typically lower rates of return.

It remains possible to make a healthy return by investing in active funds. However, it is important to find a good fund manager; a tricky task in itself due to the large numbers of active funds on the market.

Passive fund management

A passive investment fund tracks the movement of a specific index or stock market.

The fund's value will rise when the market performs well and fall when it performs badly, hence why passive funds are referred to as 'trackers'.

Passive funds will either purchase shares from all companies listed on a particular index or buy a majority that reflects the index's overall performance.

Buying all assets on an index is known as 'full replication' and allows the fund to mirror the market's movements precisely.

Alternatively, 'partial replication' is done when the fund is unable to purchase all the shares on the index. The manager will then buy a majority sample of shares, carefully selected so they can still accurately track the direction of the market.

Advantages

Cost: Passive funds generally charge investors less than active funds. They do not require the fund manager to continuously trade securities and conduct market research and analysis, and thus have lower operating costs.

Diversity: Trackers are a useful way to diversify your portfolio. Both full and partial index replication will mean your exposure to risk is effectively spread.

Simplicity: Passive investors only need to monitor the moves of the market. Returns on your investment are therefore not subject to a fund manager's trading decisions, and thus you will not need to keep tabs on the performance of the individual stocks and shares.

Disadvantages

Risk: Although trackers can help you to spread risk, you will be exposed to movements in the overall market. Should the market experience a downturn, you are more likely to lose money in a passive fund compared to active funds that purchase targeted assets.

Returns: Passive funds are unlikely to generate higher returns than active funds. Because they track the movements of a specific index, it is extremely rare to find a tracker fund that outperforms its benchmark.

Flexibility: Passive fund managers cannot sell shares and bonds that are performing badly as the fund is committed to replicate a particular index.

Exchange-traded funds

Exchange-traded funds (ETFs) operate in a similar way to standard tracker funds, but are instead bought and sold on a stock exchange in a similar way to shares.

Annual charges on ETFs are usually cheaper than those charged on a standard passive fund. However, additional trading fees will be charged whenever you buy and sell ETF shares.

Fund investment: three tips

Always do your research

Effective research to limit the risks involved requires conducting due diligence on the fund manager before you invest your money. Pay particular attention to their track record in different investments and in different market conditions.

Check the costs

Before investing, make absolutely sure of the amount you'll be paying. Funds have an ongoing charges figure, which is usually set annually and will be outlined in your key investor investment document.

Understand the risks

All investments carry a degree of risk, and how much risk you're willing to take will play a key part in choosing which funds to invest in. Funds that invest in blue chip stock and government bonds usually carry the least amount of risk, while funds that buy corporate bonds or shares issued by smaller businesses will be riskier.

Contact us to discuss your savings and investments.

Important Notice

This document is solely for information purposes and nothing in this document is intended to constitute advice or a recommendation. You should not make any investment decisions based upon its content. The value of investments can fall as well as rise and you may not get back the amount you originally invested.

Whilst considerable care has been taken to ensure that the information contained within this document is accurate and up-to-date, no warranty is given as to the accuracy or completeness of any information.

Pavis Financial Management Limited is authorised and regulated by the Financial Conduct Authority. Financial Services Register No: 153871