

# Investment Tutor

## Active versus passive investment management

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**Does it pay trustees to adopt an active approach to equity management or should they take the line of least resistance to minimise the risk of underperformance and go passive? Chris Wagstaff, Head of Investment Training and Development at Aviva Investors, looks at both sides of the argument.**

The active versus passive debate has raged for the past 40 years and continues to be a topical subject for discussion amongst academics, market practitioners and trustees alike. A good place to start is with a definition of the two approaches and the philosophy that underpins each before moving onto their individual nuances.

Passive management, or index tracking, is constructing a portfolio of securities that replicates, or tracks, the performance of an equity index, such as the FTSE 100, on the premise that markets are price efficient. That is, prices continually reflect everything that is known or knowable about the market and, therefore, move randomly and independently of what has happened in the past. As, by definition, one cannot consistently outperform in a price efficient market, why devote time and effort to fruitlessly second guessing the market when you can simply track the market's performance?

By contrast, active management is conducted on the basis that markets are inefficiently priced and offer mispricing opportunities to be profitably exploited. It, therefore, seeks to outperform an index or benchmark by taking positions in stocks different from the composition of that index/benchmark.

Most index tracker funds are based on market capitalisation weighted indices, such as the FTSE 100 and S&P 500, where the largest stocks in the index by market value have the biggest influence on the index's value. The chosen index is usually tracked in one of two ways: by full replication or stratified sampling. Full replication requires that every index constituent is held as per its index weighting whilst stratified sampling, by far the most popular method owing to its lower cost, uses sophisticated statistical techniques to select a subset of index constituents to track the index as closely as possible.

On the plus side, index trackers minimise the risk of underperforming the index before fees and reduce the costs of investing by only transacting when necessary, such as when new money and dividend income is received, to meet investor redemptions and to accommodate periodic changes to the index being tracked. However, on the flip side, once fees, costs and a number of minor technical factors are taken into account, underperformance of the market often results and being fully invested in the chosen index



**By Chris Wagstaff**

Head of Investment Training and Development  
Aviva Investors

means trackers follow the market down as well as up. Moreover, trackers cannot meet all investor objectives and diversification is compromised by, for example, the top 10 stocks in the FTSE 100 accounting for about 50% of its market capitalisation.

Actively managed equity funds address most of these downsides by being positioned to meet stipulated investor objectives, capitalising upon market conditions and providing diversification in varying degrees. That said, they are plagued by poor performance, compounded by the greater costs and fees associated with running portfolios on an active basis. However, whilst active management as a whole is a negative sum game – there are more bad managers than good – sources of active management outperformance and performance persistency do exist.

Top of the list are those truly active managers who have the courage of their convictions to implement unconstrained active positions in those stocks they believe to be mispriced. These managers operate at the opposite end of the spectrum to the bane of the active management industry – the low conviction “index hugging” managers who persistently underperform. Then there are those active managers who, in running nimble small funds, have a distinct advantage over those managing larger more cumbersome funds, not least because the latter are constrained to holding mainly large, heavily researched and traded stocks that, by definition, are the most efficiently priced. Similarly, active managers operating in less well researched areas of world markets typically have a head start on those managing funds focused on more closely scrutinised market segments.

One big driver of active outperformance, however, remains investment style. Investment styles, such as value and growth investing, emerged as a result of evidence that particular groups of stocks sharing one or a number of common characteristics, or “style factors”, such as a high dividend yield, exhibit some meaningful tendency to move together and so experience long periods of out and underperformance. Although no one investment style outperforms in all market conditions, over the longer run value stocks have outperformed growth and smaller stocks have outperformed large, in both cases by a considerable margin.

So, active management when well executed is far from being a lost cause. However, for those who wish to gain broad market exposure but who do not want to be forced to choose between the myriad of active managers or who do not believe that active managers can consistently outperform the market, index funds are typically the default option.

But there is a third way. Whilst the philosophies of active and passive managers are diametrically opposed, index tracking can be combined with active management to varying degrees by adopting strategies such as enhanced indexation and core-satellite portfolios. In each case, the active finessing of passive portfolios seeks to generate index-plus performance. When well implemented, the best features of active and passive management combine to work to the investor's advantage.

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The opinions expressed are those of Aviva Investors as at 17 August 2008.

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