Active and passive investment approaches

You've undoubtedly already heard about active and passive investing but what are the differences? We explore the two approaches and how they work to determine which is the most appropriate for today's rapidly changing investment environment.

The benefits and drawbacks of active and passive investing are often the subject of fierce debate, but what do these terms actually mean? In short, an active approach involves investing in funds where a professional team chooses investments based on a thorough research process and selects those they believe are the most attractive.

As a passive investor, your aim is to match the performance of a certain market index instead of trying to outperform it. It's important to have a clear understanding of these different approaches and which is more appropriate for your circumstances, objectives and timeframe.

A mutual fund lets you and other investors pool your money together to invest in various types of assets, such as stocks and bonds, which offers key diversification benefits. The fund will invest in these assets using an active or passive approach and any returns from the fund will be shared between you and other investors.

Jargon buster

Stocks, shares and equities are terms used to describe units of ownership in one or more companies. Although they don't mean exactly the same thing, they are often used interchangeably. Strictly speaking, 'stock' refers to public shares that are listed on a stock market. But you're unlikely to confuse anyone if you use any of these terms when talking about your investments.

What is an active fund?

In an actively managed fund, a manager will buy and sell holdings to try to achieve the best returns in line with the fund's objective. This objective is usually to beat a specific benchmark over a defined period of time.

Active fund managers are dedicated to researching, finding, meeting, monitoring and reviewing all companies they invest in. Their active management approach means each decision is tailored to the fund's objective and they have the flexibility to adjust how the fund is positioned in anticipation of market movements.

Active management in practice

The investment team at Franklin Templeton, who manage the Omnis UK Smaller Companies Fund, meet at least 250 small UK companies in any given year. In 2020, they met 400 such companies. These meetings enabled them to include and remove companies from the fund. The team looked for opportunities to buy high-quality businesses that could weather the turbulence of the pandemic at attractive prices, while selling some companies that were likely to struggle.

For example, ahead of a recession an active fund manager can adapt their strategy to protect returns. They may choose to invest in defensive sectors, such as utilities and pharmaceuticals, and avoid cyclical sectors that are more sensitive to the economy, such as travel and construction. In contrast, a passive (otherwise known as tracker) fund follows an index and doesn't offer the same degree of flexibility.

Investors in actively managed funds will usually pay higher management fees for the skills and experience of the managers. While costs associated with passive funds may be lower, you miss out on the advantages provided by this high level of expertise. It's important to note that the performance objective of the Omnis funds is always after quoted fees and expenses – in essence we aim to deliver value after all fees.

What is a passive fund?

Passive funds replicate the performance of an index, and in its simplest form it will buy and sell the same assets as its index and in the same quantities, only trading when an asset is added or removed from the benchmark (for example, a share in the case of the stock market). As such, passive funds tend to have lower charges as they require less human resource to manage.

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What are the differences between active and passive management?

	Active	Passive
Objective	To outperform the returns of a specific benchmark, after fees and expenses, which are explicitly quoted.	To track or follow an index. The objective does not usually explicitly mention the impact of fees and expenses.
Strategy	The manager will actively decide whether to buy, hold or sell a specific stock or bond. They will often meet and engage with companies to decide whether to include or exclude them within a fund.	No active decisions. Passive funds cannot track an index completely, so you can expect to have some tracking error and this will impact returns to some extent.
	The manager can navigate changing market conditions – they aim to be typically 'right' more often than 'wrong' when buying and selling a particular asset.	You cannot mitigate against market corrections – your investments rise and fall in line with the chosen index.
	Actively managed funds are usually spread across a range of investments, providing diversification benefits.	Your investments can be heavily concentrated in one area depending on market circumstances at the time. For example, if you're tracking the S&P 500, more than 40% of the companies on the index are in the 'tech' industry[1].
	Active managers can incorporate environmental, social and governance (ESG) factors into their decision making.	Passive funds only incorporate ESG factors to the extent that the index does.
Fees	The manager will charge a fee for their active management.	Passive funds also charge a fee, although this is usually lower than for actively managed funds.
Decision maker	Fund manager, supported by teams of research analysts.	Either an algorithm or a fund manager whose sole task is to track an index.

[1] Source: Eeagli, using Siblis Research, Finbox data as at 28 December 2020; 'tech' consists of IT, communications and telecommunications (disc.) sectors.

As passive funds are set up to mirror an index, and as most indices are dominated by the biggest companies, passive funds have greater exposure to these companies, regardless of the future outlook for these businesses.

This strategy can work well when markets are going up. However, it can also mean passive funds have considerable exposure to a bubble before it bursts. Passive funds will behave in the same way as the index they're tracking. In essence, when markets rise, passive funds rise at a similar pace, and when markets fall, passive funds will also fall in line with the markets they invest in.

How do passive funds track their benchmarks?

The process of passive investing is quite simple. For example, a fund could follow one of the major indices such as the S&P 500 or FTSE 100. Whenever these indices switch up their constituents, the fund will automatically follow them, selling the stock that's leaving and buying the stock that's becoming part of the index.

How do active fund managers make investment decisions?

Different funds have different objectives and are designed to reach different goals, with varying levels of risk. For example, a UK equity fund will invest in shares of companies listed in the UK, whereas a US equity fund will invest in shares of companies listed in the USA. Once the universe has been defined, fund managers follow a strict process before deciding whether to invest in a particular asset.

Stock picking

Fund managers conduct extensive research before making an investment. They look at a stock from a holistic viewpoint, assessing company accounts, forecasts, the industry they sit in and market forces that could impact returns. In addition, they'll often meet with the companies to understand their business plans and, where appropriate, their environmental, social and governance (ESG) credentials.

Strategy

Depending on the fund's objective, the managers will adopt a certain strategy.

Growth – focus on firms that are still expanding and are likely to generate increased revenues to provide long-term gains.

Value – invest in stocks that are currently undervalued by the market – in other words, their current share price is low considering the company's financial health or dividend payment history.

Growth at a reasonable price (GARP) – look for companies that are showing consistent earnings growth above broad market levels while excluding companies that have very high valuations.

Disciplined sell approach

Fund managers base their decisions on qualitative and quantitative research, providing a rational and strategic guide for selling investments instead of acting on emotions. For example, when deciding whether to sell, they might measure the price target – a projection of the stock's future price – against downside risk.

What are the benefits of passive investing?

Depending on your circumstances, passive investing can offer some benefits. As nobody is picking stocks and instead the fund is simply following an index, fees don't tend to be as high as for actively managed funds. In addition, these funds have a clear mandate to track an index, so you may have a better idea of what to expect in terms of performance. Passive funds may also give you the opportunity to gain access to a niche market that you were unable to access through an active fund manager.

What are the benefits of active investing?

Actively managed funds that blend different investments can be one of the best ways to preserve and enhance wealth. This diversified approach can dampen losses when market conditions are challenging, as well as provide exposure to a wide set of investment opportunities. For example, some companies performed better than others during the Covid-19 crisis. In particular, tech firms benefited from our increased reliance on their services as we spent more time at home. Now that vaccine programmes are well under way around the world, we're seeing investors shift to businesses that are more likely to perform well during the economic recovery, such as financials, travel and hospitality.

Active fund managers now have the opportunity to prove their worth by choosing investments that will benefit as the global economy starts to reopen. We saw a similar trend after the global financial crisis in 2008 – once the dust had settled, patient managers were able to find investments that offered the best value and delivered strong results in the years that followed, despite initially underperforming. It's important to remember that markets are inefficient, and active fund managers can look for value in these inefficiencies.

Investing responsibly through active management

Investing responsibly involves considering not just how companies are managed but other issues too – from the impact they have on the environment to the roles they play in society. Investors are embracing this approach because there's mounting evidence to suggest these issues affect how companies perform over the long term.

Incorporating ESG factors into investment decisions is very much a qualitative and active approach – fund managers are able to manage risk more effectively and improve returns. In contrast, passive funds don't offer the same level of flexibility and engagement, meaning it's not as easy to invest sustainably.

We're advocates of ESG investing because we believe it should generate better outcomes. We're also committed to using our voice as shareholders to drive positive change through engagement. Our research process focuses on selecting investment managers that are the right fit for our funds, and we work alongside them to understand how they consider ESG factors as part of their investment process.

Active fund managers also have a key role to play as the emphasis on sustainable investing grows. By incorporating ESG factors into investment decisions, managers can help drive positive change through engagement with companies, as well as manage risk more effectively and improve returns (see box 'Investing sustainably through active management').

Some investors argue that the average active manager underperforms the benchmark. Our response is simple: don't invest with average managers. Omnis has developed a repeatable and robust process for identifying managers who can beat their benchmarks consistently and are likely to do so for you going forwards. It's overseen by the Omnis Investment Committee, a team of experienced industry professionals. We continuously monitor the performance of our managers, and we aren't afraid to replace one if necessary.

How do we invest actively?

At Omnis, we're committed to being active investors, which is even more important in a world where the unexpected happens frequently and markets are distorted by politics, as well as government and central bank policies. We appoint active fund managers that we believe will outperform an index, and our selection process seeks to identify managers that have a strong track record of adding value through their skills and expertise. We actively monitor our fund managers on behalf of investors and make changes where needed, without investors needing to take any action.

Most[2] of our funds' objectives are to outperform their benchmarks over a rolling five-year period, but it's not unusual for them to underperform during certain periods in the short term. Although most of our funds haven't got a five-year history, almost 60%[3] of them have already beaten their benchmark since launch. The Omnis funds are designed to be used as part of a diversified model portfolio aligned to your risk profile. Combining them into a diversified portfolio helps enhance returns, as typically funds perform differently in different market environments.

Figure 1 shows that various diversified portfolios of actively managed Omnis funds have outperformed against the same baskets of indices since 2018, when most of our funds were launched.

Figure 1: Omnis funds outperform

Performance of three baskets of Omnis actively managed funds compared with composite indices

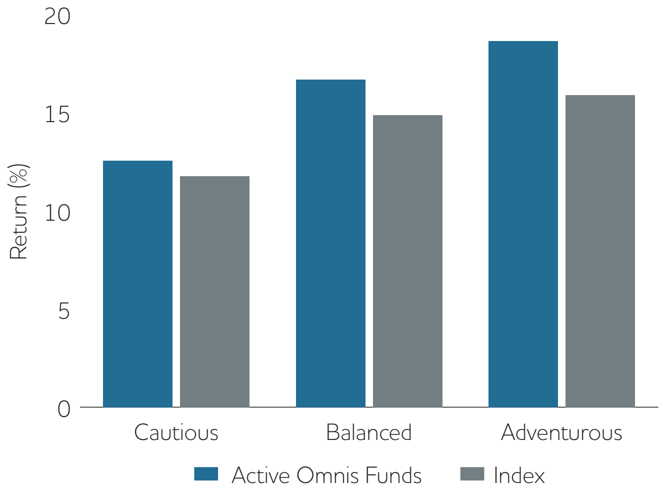

Chart shows performance of Openwork Graphene C1 Cautious, Balanced and Aggressive portfolios against their composite indices. The portfolios consist exclusively of Omnis actively managed funds. The composite indices use the same asset allocation as the portfolios but show performance of the index.

Source: Financial Express Analytics. Period: 28 September 2018 to 15 March 2021

Take a more active approach

Passive funds can be a cost-effective way of simply investing in stock markets and in some cases can also give you access to markets where you might not have a suitable active manager. While passive funds don't give you access to the potential outperformance that active managers offer, they can in some instances play a role in an investor's portfolio.

At Omnis, we are firm believers that in the long term active management can add value through outperformance to investors, even after taking into account the higher charges. Through our range of funds, investors can gain access to most global markets and, when combined in a diversified portfolio, they can deliver strong returns in line with your attitude to risk.

We want our funds to be managed by the best manager, not just the average manager. To do this our team appoint third-party best-in-class active fund managers to run each of our strategies. They have the flexibility to adapt to changing market conditions and conduct in-depth research to select solid investments that can help deliver strong, risk-adjusted returns in the long term.

If you'd like to discuss active and passive investing in more detail, please contact your financial adviser.

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[2] Excludes Omnis UK Equity Income Fund, which has a specific income objective

[3] Source: Financial Express Analytics, as at 28 February 2021

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