Advertorial

Why an active or passive approach to investing matters

By: Joyce Tan

"Utilising a combination of low cost ETFs for efficient markets and competitively priced active funds for inefficient markets is likely to improve returns for investors."

- Mr Teo Joo Wah, Chief investment officer, Lion Global Investors

With the myriad of investment products in the market, retail investors are often spoilt for choice but it may be overwhelming for some. To add to the confusion, they are constantly bombarded with information on how to make their money work harder.

One such debate is about the active and passive approaches to investing, with some investment managers strongly favouring one strategy over the other.

In a nutshell, proponents of active investing attempt to beat the market by seeking outperformance from actively managed funds while those of passive investing believe in lower fees and delivering whatever the market returns are – good or bad.

It is important to understand the distinction between the two contrasting investment styles.

In recent years, trillions of dollars have flowed into passive index products while largely shunning actively managed funds. This was largely boosted by the relatively lower fees of passive funds, which helped to win over many new converts.

However, as market risks and volatility grow, retail investors are turning to the active approach which has the ability to actively manage risk.

Active and passive investment strategies each have their own merits. Depending on market conditions and investment objectives, fund managers may choose one strategy over another.

Still, the active versus passive approach doesn't have to be an either/or choice. Combining both strategies can further diversify a portfolio, manage overall risk, and potentially help to optimise risk-adjusted returns and improve overall fund performance.

Active investing

This is an investment style where portfolios are created by selecting individual securities based on their perceived worth.

Active investors make a judgement on which securities they believe will outperform (to buy or hold) versus those that will underperform (to sell, not buy or not hold).

This involves in-depth research as well as ongoing buying and selling activity, which fund managers need to continuously monitor to exploit profitable conditions.

By doing so, it allows fund managers to take advantage of short-term trading opportunities, which increases the odds of outperforming the market.

An active investment approach also allows fund managers to adjust their portfolios to align with the prevailing market conditions with a view to minimising potential losses and improving risk-adjusted returns.

Active investing can be adopted for both equities and bonds.

For equity investments, active managers may have different investment styles. "Value managers" seek to invest in under-priced and undervalued stocks, while "growth managers" look for companies which have exceptional growth potential over the longer term.

For bond investments, fund managers seek to predict potential changes in interest rates, which would affect bond values, while taking into consideration bond prices, returns offered and the creditworthiness of issuers.

Most fund managers believe that active investing works better in inefficient markets, where there is less information available, for example, in relation to small -capitalisation companies, emerging markets, and so on. Arguably, this market inefficiency creates opportunities for fund managers to achieve outperformance through security selection.

Morningstar has a stronger conviction in the use of active managers for high-yield bonds due to market inefficiency, limited passive product advancement, competitive fee differentials, liquidity issues and poor benchmarking[1].

Some constraints of active investing include higher expenses, inappropriate investment styles in different market conditions, and no absolute certainty in choosing winners.

Passive investing

Passive investing involves closely tracking an investment index by buying and holding all or a representative sample of the securities in the index.

As no research is needed and lower transaction costs are incurred due to less frequent buying and selling of securities, the management fees and operating expenses of passive funds will typically be lower than those of active funds.

Passive investing often provides greater portfolio diversification as investors essentially invest in a wide range of securities across an entire index.

An example of a passive approach is to buy an index fund that follows one of the major indices like the Euro STOXX 50 or the S&P 500.

The Euro STOXX 50 tracks the stock performance of the Eurozone's 50 largest companies by market capitalisation while the S&P 500 includes 500 large companies listed on the New York Stock Exchange or NASDAQ.

Whenever these indices change their constituents, the index funds that follow them automatically follow suit, selling the stock that is exiting and buying the stock that is becoming part of the index.

The rapid growth of passive fund management is partly due to the emergence of exchange-traded funds (ETFs) which track an index, a commodity, bonds, or a basket of assets like an index fund. Unlike unit trusts, an ETF trades like a stock on a stock exchange. ETFs typically have higher daily liquidity and lower fees than unit trusts, which make them an attractive alternative for individual investors.

Some fund managers believe that passive investing tends to work better in efficient markets, such as the US, where assets are more likely to be fairly priced and due to more insights and analyses conducted on the securities listed in the market, which won't allow an investor to make higher returns than other investors in the same market.

However, passive investing has its constraints too. For instance, the returns of funds using this strategy will fall when the overall stock or bond market falls in accordance with the markets they track. In funds using a passive investment strategy, it is also not possible to select securities flexibly for defensive portfolio positioning, as these funds are designed to replicate or sample the underlying index. Also, as such a fund's performance is tied to the performance of its underlying index, it may sometimes perform slightly weaker than the index due to fund operating costs.

The Best of Both Worlds

Generally, many investors favour the active investing approach in less efficient markets and the passive approach in very efficient markets. But it may be worth considering funds that combine active and passive investment strategies so as to harness the benefits of both investment approaches.

Chief investment officer at Lion Global Investors, Mr Teo Joo Wah, said: "Utilising a combination of low cost ETFs for efficient markets and competitively priced active funds for inefficient markets is likely to improve returns for investors."

Many sophisticated investors have blended these two approaches, reducing expenses by allocating to passive strategies in some markets, while using active strategies in areas where they believe they can generate excess returns over the market. According to Morningstar[1], it is important that investors think about active and passive funds holistically to get the right exposure to the right assets, be aware of liquidity and trading risks and maximise risk-reward at a total portfolio level, and reducing costs where possible. In particular, it noted that while investment returns are not guaranteed, fees are definite, so minimising fees should be an underlying principle when thinking about the investment selection process.

When aligned with the investment objective, a combination of active and passive strategies can harness the advantages of each approach.

To learn more about a fund that combines active and passive investment strategies – the LionGlobal All Seasons Fund – visit **www.lgidirect.com.sg/allseasonsfund.**

[1] http://www.morningstarco.uk/uk/news/163596/when-to-use-ative-and-passive-funds-in-a-portfolio.aspx

About the LionGlobal All Seasons Fund

- The LionGlobal All Seasons Fund is a fund of actively managed funds and ETFs, combining both active and passive investment strategies.
- The fund comes with a low total expense ratio capped at 0.5% p.a., including an annual management fee of 0.25% p.a.
- With a widely-diversified portfolio of funds and ETFs, comprising bond and equity funds, the fund is designed to better weather investment risks in all economic seasons.
- The fund has two portfolio options – "LionGlobal All Seasons Fund (Standard)" and "LionGlobal All Seasons Fund (Growth)" – to cater to investors of different risk profiles.

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