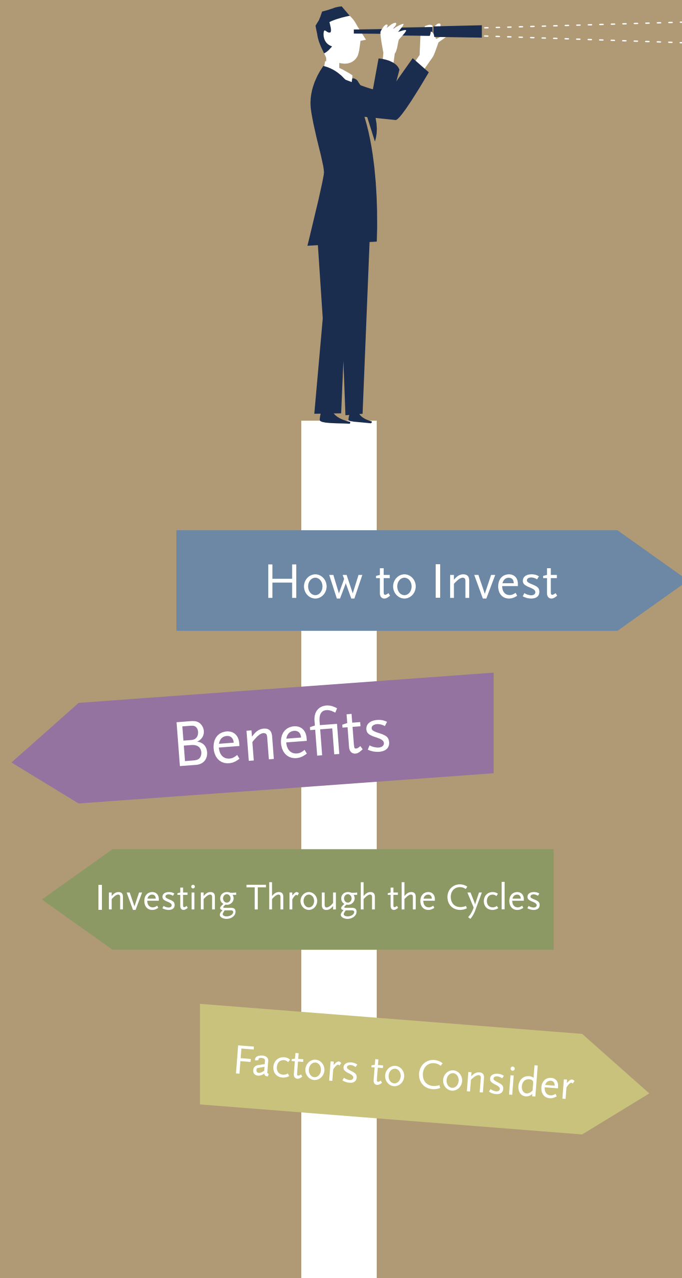
Davy Select

DAVY SELECT



A Guide to Active versus Passive Investing

Please note: Davy Select provides services on an execution-only basis.
This guide may refer to service levels in order to more fully describe investment processes.
Davy offers other service levels separately. Further information is available on request.
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Introduction

The rise of index investing and the strong growth of the exchange traded fund industry in recent years have called into question the merits of the role of active managers in modern day investing. In this guide we attempt to answer one of the most topical debates in the investment industry: Which is better, active or passive investing?

To shed some light on this debate, we outline the benefits and drawbacks of both investment styles and demonstrate that it is not an 'either, or' question but a 'when and where' question. We believe a combination of both active and passive investments can compliment each other in different market environments. While passive instruments can provide broad market exposure, top quartile active managers have demonstrated their ability to add to performance, as well as providing a level of protection when markets enter a downturn.*

Whether investing with an active or passive manager, we believe a robust and disciplined investment process is vital to a successful investment strategy. At Davy, we place significant emphasis on manager due diligence. When choosing actively managed funds we aim to identify managers that have demonstrated consistent outperformance of their respective benchmark in the past, while also focusing on portfolio construction and risk to protect on the downside.

I hope you find this guide useful in considering your investment options.

Sara MacGrath
Analyst – Global Investment Selection

** Source: MFS, There's No Substitute for Skill, September 2015*

01

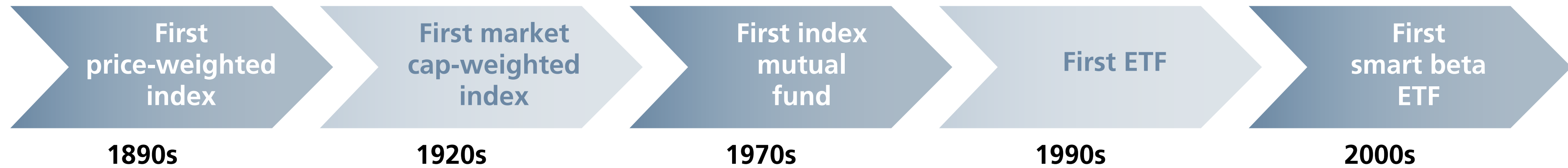
Passive Investing

An Overview of Passive Investing

What is passive investing?	A passive investment strategy seeks to track a specific market or section of the market by replicating the underlying index using a pre-determined strategy. A passive approach does not entail any forecasting, use of market timing or stock picking skills.
How to invest passively?	Investments can be made through Exchange Traded Products (ETPs) such as Exchange Traded Funds (ETFs) or Index Managed Funds.
Benefits	• Passive investing removes the emotional element of gaining exposure to the underlying market. • Passive instruments are typically lower in cost as they have lower associated resource requirements than active managers. • An investor can still influence their investment portfolio through asset allocation decisions rather than individual stock picking. • Passively managed investments enable investors to gain broad access to market sentiment.
Drawbacks	• Passive instruments are not expected to outperform the underlying benchmark due to the deduction of fees. • Investors have no control over the individual asset exposures, they simply hold the same instruments as the benchmark in equal weight. • When markets are volatile, passive instruments experience the full extent of market volatility. If the market experiences drawdowns, a passively managed fund will participate to the full extent of the market drawdown. • As most indices are market capitalisation* weighted, passive instruments tend to increase exposure to stocks that are performing well and reduce exposure to those that are not performing well, regardless of their future outlook or valuation. Investors risk buying more of an asset when prices are increasing and selling when prices are decreasing. • It is difficult to gain exposure to the more illiquid asset classes — including hedge funds and private equity — through passive investments.

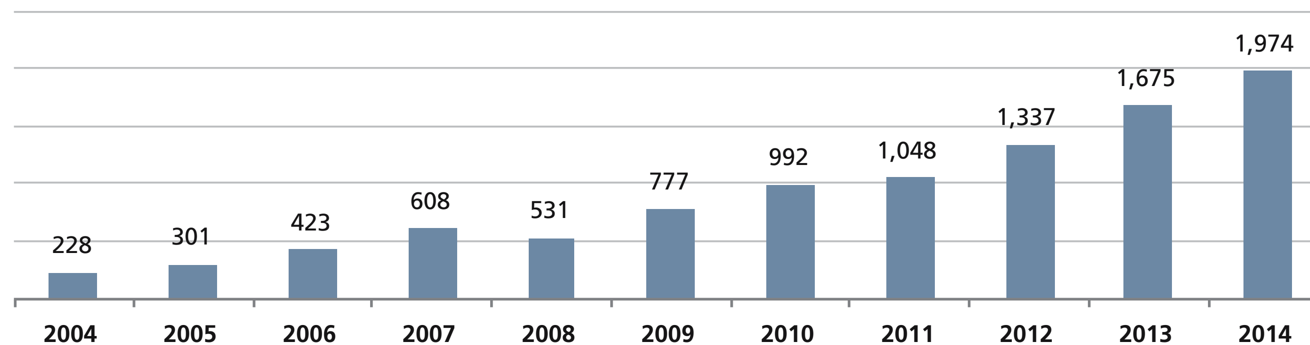
** See glossary for further information.*

The Growth of Exchange Traded Funds



Please see Glossary for further information.

Figure 1: Total Net Assets Under Management in ETFs ($ Billions)



Source: 2015 Investment Company Fact Book, Chapter 3: Exchange Traded Funds.
Note: Data for ETFs that invest primarily in other ETFs are excluded from the totals.

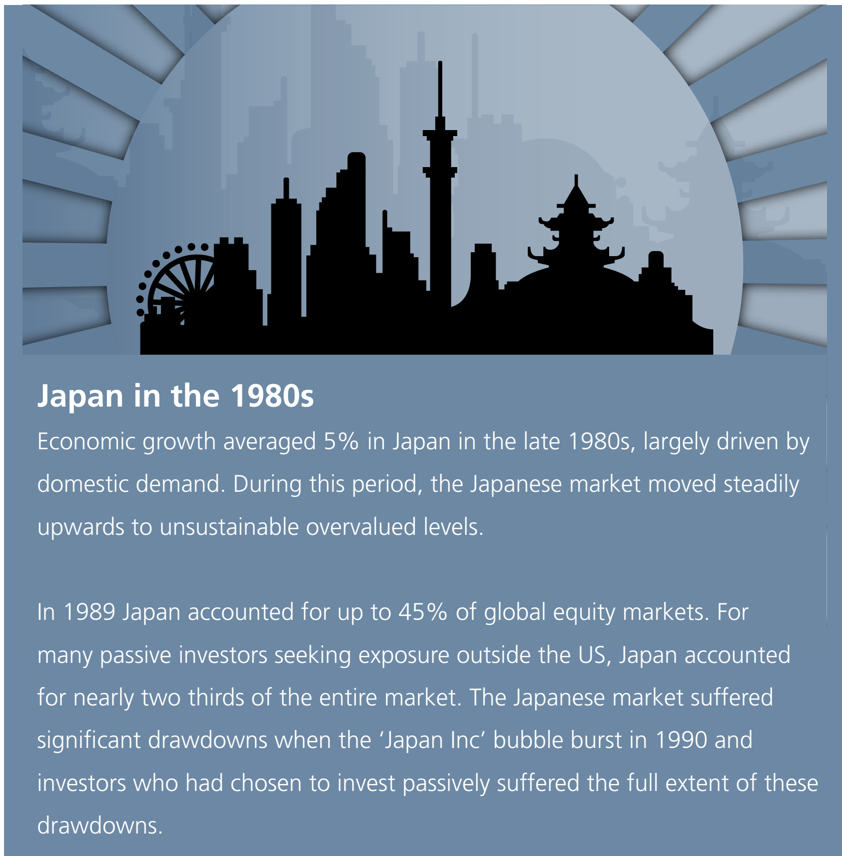
The size of the ETF market has grown considerably since the first ETF in 1990. European ETPs saw net inflows of over $48 billion in the first half of 2015, with the overall market representing more than $504 billion in July 2015. At this point in time, the ETF market represented 3.35% of the overall European market and 11.43% of the overall US market.*

The large growth in the ETF industry, coupled with low levels of liquidity in the markets makes them one of the largest players in the market, influencing underlying stock prices by buying in and out to track an index with no real fundamental analysis.

**Source: Source ETFs, EFAMA Monthly Factsheet; ETFGI Global*

The Issues of Passive Investing

There are several issues surrounding passive investing, perhaps the most prevalent of all was brought to light in Japan in the late 1980s. Traditionally, indices have been market capitalisation-weighted which results in index funds being most heavily invested in stocks that have performed well in the past with no consideration for their future outlook. Investing in a passive fund that tracks a market capitalisation index, however, may lead to unwanted exposure to overpriced companies.

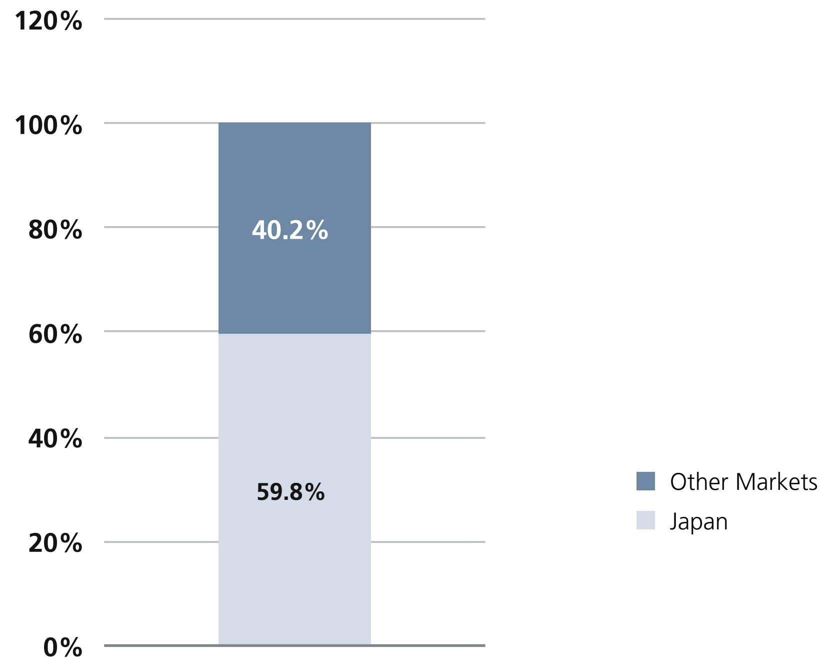


Japan in the 1980s

Economic growth averaged 5% in Japan in the late 1980s, largely driven by domestic demand. During this period, the Japanese market moved steadily upwards to unsustainable overvalued levels.

In 1989 Japan accounted for up to 45% of global equity markets. For many passive investors seeking exposure outside the US, Japan accounted for nearly two thirds of the entire market. The Japanese market suffered significant drawdowns when the 'Japan Inc' bubble burst in 1990 and investors who had chosen to invest passively suffered the full extent of these drawdowns.

Figure 2: MSCI EAFE Index as at 31st December 1989



For Illustrative Purposes Only.
Source: Lazard Asset Management, 'The Case for Japan'.

Smart Beta – The Revolution of Index-Based Investing

What is Smart Beta?	Smart beta is a relatively new phenomenon that may provide a way to mitigate the problems associated with tracking a market capitalisation-based index. Smart beta ETFs employ a range of techniques in order to mitigate the drawbacks of traditional market capitalisation-based ETFs. These techniques can vary from thematic to systematic approaches.
The Thematic Approach	This strategy requires investors to hold certain beliefs about the future and uses a rules based approach to take advantage of secular or temporal mispricing in the market on the back of their convictions.
Systematic Approaches	• **Equally weighted**: This is the most simplistic approach and gives no regard to market factors – it simply gives equal weighting to all stocks in the index. The main drawback to this approach is that it can generate a relatively large exposure to small illiquid stocks. • **Fundamentally weighted**: Under this approach, the index is weighted relative to economic size by using fundamental business metrics to remove the link between the stock's price and its weight within the index. • **Risk weighted**: This approach makes assumptions regarding future volatility, potential returns and correlation using historic performance to identify the most efficient portfolio. • **Factor tilts**: This approach typically employs factors that are associated with drivers of excess returns in active management styles (e.g. value, momentum and size).

Factors to Consider When Selecting Passive Instruments

When choosing ETFs, many investors may look solely at fees. However, other factors such as the replication method used and magnitude of the tracking error introduce risk and should also be considered.

Fees	Fees for passive instruments are generally lower than their active counterparts. However it should be noted that fees may vary by provider, by region and by replication type.
Size	It may be difficult to gain entry to or exit from smaller ETFs depending on trading volumes. In addition some smaller ETFs may find it difficult to gain full exposure to the underlying index.
Tracking error	This is the divergence between the net asset value of an investment fund and the net asset value of the index being tracked. The larger the tracking error, the less effective the passive instrument is at tracking the underlying index.
Counterparty	The track record and credit rating of the potential provider should be assessed.
Stock lending	Put simply, an issuer lends out stocks bought for a physically replicated ETF to another institution in exchange for cash and some collateral from the borrower to secure the loan. This introduces the risk of borrower default.
Replication	There are several different methods of replicating an index. When physical replication is not employed, passive instruments are more susceptible to large tracking errors. These methods are described below: • **Physical Replication** - Physically buying the securities held in the index in the same proportion as the index. • **Synthetic Replication** - Mimics the behaviour of the index through the use of derivatives, such as swaps. • **Optimisation** - Buying the securities in an index that provide the most representative sample of the index based on correlations, exposure and risk. • **Sampling** - Holding a broadly diversified collection of securities that, in aggregate, approximates the full index in terms of key characteristics.

Source: Davy

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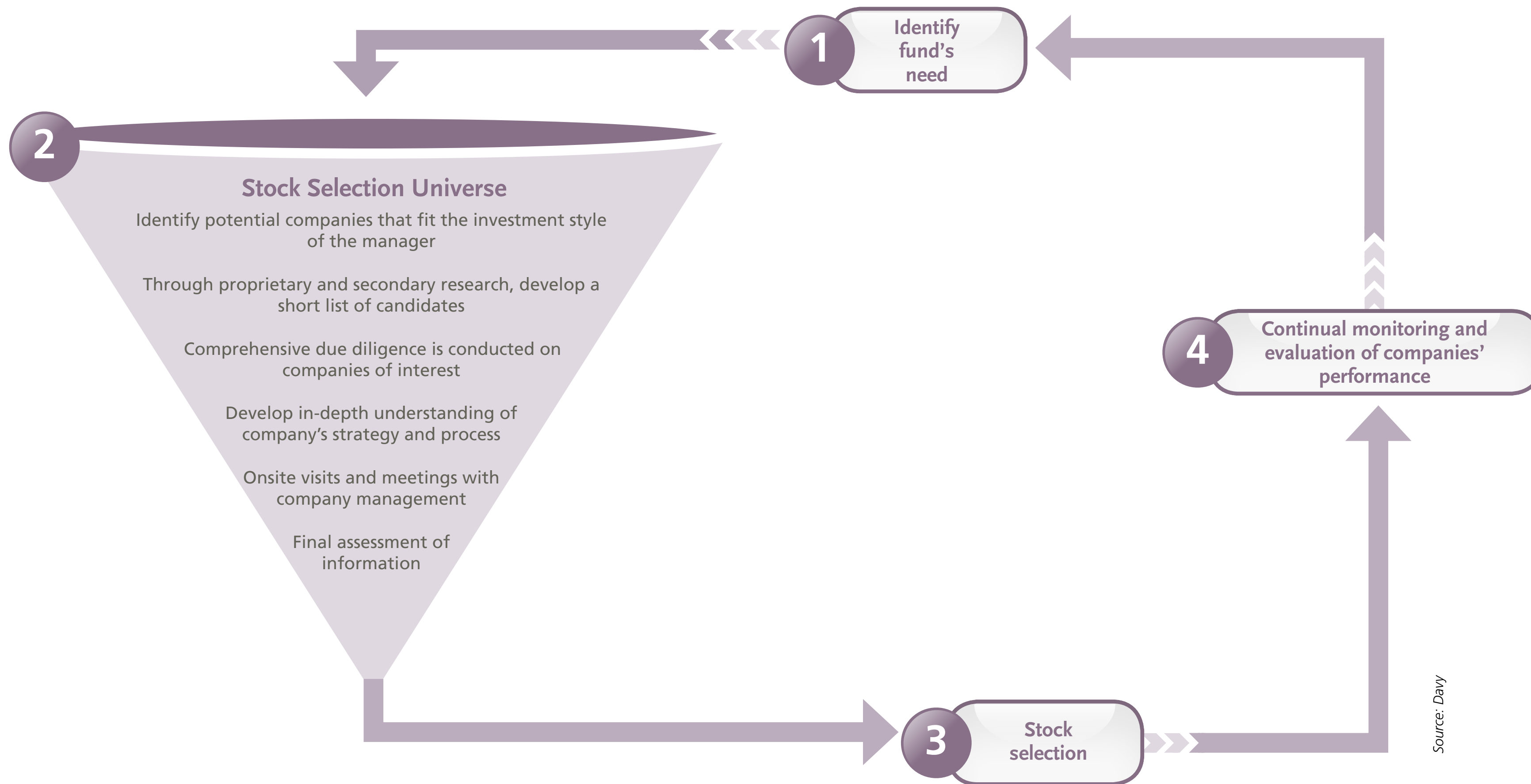
Active Investing

An Overview of Active Investing

What is active investing?	An active investment strategy will aim to outperform a specified index or benchmark. The active investment manager will aim to do this by selecting investments which they believe will outperform the broader market with the aid of research analysts and traders. As a result, active managers tend to have higher fees than passive managers.
How do active managers outperform an index or benchmark?	Active investment managers aim to outperform their respective benchmarks through their own investment styles and stock selection skills. In the course of identifying attractive and unattractive stocks, good active investment managers follow a rigorous stock selection process. They use a range of qualitative and quantitative tools including idea generation, stock screens, analysts' reports and often engage with company management. Active investment managers also apply varying levels of risk management and techniques to mitigate downside risk.
Benefits	• Active investment managers can make informed decisions based on their insights, knowledge and ability to identify potential investment opportunities. • Active funds may significantly outperform the benchmark due to active investment manager's skill and expertise. • Flexible mandates allow managers to move in and out of stocks at will. • Active investing can provide downside protection and mitigate risk in bear markets.
Drawbacks	• Actively managed investment funds are generally more costly to run resulting in higher fees for investors. • Actively managed investment funds tend to be more concentrated with fewer securities. • Significant underperformance may occur due to specific investment decisions. • Investing in active instruments requires the ability to select those active investment managers who can outperform.

An Overview of an Active Manager's Investment Process



This is for illustrative purposes only and may not be the same process for all active managers.

03

Combining Active and Passive Instruments in an Investment Strategy

The Role of Active and Passive Investments in a Portfolio

It is important to recognise that value for money is not always just about low fees. The additional risks associated with both passive and active instruments also need to be considered. Whether to go passive or active will depend largely on the individual characteristics of the exposures being analysed.

Passive Investments

Passive investment instruments provide the core of any multi-asset portfolio and are most effective when used to provide broad access to markets. They are valuable at the core of a portfolio and provide low cost exposure to efficient markets.

Active Investments

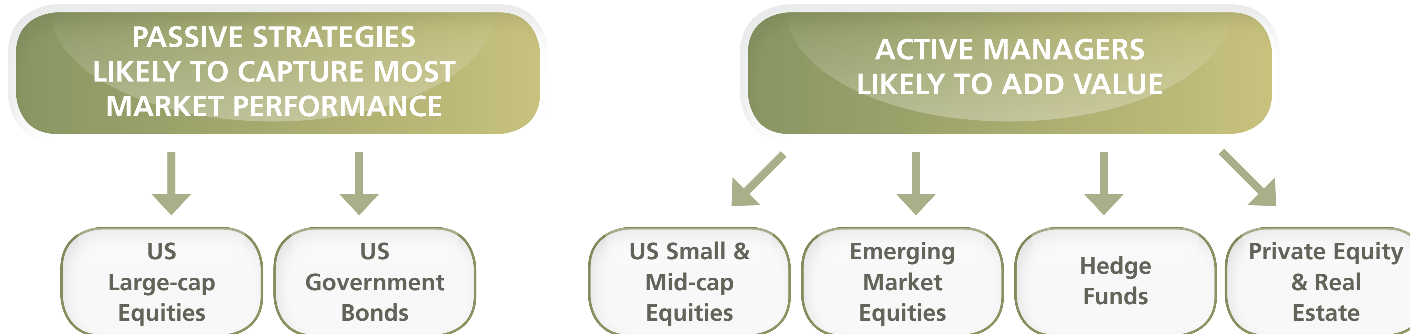
It is often cited that the average active investment manager does not outperform their passive equivalent. However, the key is to employ a robust and rigorous manager selection process to ensure that the selected investment manager is not average but best in class. Carefully selected active investment managers chosen in this way should be used to supplement the passive core of a portfolio.

Source: Alfred Lee CFA, DMS, BMO Asset Management "Combining Active and Passive Investing in a Core-Satellite Strategy"

To Go Active or to Go Passive?

In some instances, the decision to go active or passive is very simple. For example, it is very difficult to identify passive ETFs that will provide exposure to some asset classes, such as real estate or hedge funds. On the other hand, active managers tend to struggle to consistently outperform in large efficient markets such as US large cap stocks and so a passive approach may be more appropriate. The following table illustrates the conditions under which one should consider using either the active or passive investment management style.

Consider going passive	Consider going active
Efficient markets	Inefficient markets
High level of analyst coverage	Low level of analyst coverage
Sufficient levels of liquidity	Low levels of liquidity
ETFs of high quality with low tracking errors and lower associated costs	Insufficient ETF quality and higher cost



Source: Davy

80% of Yale's relative outperformance in the 20-year period prior to 30th June 2012 was attributed to the value add of Yale's active managers.

Source: The Yale Endowment:

2012 Annual Report

Investing Through the Cycles

In constructing a multi-asset portfolio there are two key types of risk that investors become exposed to:

Active risk	The risk that a manager will perform differently from the market or its benchmark index during both market advances and declines.
Market risk	The risk that the value of an investment will decrease due to fluctuations in various market factors.

Investing in passive instruments, while providing broad market exposure, leaves the investor completely exposed to market risk. Successful active investment managers, through a high level of active share, have the ability to mitigate market risk. Carefully selecting active investment managers that are proven to be best in class can also help in reducing the exposure to downside risk by providing significant excess returns to a portfolio.

The Benefits of Good Investment Manager Selection

The ability to identify the most skilful managers is key to employing an active investment management approach. Figure 3 shows the performance of the top quartile of actively managed large-capitalisation European funds versus the Euro Stoxx 50 (a market capitalisation weighted stock index of the 50 largest blue-chip European companies operating within the Eurozone nations) and the bottom quartile of actively managed large-capitalisation European funds.

Figure 3: Performance of top quartile and bottom quartile large-cap European managers versus the Euro Stoxx 50

Warning: Past performance is not a reliable guide to future performance. The value of your investment may go down as well as up.

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Summary

Summary

When designing the optimal investment portfolio, it is not a choice between investing passively or actively; both have their benefits and their drawbacks. The approach taken will depend on a number of factors including the characteristics of the underlying market or exposures, the ability of an active investment manager to outperform relative to their peers or benchmark, the risks and the costs.

Any well-constructed portfolio is likely to include a combination of both passive and active instruments. Both require a robust instrument selection process which is not limited to just performance and costs, but also considers the skill and process of an investment manager or the fundamental characteristics of the underlying market.

Both active and passive investment strategies have their advantages, but they are not without their risks. Active investment strategies, while having the ability to provide downside protection, are also capable of underperforming their benchmark. Passive investment strategies, while facilitating access to the broad market sentiment, also experience the full extent of market volatility. If the market experiences drawdowns, a passively managed fund will participate with the full extent of the market drawdown.

To conclude, neither is appropriate on a standalone basis, rather a well-researched combination of both should be employed to achieve a well-balanced risk adjusted portfolio.

05

Glossary

Glossary

Term	Definition
Exchange Traded Fund	A marketable security that tracks an index like an index fund. Unlike mutual funds, an ETF trades on an exchange.
Index Mutual Fund	A mutual fund with a portfolio that is constructed to match or track the components of a market index.
Market Capitalisation-Weighted Index	A stock market index weighted according to the underlying publicly traded company's total market value of the shares outstanding. Market capitalisation is calculated using the current share price times the number of shares outstanding.
Mutual Fund	A professionally managed investment fund that pools money from many investors to purchase securities.
Price Weighted Index	A stock market index where each stock influences the index in proportion to its price per share.
Smart Beta	A passive approach to investing that uses alternative index construction rules to traditional market capitalisation based indices.

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