Actively vs Passively Managed Funds

Have you ever wondered what the difference is between an active or passive investment fund? It's important to differentiate between the two. There are many considerations before choosing to invest in either actively managed funds or to go with a passively managed unit trust fund or an exchange traded fund (ETF).

The basic differences between active and passive funds are:

- Active funds are traditional unit trust funds, managed by fund managers. These managers, within the mandate of the fund, allocate investors' money to assets that they believe will provide good returns. To do this, they need to research these assets thoroughly. Their aim is to outperform the fund's benchmark, which is usually an index, such as the FTSE/JSE All Share Index (Alsi). However, in reality, they rarely succeed in outperforming the index.

- Passive funds are either unit trust funds or ETFs that track an index, meaning they hold the assets that comprise the index in the same proportions. No research is done on investments, and there is no intervention by the fund manager, except to ensure that the composition of the fund reflects the index. The performance of the fund should roughly equal that of the index minus costs.

The first index-tracking funds were launched in the United States in the mid-1970s, and ETFs were launched in the US in 1993 as an alternative to traditional index funds. Globally, there has massive shift towards passive investing, particularly in the US and Japan.. Research by Moody's Investors Service suggests that index funds will have more than half of the investment-management business in the US by 2024, up from the current 30%. According to Bank of America Merrill Lynch, in Japan, nearly 70% of the assets under management of Japan-focused equity funds are passive, mainly ETFs.

In South Africa, the number of passive funds has also risen to approximately 100 passive unit trusts and over 50 ETFs.

A large reason for the move to passive investing has been the continuing underperformance of active managers to their benchmark. In South Africa, on average, 80% or more of general equity unit trusts fail to produce total investment returns above the FTSE/JSE All Share Index for periods ranging from 1 to 10 years.

Furthermore, of the funds that have outperformed the index, increasingly such index beating returns were produced by passive index tracking products, rather than typical active stock selecting asset managers.

Of the Top5 performing General Equity Unit trustsover 1 year as at 31 October 2018, the top performing funds are again passive index tracking funds.

Satrix Dividend Plus Index	10.20%
Satrix Quality Index	6.00%
Fairtree Smart Beta Prescient	5.70%
Counterpoint SCI Dividend Equity	4.00%
Aylett Equity Prescient	3.30%
FTSE/JSE All Share Index	-8.40%

As Mike Brown from ETFSA points out, this is astonishing since there are now 1200 plus actively managed unit trusts versus less than 100 passively managed index tracking ETFs and unit trusts in South Africa. So while the actively managed industry is more than 10 times the size of the passive industry, it continues to underperform.

Passive index funds have evolved from just following the broad market. In the investment industry, the performance of the markets, which can be replicated in a passive fund, is known as beta. Any performance above beta that can be attributed to the skills of a fund manager is known as alpha.

The indices themselves that passive funds track have become more sophisticated, and there are indices that reflect investment styles used by active managers, such as value (reasonably priced shares that offer good value), growth (shares of fast-growing companies), quality (shares of well-managed, quality companies) and momentum (shares whose prices are showing upward momentum). These indices are now known as smart-beta.

In a further development, multi-factor indices combine single-factor indices such as those mentioned above, providing better diversification and lower risk.