Passive investors more likely to see gains

BY BARRY O'NEILL

A REPORT by Standard and Poor's has once again revealed that the majority of actively-managed US mutual funds failed to outperform their respective benchmarks over three years.

There are compelling reasons why passive funds should form the core of your portfolio: from better performance and continuity of investment process to lower costs and greater risk control.

If you use passive investments to simply deliver the return from the markets in which you chose to invest, you are likely to do better than the majority of investors. This is because two-thirds of active fund managers routinely fail to deliver returns in excess of the benchmark indices against which they are measured when costs are taken into account.

Although the average total expense ratio (TER) of actively-managed equity funds is about 1.65% a year, the true cost of many funds can be 3% or more. The active fund-management industry is predisposed to trade. The average UK equity fund turns over two-thirds of its holdings each year meaning an estimated additional cost to investors of 1.2%. Investors generally pay the price for this activity in the form of inferior performance.

Barclays' annual study of long-term asset-class performance shows the average "equity risk premium" – the additional return you can expect from investing in shares over the return from safer assets such as short-term government bonds – is 4-5% a year. Therefore if you are paying 3% a year in costs, you are simply not being compensated sufficiently for the risks you are taking.

Passive funds, where the goal is simply to track the performance of an index, are much cheaper to run because there is no need for an extensive team of analysts or a "star" fund manager to pay. Typical TERs are about 0.5% a year for passive funds, but can be as low as 0.15%.

Active fund managers change employers on average every two-three years meaning that your investment goals and theirs are rarely aligned. Passive funds provide continuity of approach as they simply buy the index they are seeking to replicate the performance of, so it does not matter who is at the helm.

Passive funds provide far greater diversification than their active counterparts. Some active funds take large bets on a small number of individual holdings in the belief that these will be tomorrow's winners.

This concentration risk is not present in passive funds which hold hundreds and sometimes thousand of securities.

However, most active equity funds hold around 100 stocks, meaning the manager has felt the need to dilute his best ideas to ensure the performance of the fund does not deviate too much from the herd. So, you can either pay 0.15% to buy a fund that states it will track an index, or 1.65% for an active fund which purports to beat the index but ends up lagging it because of the additional costs.

Barry O'Neill is an investment director with Carbon Financial Partners in Aberdeen