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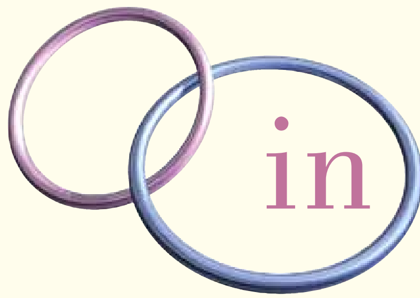

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FINANCIAL DESIGN

SEPTEMBER / OCTOBER 2016

GUIDE TO

ACTIVE AND PASSIVE INVESTMENT MANAGEMENT

WHAT'S BETTER – ACTIVE OR PASSIVE MANAGEMENT?

IN PARTNERSHIP FINANCIAL DESIGN LTD

Chilworth Point 1 Chilworth Road Southampton SO16 7JQ UK t 023 8065 2152 f 023 8076 0108

e info@inpartnershipfd.co.uk w www.inpartnershipfd.co.uk

Company registered in England no. 3972346. Registered Office: Chilworth Point, 1 Chilworth Road, Southampton, SO16 7JQ. Authorised and Regulated by the Financial Conduct Authority

GUIDE TO ACTIVE AND PASSIVE INVESTMENT MANAGEMENT

What you need to know

If you are looking to invest in shares or bonds, you may think about putting your money into one or more managed funds. Managed funds are pooled investments that contain different securities, so you reduce the risk of holding just a few individual shares or bonds.

You can invest in funds which provide access to a variety of different markets and sectors. But wherever you invest, you will be faced with one of the most basic questions: do you want to put your money in 'actively' or 'passively' managed funds?

CHOICE OF FUNDS

Deciding if you would prefer your investment 'actively' or 'passively' managed is an important consideration and a useful step towards narrowing your choice of funds to invest in. Your first consideration is deciding how you want your investments managed. Are you looking for a fund that will be impacted by an individual fund manager's choice of investments? Or are you more interested in keeping charges lower and prefer one that simply reflects the performance of a major index, such as the FTSE 100?

ACTIVE MANAGEMENT STYLE

Active funds typically have higher annual management charges than passive funds. This reflects the investment managers' potential to outperform the market, and they are managed with the aim of generating returns greater than the relevant markets, as measured by an index – known as its 'benchmark'. The index contains the companies whose shares are being bought and sold daily by the fund. All equities belong to at least one index depending on the location of the company and the type of business.

GOOD STOCK SELECTION

Professional fund managers or investment research teams run active funds, and they make all the investment decisions – like which companies to invest in or when to buy and sell different assets – on your behalf. The manager will pick stocks to buy and then compare the returns that they make against the benchmark. Good stock selection is designed to pick the companies that the fund manager thinks will outperform others within the index.

BEST DIVIDEND PAYMENTS

The manager does not have to buy all the index stocks, only the ones they believe will increase the most in value or, in some cases, pay the best dividends to give the best overall returns. They have extensive access to research in different markets and sectors and often meet with companies to analyse and assess their prospects before making a decision to invest. Typically, active fund managers base their stock buying and selling decisions on several factors including market conditions and the political climate, the state of the economy, and company-specific factors (for example, profitability and market share).

MOST PROMISING OPPORTUNITIES

Depending on the fund's objective, an active fund manager may have little or no constraint on their investment choice. Where this is the case, they can select what they consider the most promising opportunities, regardless of industry sector or company size, and aim to maximise gains in rising markets and limit the effects when markets are falling.

PASSIVE MANAGEMENT STYLE

The passive management style of investing is called 'passive investing', also known as 'tracking'. A passive, or index-tracking, fund is managed with the aim of replicating the performance of a specific index. Passive investment funds track a market and charge less in comparison to an active fund. To track the FTSE 100, for example, an investment manager will aim to invest in the same shares, in the same proportions, as this index.

"Professional fund managers or investment research teams run active funds, and they make all the investment decisions – like which companies to invest in or when to buy and sell different assets – on your behalf."

Passive fund managers won't make any 'active' decisions, as they're only trying to match the index. The fund will generally rise and fall with the index. Typically, the fund will buy all the stocks in, for example, the FTSE 100 in the same proportion they represent in the index. So if Vodafone accounts for 6% of the FTSE 100 Index by value and a smaller company such as Tate & Lyle accounts for 1%, some 6% of fund by value will be in Vodafone shares and 1% by value in Tate & Lyle, and rebalancing will occur to ensure the fund is consistent with the index.

LOWER TRANSACTIONAL COSTS

Passively managed funds perform well when markets rise and poorly when they fall, and they can be less diversified than active funds, as the relevant index may be dominated by just a few large companies. A change in the investment manager should have no impact on its performance, and they generally offer lower annual management charges, with a lower turnover of shares leading to lower transactional costs.

DEGREE OF RISK

It's important to remember that a degree of risk is inherent with any investment, and the potential for greater returns comes with a higher degree of investment risk. While a passive fund is considered to have less investment risk associated with it than an actively managed fund, there are still risks (such as stock market risk) involved.

DOES YOUR INVESTMENT PORTFOLIO TRULY REFLECT YOUR INDIVIDUAL INVESTMENT OBJECTIVES?

It's important to understand the difference between 'actively' or 'passively' managed funds before you embark on choosing a fund or combination of funds, and we always recommend you obtain professional financial advice. That way, you can build an investment portfolio which truly reflects your individual investment objectives. To discuss your particular situation, please contact us.

INFORMATION IS BASED ON OUR CURRENT UNDERSTANDING OF TAXATION LEGISLATION AND REGULATIONS. ANY LEVELS AND BASES OF, AND RELIEFS FROM, TAXATION ARE SUBJECT TO CHANGE.

THE VALUE OF INVESTMENTS AND INCOME FROM THEM MAY GO DOWN. YOU MAY NOT GET BACK THE ORIGINAL AMOUNT INVESTED.

PAST PERFORMANCE IS NOT A RELIABLE INDICATOR OF FUTURE PERFORMANCE.

WHAT IS THE RIGHT INVESTMENT APPROACH FOR YOU?

As with most investment decisions, the choice is down to you, your investment objectives, your attitude to risk and the economic and market environment at the time. We always recommend that you obtain professional financial advice.

To discuss your particular situation, please contact us.

This guide is for your general information and use only, and is not intended to address your particular requirements. The content should not be relied upon in its entirety and shall not be deemed to be, or constitute, advice. Although endeavours have been made to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No individual or company should act upon such information without receiving appropriate professional advice after a thorough examination of their particular situation. We cannot accept responsibility for any loss as a result of acts or omissions taken in respect of the content. Thresholds, percentage rates and tax legislation may change in subsequent Finance Acts. Levels and bases of, and reliefs from, taxation are subject to change and their value depends on the individual circumstances of the investor. The value of your investments can go down as well as up and you may get back less than you invested. All figures relate to the 2016/17 tax year, unless otherwise stated.

Published by Goldmine Media Limited, Basepoint Innovation Centre, 110 Butterfield, Great Marlings, Luton, Bedfordshire LU2 8DL
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