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INVESTMENT MANAGERS

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Are you missing out on active returns?

Although a discussion over the merits of active versus passive investing can turn heated as investors tend to favour one strategy over the other, at Prudential we believe the two can live alongside each other in harmony. Portfolios can combine both approaches to result in favourable investor outcomes.

As active investment managers, however, we do firmly believe that active investing will give investors superior outcomes over time – even when including all costs. In this article, we examine the advantages and disadvantages of active investing which – as its name implies – relies on a hands-on approach from a portfolio manager who is continually looking for opportunities to add value to client portfolios. This compares to passive investing, where money is typically left to track indices via Exchange Traded Funds (ETFs) and index-tracking funds over long periods of time.

Active objective

The objective of active investment managers is to use their expertise to select individual stocks or securities, and allocate funds between asset classes, with the goal of outperforming a specific benchmark chosen by the client. Unlike some much larger financial markets like the US, there are quite a few well-known active investment managers in South Africa with long track records of consistently outperforming their benchmarks like market indices – and therefore passive investments – including all fees.

How does active management work?

Active managers use data gathered by teams of investment research analysts, and their experience, to make the best possible decisions about which assets to buy, sell or hold, and in what quantities. They believe that short-term price fluctuations are important and can be used to add value to client portfolios by buying or selling when these prices move lower or higher than they judge they should be. Valuation-based managers like Prudential buy undervalued securities and sell overvalued securities, often buying in the worst market conditions when others are selling.

Four advantages of an active approach

Flexibility: Active managers have the flexibility to select and combine different securities like stocks, bonds and money market instruments to diversify across a wide range of industries and geographies. Unlike passive managers, they have the ability to ignore specific securities within an index that they think might be too risky, thereby avoiding the fallout from corporate disasters (like an African Bank or Steinhoff). Active management requires involved decision-making, which includes keeping abreast of factors such as changes to taxation, laws and politics which could affect investments. Even more importantly, these managers follow company decision-making closely, with the ability to understand each step in a company's growth path and, as shareholders, to vote on the important decisions affecting the company's future with shareholder interests at heart.

Risk management: Being able to manage risk is another key benefit to active management. There are two aspects to this risk management.

The first involves the actual longer-term structure of a portfolio, where the active manager decides how much overall risk will be allowed for the entire set of holdings, and for each individual security, over time. For example, they may set a lower limit on the credit rating of bonds the portfolio can hold (like no "junk bonds"), or an upper limit on the maturity of debt securities (such as no more than 3 years). The second involves the portfolio's shorter-term management: the manager will continually monitor a fund's actual risk measures. They can then either increase or cut back on the risk within the investment at any time. And, if a particular stock becomes too risky and shows the potential for permanent capital loss, the manager can sell it before serious damage is done.

What's more, experienced active managers can skilfully navigate market volatility by selecting undervalued high-quality investments with the potential for longer-term growth. They can also sell assets the market may be overvaluing. The result is that active managers help limit the downside in their funds' value during times of market volatility, cushioning losses.

Efficient capital allocation: Active management is based on the in-depth analysis of relevant company information, and so allows for efficient allocation of capital. This means that, in theory, the "best" companies, with the highest returns on investment, get the most financing, through either borrowing (issuing bonds) or selling shares. This has the potential to create significant value for investors over the long term.

Use of data: Active management allows for the use of quantitative and qualitative data, including company social responsibility ratings, which consider both financial returns and social/environmental benefits which can bring about positive change.

Some active disadvantages

Changing short-term returns around a benchmark: On a relative basis, actively managed funds will record higher highs, and lower lows, against their benchmark than a passively managed fund. This means investors could experience higher volatility than a passive approach. Nevertheless, the latter will never beat its benchmark, while the former certainly has the potential to do so.

Over the past 30 years, it has been shown globally that there are periods during which it is easier for active managers to outperform their benchmark index, and also times when it is more difficult. This will depend on global and local market conditions, as well as the inherent abilities of active managers. Fund managers like Prudential consistently outperform their benchmarks, including fees, over many different periods. However, there will always be periods of underperformance due to changing market conditions or other short-term factors. This is why it's important to choose a fund manager with a strong long-term track record for outperformance.

Equally, it's important to know what investment time horizon your chosen active fund is managed to. Generally speaking, to limit your investment volatility you should choose more conservatively managed funds with higher bond and cash exposure, and investment horizons of up to three years or so.

Fees: Besides the basic administration fees incurred by all different types of investments, actively managed funds include additional fees to pay for the professional teams that manage them and to cover the transactional costs incurred by more frequent trading. However, it's important to note that it's not always true that active funds cost more than passive. Active management fees have been falling in South Africa, while passive management fees can be high if the passive fund is tracking a specialised or complex index. It is best to compare total costs carefully.

The active bottom line

It's difficult to argue against the benefits of tailored investing by the experts when this active approach has delivered top performance for investors over the longer term. It takes into account not only the investment fundamentals, but also complex factors such as the economic and political environment, social and environmental responsibility and corporate governance practices. Fees can be higher, but these are typically compensated for by strong performance over time. Of course there are periods in which passive managers can outperform the majority of active managers as well, so there's room in everyone's portfolio for both solutions.

If you're missing out on the benefits of active investing, see Prudential's Fund Selector tool to see which of our actively managed funds might be appropriate for you. Or to find out more contact our Client Services Team on 0860 105 775 or email query@prudential.co.za.