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Tracking error

It's been that time of year when the financial press attack active investment managers for failing to beat major market indices. Active management is presented as being too expensive, and failing to deliver the goods. Passive investing via index funds is presented as being the prudent investor's best option.

Actually, over any meaningful longer period of time, this is patently untrue. 2016 was an unusual year, in that active managers did indeed find it challenging to beat indices. In the UK, a lot of this was to do with the sharp fall in sterling post the EU referendum. However, looking at longer periods, active managers have added value and justified their higher management fees. In the UK growth and income orientated fund sectors, active managers have, on average, beaten the UK stock market by around 2% per year since 2010. On a cumulative basis over the same period, the average active UK fund has risen in value by 91.2%, which compares with a typical passive fund such as Vanguard UK All Share Index Fund, which has gained 78.8%. *(All figures to 31 December 2016, source: Morningstar).*

But it's not just about whether an active fund will beat a passive fund over any given period. It's also about investors needing to decide what they want to own in a portfolio. An active fund provides investors with professional investment managers who are single-mindedly dedicated to stock selection, backed up by deep and solidly based investment research. Passive investors in a UK top 100 tracker, on the other hand, will, whether they like it or not, have almost 10% of their money invested in the UK's largest firm by market size, Royal Dutch Shell. Add four more mega stocks (HSBC, BAT, BP and GlaxoSmithKline) and this then constitutes about a third of the total investment in a tracker fund. Some investors will be fine with this, but a diversified approach it is not.

So, despite some predictable carping in the financial press about the skills shortage in the investment industry, investors should not lose faith in active managers who continue to select companies based on solid and longer term attributes. The investment industry is accustomed to periodic accusations of this nature, but to us it feels like another Mark Twain moment – reports of the demise of active management are greatly exaggerated.

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