Advice Matters

September 2018

Volume 5, Issue 9

- One hour of structured CPD
- Industry update
- Key factors for your business
- Better interviews with your clients
- Technical know how

The CPD Solution For Financial Professionals

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Welcome to the September Edition of Advice Matters

ApEx standards

The learning outcomes and the ApEx Standards can be found at the end of this edition of Advice Matters

Welcome to the September edition of Advice Matters.

Can you believe it is 10 years since the financial crisis hit the headlines and the financial services industry and its clients across the world?

A lot has happened in those years to build the trust in the sector including, as you are all too aware, the requirement to hold relevant level 4 qualifications or higher and maintain that knowledge.

This edition brings you another 3 informative articles covering a number of the NOS standards for those, like yourselves, who need to maintain their knowledge at the appropriate level:

Your AML Obligations

Active vs. Passive Investment Management

A Guide To Lending – The mortgage market and beyond

It will be interesting to see how the FCA uses the re-assessment test that they have developed with the CII. Currently it is not mandatory and we believe it will only be used where the regulator has a concern (no evidence) that "advisors" are not maintaining their knowledge.

Luckily you take Advice Matters and have the evidence of validating your learning and knowledge by answering the questions that accompany each edition.

You will find more about the FCA re-assessment in the useful links at the back of this edition.

As usual please let us know if you would like us to cover anything in

Coming up next month, we will be looking at:

- Apart from the Big Bad Wolf (A guide to other regulatory bodies)
- Taxation case studies

Recognised CPD programme

The London Institute of Banking & Finance

In Tech Check we address aspects of technical knowledge that you need to keep abreast of and that will enable you to have better conversations with your clients.

In this issue we focus on Active vs. Passive Investing.

Active vs. Passive

Investors often face a bewildering choice of investment vehicles and styles these days and the need for good advice has arguably never been so important.

One of the many decisions which advisers and potential investors need to make is whether to adopt a passive or an active approach with their investments.

Active management is generally more expensive than passive management. Often in life 'you get what you pay for' but does this always apply when it comes to investment management?

According to many recent academic studies, after costs, the majority of active funds underperform the market so the debate continues to rage in investment circles about which is the best policy to adopt. But should it be a binary decision or is there a 'third way' in which investors can get the best of both worlds?

Before we consider that question, let us just remind ourselves of what we mean by passive and active management.

Passive investment primarily aims to track a market index aiming to deliver market returns and not outperform an index. Compared to active management, there will be a reduction in certain costs, for example research, management and dealing costs so this is why many passive funds manage to outperform active funds on a like for like basis, after costs.

There are many approaches to passive management, ranging from funds that fully replicate an index to ones that use computer models aiming to replicate the performance of an index but select a smaller number of index constituents thereby keeping the dealing costs down.

The difference between the return on a passive managed fund and the index it is aiming to mirror is known as tracking error. The issue for fully replicated tracker funds is that the constant need for rebalancing can lead to prohibitively large dealing costs, particularly in the case of funds aiming to track broad based indices. These costs can result in a large tracking error. By reducing the number of stocks used by the fund, these costs can be reduced but there is a danger of the smaller sample of stocks selected for the fund not performing in the same way as the index they aim to track.

A potential solution is the use of Exchange Traded Products (ETPs) which can physically replicate an index at a very low cost for example 0.06% per annum or even less if held on a platform. It has arguably never been a cheaper time to invest passively.

Critics of passive investment would state that even a fund exactly replicating the performance of an index would, after costs, underperform it delivering negative alpha. They may believe that the chance of a positive return by adopting an active management style is better than the near certainty of a negative return after costs of a passive fund.

Active management aims to deliver returns over the market index but as explained above, it is sometimes better to travel hopefully than to arrive - the higher level of costs can negate any out performance or, even worse, the fund could underperform the index even before costs are deducted.

An argument in favour of passive investment is that developed markets are so informationally efficient that prices fully reflect all public and privately held information. Given that assumption, you may beat the market in the short term, by chance, but it would be futile to try to beat the market consistently in the long term.

But is the market fully informationally efficient at all times? And do certain markets display more inefficiency than others? The answers to these two questions appears to be no and yes respectively.

Active management appears to be most successful for small cap companies and possibly emerging markets. There may be less research available for these investment opportunities and therefore more opportunity to generate superior returns.

Active management also can be a distinct advantage in certain market conditions. The downside of passive investment is that the funds will track indices down as well as up.

When tracker funds are following an index down, active managers can disinvest or invest in more stable assets; effectively finding calmer waters until the storm passes and the market recovers.

Arguably the most successful investment manager of modern times, Warren Buffet is an active manager who passionately believes in the value of fundamental and thorough analysis of potential investment opportunities. The long-term performance of his Berkshire Hathaway Inc.

company has been nothing short of phenomenal. Over the past 50 years the shares have achieved a compound annual return of over 20% per annum, far superior than the S&P500 which returned a compound annual return of just over 7% during the same period.

It can be seen from the above that each form of investment has its potential advantages but can also have its drawbacks.

That is why many advisers are now coming to the conclusion that, rather than trying to argue about which approach is better, it may be more beneficial to get the best of both worlds by combining passive and active management in different proportions in different market conditions.

In rising markets, a core-satellite approach could be adopted where a passive style is taken to track the index up at very low cost. This proportion of the fund (usually the majority) is not trying to outperform the market but to cheaply mirror the index with as low a tracking error as possible.

The balance of the fund can then be invested actively in companies, sectors or markets that offer the greatest potential to deliver superior returns above the index (alpha) after costs.

By adopting a more actively managed approach in falling markets, the manager could tactically disinvest some or all of the passive core to avoid tracking the market down. They could also reinvest the proceeds into alternative asset classes that actually gain in value in falling markets. This could include so called 'risk off' assets like gold or possibly the use of derivatives depending on the risk profile or sophistication of the client.

At the end of the day there is a lot of conflicting data concerning the relative merits of active or passive investment and therefore it may be a matter of personal choice. A blended approach may be a sensible and cost-effective alternative. However, much will depend upon the risk profile of the client, including the clients' capacity for loss and the willingness to invest actively in more risky assets.