The Trustee toolkit downloadable

An introduction to investment

Tutorial seven: Active and passive management

By the end of this tutorial you will better understand:

- key characteristics of active and passive investment management

This tutorial is part of **Scenario three**.

Glossary

A detailed glossary of technical terms can be downloaded from the Resources tab when you log in at **www.trusteetoolkit.com**

The Pensions Regulator

Active investment management

Active investment management is where the investment manager is actively involved with decisions on choosing investments and buying and selling the investments, with the aim of creating a positive return.

Investment manager

The performance of a fund is down to the manager trading investments in such a way as to produce the best return. Essentially, the member is buying the skill and judgement of the manager.

Benchmark and target

Active investment managers may set a target for the performance of the fund or portfolio that they manage. This will usually be against a benchmark. For example, they might have a target to exceed the FTSE 100 index by 1.5% pa (net of fees). However, there is still the risk that the manager could fail to meet not only the target but even the benchmark.

Costs

Because of the active trading and labour intensive nature of active fund management, it is generally more costly than its counterpart, passive fund management, but there can be potential for better returns.

Investors need to monitor very carefully whether the additional costs (and charges) are being rewarded, net of fees, by a return that is superior to the benchmark.

Passive investment management

Passive investment management will normally follow a strategy, eg to track the performance of a particular stock market index (for example the FTSE 100).

Investment manager and a computer

This may involve the investment manager purchasing a proportionate number of every share to mirror the index exactly. However, in other cases, the investment manager may only acquire a representative subset of shares in the index. Shares will then be bought and sold automatically (normally according to a computer model of the index). This is called index tracking.

Index tracking is most commonly used for equities, however it can normally be used for any asset class for which there is an index (eg commodities or hedge funds).

Benchmark index

There are no active investment management techniques employed such as market timing and stock picking.

You would normally expect the return to be close to the index being tracked. The returns will normally be lower than the returns of the index because there will still be costs that need to be accounted for.

This difference from the index is referred to as the tracking error. Investors need to monitor the tracking error very carefully. Significant deviation from the index return may indicate that there is an error in the way that the fund replicates the index.

Index options

The range of index benchmarks available has expanded significantly in recent years to enable investors to align their investments with different investment themes, including, for example ESG or sustainability.

All of these indices will be constructed around a specific set of rules. For example, some ESG and sustainability indices will screen our certain investments or focus on investments with measurable environmental and social impact.

Trustees should do due diligence on any index they select and take appropriate advice to ensure that it aligns with their requirements and complies with their fiduciary duties.

Costs

This strategy reduces trading and fund management costs. This may benefit investors through considerably lower charges.

The cost of managing the fund is dependent upon the number of times the investment manager chooses to rebalance the portfolio, ie when he/she chooses to realign the stocks of the passive fund with that of the chosen index or to adjust for cash flows such as the receipt of contributions from members.

Costs and value for money

There are some costs common to both active and passive investment management plus some additional costs involved in active management.

Common costs

These costs are common to both active and passive management.

- Buying and selling assets, usually known as dealing or trading costs.
- Stamp duty, which applies to the purchase of UK equities and property.
- The costs of reporting and communicating with investors.
- Custody of assets.

Costs specific to active investment management

These costs only apply to active management.

- Payment of investment manager for their expertise, research costs, and bespoke selection of assets.
- Additional buying and selling costs and extra stamp duty to reflect the higher level of dealing which generally will occur.
- There may be additional costs to the trustees (or indirectly to the employer) if extra monitoring is required on the active investments.

Value for money

When assessing value for money (particularly in relation to the legal requirement on the trustees of most DC schemes to assess value for members), trustees will need to consider the investment approach which best meets the requirements of the strategy of the scheme (the default strategy in a DC scheme) and make a judgement about whether the costs and rewards of their chosen investment approach are appropriately balanced.