# Active and passive investing
## What you need to know

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When you're 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 dozens of different securities, so you reduce the risk of holding just a few individual shares or bonds.

You can find funds which invest in a wide variety of markets and sectors. But wherever you invest, your fund managers will take one of two basic approaches to managing your money: active or passive investing.

It's important to understand the difference, before you discuss choosing a fund or combination of funds with your financial adviser. That way, you can build an investment portfolio which truly reflects your individual investment objectives.

This guide is here to help you understand how each investment approach works.

# Active equity investing

The aim of an actively managed fund is to beat the return from a particular market index or benchmark.

Fund managers who use an active investment approach aim to either outpeform the market average by beating a selected index of shares (such as the FTSE 100) or bonds, or by achieving a specific investment objective.

They seek to do this by using their knowledge and skill to analyse the market. Then they buy shares which they believe are presently undervalued, and so have potential to increase in price – or pay increased dividends – over time. This process is known as **stock-picking.**

Managers can also adjust their portfolios to minimise potential losses. For example, they can avoid individual shares or bonds, sectors, industries, or even countries which they believe may underperform over a certain period.

**Different styles – value and growth**
Active managers use different styles of investing.

- **Value managers** seek to buy companies whose shares are currently selling for less than their net asset value (their total value after any debt and other liabilities have been deducted), or where they believe future earnings potential has been underestimated.

- **Growth managers** look for companies which have exceptional potential to grow, and to increase their share price over the longer-term.

# Stock-picking: the basic strategies

Typically, stock-picking involves choosing between a top-down and a bottom-up approach.

- **A manager who uses a top-down** approach studies broad market trends to predict which geographic or industry sectors will prosper. Only then do they research individual companies, to find which offer the best value in their sector.
- **By contrast, a manager who uses a bottom-up** approach starts by analysing individual companies. They are looking for strong performance or potential that is not reflected in the current share price. They believe great companies will eventually thrive and deliver profit for investors – regardless of their geographical market or sector.

Whichever approach they take, active managers will use the results of their research to purchase more of those shares or bonds they believe show the most promise. As they hold a higher proportion of those securities than they would if they were simply copying the index, they are said to be **overweight** in those securities. It also follows that they will hold proportionately fewer securities, or be **underweight,** in other shares or bonds in the index.

**Don't forget the investment costs**

The return delivered by an actively managed fund depends not only on the manager's talent, but also on the costs to the fund.

Higher costs (such as research, and buying and selling securities more frequently) will affect any extra potential profit that an active manager may aim to provide. So always be sure to check how much you're being charged.

# Actively managed bond funds

As with active stock funds, active bond funds focus on identifying and buying those investments which will provide the best returns.

When analysing company bonds (often called corporate bonds), managers take into account the price of the bond, the return offered, and the creditworthiness of the company.

They also try to predict potential changes in interest rates which could affect the value of each bond in the future. This is crucial, as bond prices move in the opposite direction to official interest rates.

However, the prices of short-term bonds are usually less affected by interest rate changes than longer-term bonds.

This means that an active fund manager who **expects interest rates** to rise may buy **shorter-term bonds** to protect against price falls. But a manager who **expects interest rates to fall** may buy **longer-term bonds**, to benefit from a relatively higher potential return in the future.

**What is a bond?**
A bond is a certificate confirming that its owner has lent money to a bond issuer (such as a government or a corporation). This money will be repaid at a fixed date with interest payments at fixed intervals.

As most bonds pay a set interest payment on a regular basis, they are also described as fixed-income investments.

# Active investment management: benefits and risks

The table gives you an at-a-glance overview of the potential benefits and the risks of active investment management.

By taking a view on which securities should be bought and which sold, active fund managers hold out prospects of beating the index. On the other hand, the risk is that they choose the wrong securities – or spend too much on the research and buying and selling processes.

| The benefits | The risks |
|---|---|
| **The opportunity for outperformance**<br>As active funds aim to beat the index, they offer you the potential to make higher returns than the average. | **Expense**<br>Professional market research costs money, which means active managers often charge higher fees. They can also have higher operating expenses such as transaction fees and taxes, as they are likely to buy and sell investments more frequently. |
| **Research insights**<br>Active managers carry out in-depth research to identify which companies to invest in. The quality of this research gives a fund its potential to outperform the index. | **Style issues**<br>A manager's investment style may limit performance when this approach is out of favour with the market. (Typical styles might be a **value** style aiming to choose securities that could offer value for money, or a **growth** style focused on finding securities with the potential for growth). |
| **Defensive measures**<br>Managers can minimise potential losses by avoiding certain securities, sectors, or regions. | **No guarantees on picking a winner**<br>While successful share selection offers prospects of outperformance, there are no guarantees. It is not easy to pick winners consistently, year after year. |

# Passive investing

Passive investment management is the opposite to active management.

Passive managers generally believe it is difficult to out-think the market, so they try to match the performance of the market (or their chosen sector) as a whole.

They tend to do this by closely following or tracking an investment index, such as the FTSE 100 Index of the UK's biggest 100 companies. That's why passive investments are often called **index funds** or **tracker funds.** These have a simple, precise objective: to match a specific index, rather than try to beat it.

Passive managers do this by buying and holding all or a representative sample of the securities in the index.

The advantage of this approach is that it spreads risk widely within a market, avoiding the losses that can follow a dramatic decline in any one specific company or industry sector. However, risk is spread rather than avoided. The passive approach cannot protect against broad market declines, as it follows the market or sector as a whole.

Passive investing also keeps management costs low. There is no need to research companies or bonds, and transaction costs are reduced because securities are bought and sold much less frequently.

**What is an index?**
An index is a collection of shares or bonds chosen to represent a particular part of the market. Passive investors use indexes to track market performance. In fact, a change in the price of an index should produce an almost identical change in the price of a fund that tracks it.

# Passive management: two different approaches

- **Replication – straightforward matching**
  Used by many equity index funds (but not bond index funds), this means closely tracking the performance of the target index. So a fund will hold every security in its target index, in the same proportion as the index. For example, if a company's share made up 1% of the value of the FTSE 100 Index, then the manager of an FTSE 100 fund would invest 1% of fund assets in that company.

- **Sampling – useful when the index is very large or complex**
  Here, the fund managers select a representative sample of securities from the target index, seeking to reflect the index in terms of key risk factors and other characteristics. Sampling involves using complex mathematics, but the principle is simple.

For instance, if a particular industry sector makes up 10% of the target index, the manager of an equity index fund might invest 10% of fund assets in that sector, even though the fund might not hold every one of the index's underlying shares.

Managers of equity index funds use sampling when the target index is so large that it's too expensive and inefficient to buy all of the shares. Managers of bond index funds typically use sampling to track bonds that are not traded often enough to be purchased easily, or at an efficient price.

**There are still potential risks with trackers**
Any fund that tracks an index takes on that index's capacity for risk.

An index fund can protect against falls in a particular share, bond, or sector, however, it does not reduce overall market risk. So, when the overall stock market rises or falls, so will the value of a fund that tracks it.

# Passive investment management: benefits and risks

This table gives you an at-a-glance overview of the potential benefits and the risks of passive investment management.

By tracking an index, a fund will always deliver returns in line with overall market or sector performance. However, this approach is still not without risks.

| The benefits | The risks |
|---|---|
| **Diversification**<br>Maintaining a well-diversified portfolio is an essential part of a successful investment plan, and indexing can be an ideal way to achieve diversification. Index funds provide a broad spread of risk because they hold all (or a representative sample) of the securities in their target benchmarks. | **Total market risk**<br>Index funds track the entire market: so when the overall stock market (or bond prices) fall, so do index funds. |
| **Low costs**<br>As index funds track a target benchmark or index rather than looking for winners (and so can avoid constantly buying and selling securities), they generally have lower fees and operating expenses than actively managed funds. | **Lack of flexibility**<br>Index fund managers are usually prohibited from using defensive measures such as moving out of shares, even if the manager thinks share prices are going to decline. |
| **Simplicity**<br>An index fund offers an easy way to invest in a chosen market as it simply seeks to track an index. There is no need to select and monitor individual managers, or chose between investment themes. | **Performance constraints**<br>Index funds are designed to provide returns that closely track their benchmark index, rather than seek outperformance. They rarely beat the return on the index, and are likely to return slightly less as a result of fund operating costs. |

# Tracking down the index trackers

Here are some examples of market indexes that many passive funds follow.

**FTSE**
FTSE Group (Financial Times Stock Exchange) is an independent company jointly owned by the Financial Times and the London Stock Exchange. The group is a world-leader in the creation and management of over 120,000 equity, bond and alternative asset class indexes. The well-known FTSE 100 Index tracks the top 100 UK companies.
**www.ftse.com**

**Dow Jones Industrial Average**
The Dow Jones Industrial Average has chronicled more than 110 years of investing. The Dow tracks the stocks of major US companies, across a variety of industries.
**www.djaverages.com**

**Standard & Poor's (S&P)**
Standard & Poor's is the world's largest index provider. The S&P 500 is a world-renowned index which includes 500 leading US companies and is widely regarded as a gauge of the US equities market.
**www.standardandpoors.com**

**MSCI**
MSCI Barra calculates over 120,000 equity and REIT indexes daily. MSCI indexes are used by over 2,300 clients including the 10 largest asset managers. (Source: 10 largest asset managers, measured by assets under management, as published by Nelson MarketPlace in April 2008, compared to the MSCI Barra client list).
**www.mscibarra.com**

# Active and passive investing: key points at a glance

| | Active management | Passive management |
|---|---|---|
| **In essence** | **Aims to outperform the market**<br>An active manager selects some shares (or bonds) in preference to others. | **Tracks a specific index**<br>A passive fund reflects the market or a market sector as a whole, and so does not depend on a manager making the right decisions. |
| **Techniques** | **Stock-picking**<br>Active managers analyse the market in order to identify and purchase investments that are undervalued (and to sell investments that become overvalued). | **The replication approach**<br>A very straightforward way to match an index. A manager buys the same shares as are in the index, in the same proportions as they are weighted in the index.<br><br>**The sampling approach**<br>Useful when the index is very large or complex. Here, a manager uses mathematical models to buy a range of securities that reflect the index in key risk factors. |

| | Active management | Passive management |
|---|---|---|
| **Key benefits** | **In-depth research and potential for outperformance**<br>Using skill to find hidden value and exceptional future growth prospects. | **Diversification**<br>Wide spread of your investment across an entire index.<br><br>**Low costs**<br>Low research costs and low transaction fees. |
| **Key risks** | **May be more expensive**<br>Active management costs money, through both research and transaction costs.<br><br>**More volatile**<br>It’s not easy to pick a winning share (particularly consistently over a longer period of time). | **Total market risk**<br>Your investment reflects the index the fund follows, so if the market as a whole falls you will lose money.<br><br>**Performance constraints**<br>Index funds are designed to provide returns that closely track their benchmark index, rather than seek outperformance. |

# Find out more from your financial adviser

This guide has covered the differences between active and passive management styles, and the relative risks and rewards.

What it can't do, of course, is help you decide which kind of investment fund or combination of funds is right for you.

To do that, you need to take your own personal circumstances fully into account. You also need to think carefully about your investment aims and how long you plan to remain invested in the market. You must also remember that the value of investments can fall as well as rise.

This is where the advice of a qualified financial adviser can be crucial. And this is why we always recommend that you consult your adviser before investing. Vanguard Investments UK, Limited only gives information on our products and does not give investment advice based on individual circumstances.

Your adviser can answer your questions relating to your investment decision or the suitability or appropriateness of our products for you.

We hope you have found this guide useful. We look forward to helping you with your investments when you're ready – always provided that our funds are right for you.

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