# SHINING A LIGHT ON……
# L&G PASSIVE MANAGEMENT

**At a glance**

Passive management (or tracking) is gaining in popularity in the UK. In 2002 5.5% of assets under management were held in passively managed funds, by the end of 2014 this had increased to 10%. In the US this is 20% and it is expected that the UK will hit this level by 2020.

Passively managed funds effectively track an index, so for example the FTSE100 index, and rather than choosing between a good and bad stock it just buys the index. There are three main reasons why investors choose this route:

1. Cost – at a base level passive funds can charge as little as 0.10% p.a. – actively managed funds can cost as much as 0.75% to 1% p.a. plus there are often additional trading costs
2. Risk – what happens if the manager leaves, what about sector bias etc
3. Flexibility – for an investor it is easy to make investment allocation decisions i.e. they want the UK they invest in a FTSE All Share Passive Fund etc

This update is different because it is not looking at one particular fund but an overall strategy but in the discussion with the managers at Legal and General it is worth investors considering whether passive management is the right route or a blend of both active and passive or active is the way forward.

**Considering passive management**

We started by talking about the randomness of returns. The managers looked at Emerging Markets and explained that no-one economy stood out, the point being that different economies perform better at different points in time.

The manager went on to explain that 70% of actively managed emerging market funds underperform the market and the bigger the fund the greater the problem. In the US this problem is greater with 95% of active funds failing to beat the index over 5 years.

Furthermore the argument is that the products are simple, investors know exactly where the money is invested and how. There is no second guessing of the market.

From a cost view point a fee of just 0.10% p.a. will only take £16,035 out of the fund over 30 years and with a 0.75% charge this increases to £110,194.

Investors across the board can access almost any region via passively managed funds and taking their arguments it seems the right choice.

One point for investors to consider is the randomness of returns. There are periods where passive will outperform active and vice versa however over a longer period 5 to 10 years plus good active managers will significantly outperform passively managed funds. This even reflects the higher charges.

In the US as an example the projected growth on the S&P500 is 3% this year, if you take out energy stocks this increases to 11%. This means that for a passive fund it will buy the whole index and therefore if this analysis is correct it will underperform a well-managed active fund.

The same in the UK, many good managers will argue that where the market is expensive you have to search out the areas of the market which are undervalued and find good companies that can deliver value. One manager would argue that to do this currently the areas of the market which are significantly undervalued are banks and food retail and technology is overpriced, so you need to position the fund accordingly. The passive fund cannot do this.

What interested me in the discussion was their argument for calling the strategy passive management. Their argument is that they are major shareholders in some of the largest companies in the UK and therefore they are active in working with companies to deliver the right outcomes for shareholders. However, the engagement with the company is great but they cannot remove the fund from the portfolio if they feel the company is in trouble or overvalued because it is part of the index. So any engagement seems pointless if they can't use it to identify the right investments for investors.

What is clear is that just picking a manager is the wrong approach, it is much more about understanding what they are doing and whether their strategy is similar to a passive fund. An example would be a large cap UK Income Fund. Looking at a passive fund an investor may find similar holdings and therefore the argument could be that the passive route is better, however there may be more actively managed UK Income Funds which use small and mid-cap investments and this may be a better route.

In emerging markets, it is about understanding what the manager is doing, what experience they have and understanding that a holistic view of emerging markets can be dangerous. And so-on, the US the same argument……

The point and conclusion is this, for those who are prepared to do the research and legwork they can identify those managers who have the potential to outperform the index over the long term. However, they must be prepared to accept short term underperformance. However, for those who don't then passive management could be a good alternative. It maybe that the trade-off is lower returns against some of the better managed active funds but this maybe a trade-off some investors are prepared to accept.

And as for L&G, they are one of the largest passive fund managers in the UK with two thirds of their assets invested in these strategies. However, they are not the only provider and it is worth considering the whole of the market before making any decisions.

*The source of information in this note has been provided by L&G and is correct as at March 2015. These are notes from meeting the fund manager or representative and should not be seen as a recommendation to purchase any fund mentioned. Any reference to shares is not a recommendation to buy or sell. Should you wish to make a decision based on these notes we cannot take responsibility for this and you should carry out your own research before making a decision. You should note that past performance is not a reliable indicator of future returns and the value of your investments can fall as well rise.*