ACTIVE AND PASSIVE INVESTING

A guide to understanding your investment options.

Integrity 365

INTRODUCTION TO INVESTMENTS AND RISK

Investments and risk go hand in hand, therefore, it is important to understand the level of risk you are comfortable with, and find the best investment strategy tailored to your own individual needs.

Need Help Understanding Investments?

It is generally accepted that asset allocation has the greatest impact on the variability of returns within an investment portfolio. However, even after establishing your asset allocation, an important decision remains. Which investment style should you adopt when investing in each asset class?

This guide explains two common styles: Active and Passive. Throughout these pages, there is a a significant amount of information on both, during which we do not refer directly to particular papers and publications, instead, we outline the consensus view on each approach. However, before doing so, it is important to identify the key components of risk.

The Components of Risk

Investment theory separates risk into two components: market risk and company risk. The sum of these provides the aggregate risk of an investment.

Market risk comes from investing in a particular asset class, such as the UK stock market. For example, if the UK stock market declines, an investor in that market is likely to see the value of that portion of their portfolio fall.

Company risk arises where a specific security's performance differs to that of the wider market.

What is Passive Investing?

Passive investing is an investment approach that aims to reduce aggregate risk by eliminating all company risk (also known as security risk), leaving only market risk (also known as systematic risk). This involves a 'buy and hold' investment approach that will match the performance of the chosen index. For example, an Emerging Markets Fund aims to replicate the returns of the MSCI Emerging Markets Index by investing in a representative sample of the underlying companies.

The total investment returns of the fund should equate to gains or losses in the underlying index, with small adjustments for tracking error and fund charges.

What is Active Investing?

In contrast, Active investing is an approach that embraces company risk. Active Fund Managers build portfolios that seek to outperform a benchmark. They believe that markets do not always correctly price the value of a company, providing opportunities to profit from buying companies below their true worth.

Active investors hope the Fund Manager will produce a higher net return (after paying higher fees) than can be achieved by Passive investment.

EHM: THE EFFICIENT MARKET HYPOTHESIS

The Active versus Passive debate centres upon the question of whether markets are efficient, and Passive Investing strategies are largely based on the Efficient Market Hypothesis (EMH).

The Efficient Market Hypothesis Explained

The Efficient Market Hypothesis (EMH) proposes that company share prices will always incorporate all of the available information; as such, share prices will always reflect what a company is truly worth. Therefore, it is not possible to 'beat' the market as it is not possible to buy undervalued shares or sell overvalued ones.

An Active Manager believes markets are not efficient and that this provides opportunities. A believer in EMH would solely buy a Passive fund, as there is no need to pay the extra costs for no advantage.

The Evidence for EMH

Academia has long debated whether the EMH holds true; in reality, markets are not wholly efficient. Over the past 20 years or so, academics themselves have repeatedly identified inconsistent patterns of returns. These patterns would not exist if EMH represented the complete picture.

Inefficient Markets

Many recognise some specific investment markets as being inefficient. Active Managers' arguments become more powerful with evidence of inefficiency.

This at least brings the possibility of gains exceeding the market as a whole. Such inefficiencies may exist in some areas such as smaller companies' stocks, poorly researched markets and illiquid investments.

Behavioural Finance

Behavioural finance is one hypothesis that seeks to explain these patterns. It does this by extrapolating the repetitive habits of individual investors which sometimes lead to irrational investment decisions being made.

Anecdotally, some funds using behavioural finance techniques, particularly in the hedge fund industry, have achieved success. Behavioural finance aims to explain occasions when inefficiency is evident.

Indices and Trading

Many indices are created by reference to market capitalisation, where each company has an allocation in the index in proportion to its size in the market. Some investors may question the suitability of this process, particularly in the case of Corporate Bond Investment. This involves allocating more money to the more highly indebted companies.

In addition, when a security is added to or removed from an index, it can cause a cluster of trades as Passive funds seek to replicate these changes.

In these instances, Passive investors are obliged to trade, no matter what the price. This offers the potential for Active investors to exploit these opportunities by buying ahead of a security being added to an index, or selling before they are removed.

EHM: THE EFFICIENT MARKET HYPOTHESIS

As with all financial planning, it is incredibly important to choose a strategy that suits you. At Integrity365, we offer a personalised service to ensure your investments are tailored to your individual goals.

Cost

Typically, Actively managed funds are more expensive than their Passive counterparts. The greater costs need to be justified by returns in excess of a Passive equivalent. Passive funds are cheaper to manage as the underlying construction of a portfolio and the buying/selling can be largely automated. Additionally, with the growth of Passive funds, the fund providers have started to compete on cost.

In the UK, investors can purchase funds tracking major indices for less than 0.15%. Active funds in the same areas would typically charge between 0.8% - 1.0%. Active funds may also include performance fees, which can have a particularly damaging effect on an investor’s overall return.

Choosing the right style

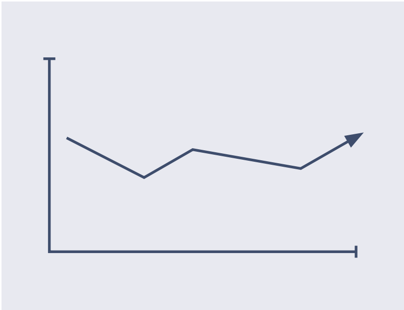
For diversification purposes, today’s modern portfolios are generally invested across a range of asset classes. Variations between portfolios then tend to arise as a result of the chosen investment style, which may differ depending on the individual investor’s personal requirements. An Active investment approach may be more suitable in certain asset classes where market inefficiencies arise through illiquidity or lack of information.

This provides scope for Active Managers to add value even after costs are taken into consideration. In well-researched, heavily traded markets, a Passive approach may offer a useful alternative, as it is likely to provide a return only a little lower than the market.

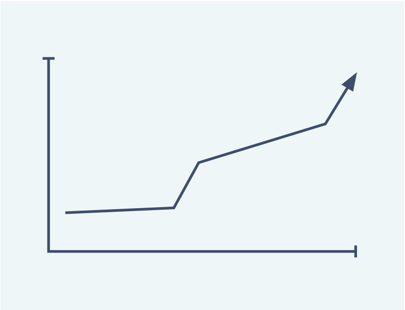
ACTIVE VS PASSIVE: WHICH STRATEGY IS BEST?

There are benefits to both Active and Passive Investing. However, there are some important considerations to be taken into account when planning your investment portfolio with your financial adviser.

Passive Investing:



Active Investing:



Please note that these graphs are for illustrative purposes only.

Both Passive and Active Investing approaches offer value to investors. However, they do generate intense debates amongst their supporters. The main argument is whether Active funds produce the long-term returns required to justify the additional risk and higher costs.

There is no simple answer. Most academic research suggests that, on average, Active Fund Managers under-perform compared to their benchmark. For example, of the Active funds invested in US equity markets – only around 30% outperform their comparable index.

Whilst the precise figures vary by asset group, there is little evidence of consistency. Those managers that outperform over one period, do not necessarily have a greater statistical probability of doing so in subsequent years. This is where the strongest arguments in favour of Passive investing come in.

Supporters of Active investing present two counter-arguments:

1. It is unlikely that all Fund Managers have only a random chance of success. Logically, some Fund Managers must have greater ongoing abilities than their peer group. A few Fund Managers are seemingly superior in their aggregate performance than statistical flukes would allow. The most likely explanation of their success is superior ability.

2. A more compelling argument is that Active investment has greater investment flexibility than Passive and is greater placed to respond to changing market conditions. Active Managers can avoid sectors or companies they believe will under-perform the market and overweight where they believe the converse is true. A Passive fund has no choice, it will invest in both the winners and losers.

Whether you select Active, Passive or a combination of both, is a personal decision. Many independent investment houses strive to identify funds that are likely to outperform in the future. It is true, that some Active funds do outperform Passive funds. However, Passive investing may not always be an option in certain markets or asset classes, as there may not be a relevant index to track.

INTRODUCING OUR CENTRAL INVESTMENT PROPOSITION (CIP)

At Integrity365 we take the responsibility of recommending where you invest your money very seriously. We are conscious that this underpins your family security and aspirations for the future.

Whatever your preferences around Active and Passive investing, our proposition is flexible enough to provide you with diversification across various investment styles in line with your beliefs and wider financial position'

We have created our 'Centralised Investment Proposition' to ensure we have a consistent and rigorous framework in place for how we select and govern the investment solutions we recommend.

This is overseen by Integrity365's Investment Committee, which meets at least quarterly. The committee sets policy guidelines for recommended portfolios and approves portfolio strategies. One function is to oversee the fund managers on behalf of all our clients, to ensure they are managing the investments as expected and that they remain in line with the agreed mandate.

Our Centralised Investment Proposition is designed to meet the investment needs of a variety of client objectives and risk profiles. It allows us to deliver a comprehensive, consistent and value-adding investment approach to all our clients without having to use a 'blank canvas' approach for each client, with the associated cost implications that carries.

The benefit to you as a client is that the associated cost and time savings can be passed on to you in the form of lower fees and charges. Additionally, CIPs often provide significantly easier access to information and reporting, as well as features such as automatic rebalancing, which all enhance the service that can be delivered to you.

INVESTMENT BLENDING
TO SUIT YOUR NEEDS

At Integrity365, we are passionate about providing a personalised service, and so we take pride on providing a wide choice of solutions to tailor accordingly to your individual needs.

One of the advantages of our investment proposition is that we have a wide choice of preferred solutions available to meet the needs of our clients. This means we can blend funds and Model Portfolio Service (MPS) portfolios together, in line with our investment beliefs, to diversify clients' investments across management styles, sectors, regions, underlying assets and individual management houses.

The actual blend of solutions we recommend on a case-by-case basis, will be subject to a client's circumstances and objectives, following a discussion with their adviser about the options available and the respective features, costs, benefits and risks.

We do not have a pre-ordained idea about the way each client's investment solution is blended, as each individual is different, rather we have a process based around a core principle to determine a suitable outcome for clients. In our experience, we have found that our clients often benefit from a balanced mixture of Active and Passive investments, across at least three fund managers, and in line with their attitude to risk and time horizon. Also, depending on your personal attitudes, part of the portfolio could typically include exposure to sustainable investments, which we see as a rapidly developing and attractive segment of the investment arena.

EXAMPLE OF BLENDING

In order to provide you with an investment strategy personalised to your needs, a blended solution may be best suited to you. The following example is a typical starting point when blending together solutions for a client.

Investment	Sector	FE Risk Score	Ongoing Charges Fee	DFM Charge	
Brooks Macdonald MPS Medium Risk (Income & Growth)	Active Managed Portfolio Service	60	0.62%	0.20%	25%
LGT Vestra Sustainable Balanced	Sustainable Managed Portfolio Service	61	0.67%	0.20%	25%
L&G Multi-Index 5	Risk Targeted Multi-Asset Fund	61	0.32%	0.00%	25%
Vanguard LifeStrategy 60% Equity	Risk Targeted Multi-Asset Fund	63	0.27%	0.00%	25%
	Weighted Average Charge	**61**	**0.47%**	**0.10%**	
	Total				**100%**

(Data as of Sept 2023)

The solutions used in the above example can be substituted for other solutions from our preferred range depending on a

THE RATIONALE FOR BLENDED INVESTMENTS

Our rationale for recommending a blended solution, if applicable, will be fully explained and documented within a personalised suitability report, which includes a description of each manager and solution.

A typical rationale would explain the benefits a client will receive from the management and oversight offered by Integrity365. For example:

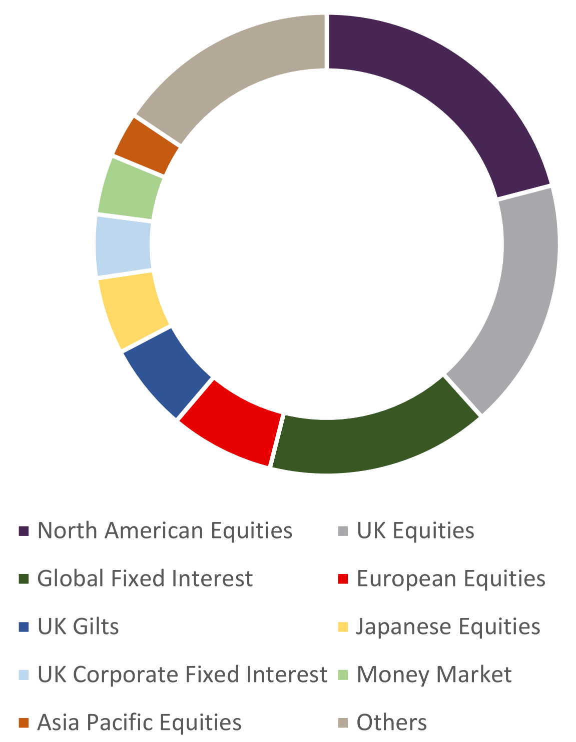
- A tailored strategy which is devised and regularly reviewed to ensure that it meets a client's objectives.
- Extensive due diligence is performed on all our investment partners to ensure the selected providers meet the criteria set out in our process.
- A blended investment approach provides access to a proven, effective, Managed Portfolio Service (MPS), designed to mitigate risk and target the return on investment that is required.
- The personalised blend of Active and Passive investments is selected to diversify your portfolio.
- A fund manager can select the most appropriate, sustainable assets that target the desired growth, using part of your portfolio to invest through sustainable solutions.
- A variation of investment managers from our approved providers are used to mitigate risk by ensuring funds are not all held with one provider.
- A blend of different investments can be offered which vary in terms of features such as investment style, underlying assets and geographical bias.

If a blended solution is deemed to be the most suitable solution for your individual needs, this will be supported by a full explanation within a tailored suitability report, including a description of each manager and solution.

Wrap Platforms

Holding a number of investments with different providers can be difficult to monitor and review. However, a wrap platform provides clients with the opportunity to access a significant number of investments in one place, allowing for a diversified portfolio as well as investment into a number of different tax wrappers.

A wrap platform, also allows you to efficiently invest with a number of different fund managers combined under one umbrella, which could prove particularly useful with a blended solution.



NEXT STEPS
TO TAKE

We will advise you on the most appropriate solutions to meet your investment objectives. Get in touch with our Independent Financial Advisers to discuss your investment options.

Whether you are looking to save on a regular basis, invest for income, growth or a combination of both, seeking Independent Financial Advice is extremely important in helping you secure your long-term financial goals.

Please note that past performance is not a guide to future performance.

All investments carry some degree of risk - but it is risk with the aim of growing the value of your money. The value of investments can fall as well as rise and may be worth less than you originally invested. This material is not intended to be relied upon as a forecast, research or investment advice, and is not a recommendation, offer or solicitation to buy or sell any securities or to adopt any investment strategy.

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