



ACTIVE AND PASSIVE INVESTING

A guide to understanding your investment options.

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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 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.

EMH: THE EFFICIENT MARKET HYPOTHESIS

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.

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