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No more idling – active funds are starting to perform

Investment For too long savers in expensive active funds have not enjoyed the best returns. Many people began to prefer cheaper trackers. But if you are looking for growth this year, Mark Atherton explains how to reposition your portfolio.

New research has reignited the long running debate over the relative merits of "active" and "passive" funds. Trackers have always enjoyed the advantage of being cheaper and have benefited from the inability of most active funds to beat their own benchmark index.

However, a fresh study by HFM Columbus, the financial adviser, shown exclusively to *Times* Money, challenges the argument that most active funds underperform. It found that the funds in the UK all companies sector – the largest for UK funds – had, on average, returned about the same amount as the FTSE 100 index, after charges, over one year and significantly outperformed it over three and five years, returning 46.1 per cent against 31.5 per cent and 59.7 per cent against 44.8 per cent respectively.

The equity income sector did even better, with funds, on average, beating the FTSE over one, three and five years, with returns of 3.2 per cent versus 0.7 per cent over one year, 47.3 per cent versus 31.5 per cent over three years and 63.8 per cent against 11.8 per cent over five.

The active funds that did well

Rob Pemberton, of HFM Columbus, says one of the reasons for this outperformance is that several of the larger stocks in the index, which automatically feature in tracker fund portfolios, have produced poor returns.

He says: "The big energy and materials stocks, such as BP. Royal Dutch Shell, BHP Billiton, Glencore and Rio Tinto, have underperformed the FTSE 100 index by between 25 per cent and 50 per cent over the past three years whereas they have been underweighted, or not held at all by active managers.

He adds that the other main reason for active managers' recent outperformance against the index is that they typically have a larger percentage of small and mid-cap stocks in their portfolios than index funds would have. He says: "Smaller stocks have significantly outperformed the large and mega-cap stocks that make up a large proportion of the FTSE 100 and the FTSE all share indices."

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He accepts that there is no guarantee that this outperformance of smaller stocks will continue but argues that it is a well established phenomenon and one which active managers have proved capable of turning to their advantage in recent years.

Did the outperformance of active funds feed through to the big popular funds?

Yes. HFM Columbus looked at some of the largest UK equity and UK equity income funds (all with more than £ 1.5 billion of funds under management) and found that almost all beat the FTSE 100 and FTSE all share indices over three and five years. Amongst the funds posting the best returns were the £1.9 billion Old Mutual UK Alpha fund, the £1.6 billion Schroder Income and the £3.3 billion Threadneedle UK Equity Income. So the index-beating performance was driven as much by the big popular funds as by the smaller niche funds.

The drag effect of 'closet' trackers

Another investment commentator believes that active funds would outperform the index by an even greater margin if they were not held back by the mediocre returns posted by 'closet' tracker funds, which are classed as active but behave like trackers, though with the added handicap of the higher charges of an active fund.

Until recently, it was difficult to identify with any precision which funds were closet trackers, so it was virtually impossible to say how much impact closet trackers had on the performance of a particular sector. Now Premier Asset Management and Morningstar the research group. Have developed a measurement , known as the active share score, which gauges how different a fund is from its benchmark, ranging from 100 for an active fund to zero for a tracker that perfectly reflects the holdings of its benchmark.

Closet trackers are classified as those with a score of between 15 and 60 on this scale and, according to Premier, they make up 29 per cent of all UK funds, containing £58 billion of investors' money. Simon Evan-Cook, of Premier, says: "In the current market cycle, stretching back seven years, closet trackers have underperformed genuinely active funds by 2.9 per cent a year. By being unfairly lumped in with actively managed funds, investors are still pouring billions a year in to trackers. In November alone UK investors bought a net £488 million worth of tracker funds, which was 37.5 per cent of the total net fund purchases of £1.3 billion that month.

A spokesman for Vanguard, a leading provider of index funds, says: "There are always periods where active funds may perform well and beat the index and this is what has happened in recent years, with 2013 being a particularly good one for active funds. However, if you look at the much longer term it remains the case that the majority of active funds fail to beat their benchmark. Some funds may adopt a strategy that enables them to outperform for a number of years, but it's difficult for them to do that over the very long term."

Taking the active approach can boost your financial as well as your physical health

Hidden obstacles

- A new study has looked at funds in six main regions of the world to see how many of them are closet trackers. The research by Premier Asset Management and Morningstar, the fund research research group, used a measure known as the active share score (see story) to determine whether a fund was a genuine tracker, a closet tracker, an active fund or a highly active fund.
- By far the biggest proportion of closet trackers were found in the UK (in all companies and equity income sectors). Almost a third (29 per cent) of all funds were given the closet tracker label – a much higher figure than for any of the other regions examined.
- The places with the next biggest concentrations of closet trackers were emerging markets (14.5 per cent) and Europe (13.5 per cent). Next came the US (7.5 per cent) and Asia 5.8 per cent).
- The region where you can be most confident hat you wont be saddled with a closet tracker is Japan, where just 3.2 per cent of all funds fell into that category.
- Why such a concentration of closet trackers in the UK? Simon Evan-Cook, of Premier, thinks it is partly down to a bias towards home-market funds from comparatively inexperienced investors who cannot tell whether a fund is genuinely actively managed or not.
- The other reason, he thinks, is that investors tend not to dump a fund unless short-term performance is really bad. So fund managers may respond by "hugging" the index to ensure that performance never appears too bad when set against this benchmark. The problem, as he points out, is that performance using this approach may never be as terrible, but it is never very good either.