A guide to active and passive investing

Investment funds can be broadly split into two categories – active and passive. And while both options play a part in an investment portfolio, it's important to understand how each works before allocating money to them.

BASICS OF PASSIVE INVESTING

Passive investing has gained momentum in Australia, and beyond, over the last decade. It could be because this style of investing aims to replicate the returns of a particular market index (for example, the S&P ASX 200 Index). This means, that when the value of the index rises, so too will the value of the fund. On the flip side, as the value of the index falls, so too does the nature of the fund.

Exchange-traded funds (ETFs) are some of the most popular passive investments. They are similar to managed funds, in that they involve a trust structure which holds a basket of securities.

As described above, the investments in the fund replicate the make up of the relevant market index. For example, if the index is made up of stocks that include banks, mining businesses, retail companies and supermarkets, the ETF will also hold these stocks. Units in ETFs are listed on stock markets and can be traded just like shares.

It's important to note, that while there are also actively managed ETFs, passive ETFs are most common of the two.

BASICS OF ACTIVE INVESTING

In contrast, an active approach to investing involves a fund manager choosing the assets in the fund, depending on the manager's view of markets and the type of fund it is.

Like passive investments, there are many types of actively managed funds which offer exposure to different asset classes and industries. Rather than track an index, an active fund will target a return above a particular benchmark. An example of this is, every year, an actively managed fund might aim to achieve the same return as the S&P ASX 200 plus two per cent.

Another common way of measuring the performance of an active fund is for it to target a premium above the rate of inflation. For example, a fund might aim to achieve inflation plus two per cent per year.

COST BENEFIT ANALYSIS: FEES

Cost is one of the major differences between these two styles of funds. Typically, passive investments are lower cost, as investors are not paying for the fund manager's expertise in choosing the investments in the fund. Active funds, on the other hand typically charge a base fee and a performance fee, to incentivise the fund manager to produce the highest possible return.

MARKET CONDITIONS

It's important to remember that markets will always go up and down, and actively managed funds still have many benefits (as well as risks) while factoring:

- Funds that track an index only produce the return of the index

- Fund manager skills can be used to pick investments that have the potential to do well when economic growth is slow and markets are falling

Active managers can also avoid stocks and sectors that are not doing well.

It's very difficult to get a true picture of whether actively managed funds perform better over time versus passive funds. It's probably more instructive to think about how each style of investing is used in a portfolio.

A BALANCED PERSPECTIVE

There's really no right or wrong approach when it comes to investing in active and passive investments. Many investors choose to invest in a combination of the two styles to achieve a level of diversification in their portfolios and to get access to a broad range of asset classes across the risk spectrum.

Source: BT

We will guide you with a tailored approach that works for your circumstances. Give us a call on 4927 4588 (Rockhampton) or 4939 1766 (Yeppoon) to see how we can help.

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