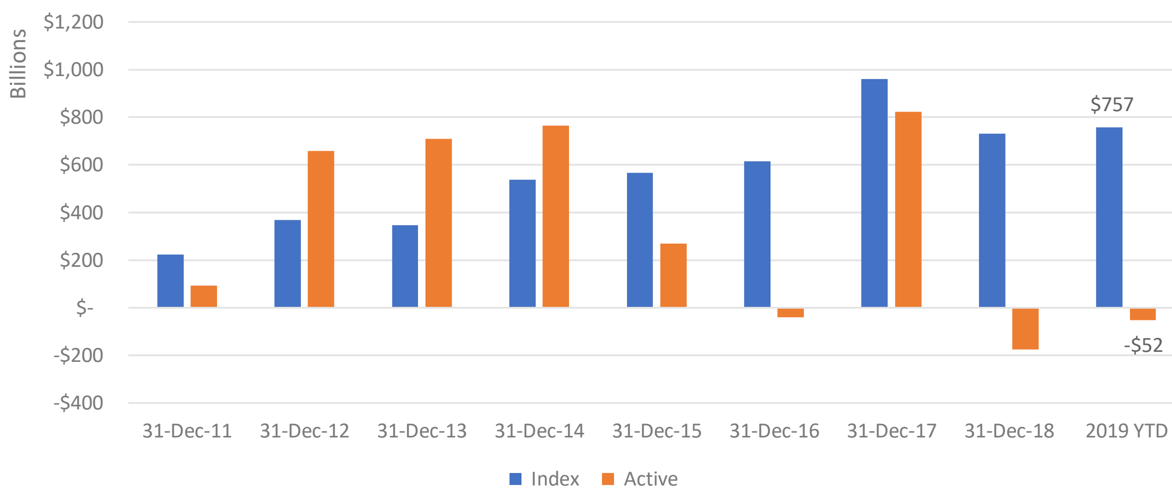
The Fry Group
since 1898

Be Active in Your Choice of Active Versus Passive

Looking at 2019 product net flows, passive funds have won the hearts and minds of investors. In 2019, passive funds again took in more net flows than active funds, generating inflows of $757bn in the year to October 2019, compared to outflows of $52bn for active.

Chart 1: Inflows to active funds vs. passive funds



Source: Morningstar, all worldwide funds excl. money market, feeder and fund of funds. 2019 data for year to Oct 2019

But are investors paying close enough attention to the nuances of active vs. passive management? 2019 saw a continuation of a trend established in 2015 where even asset classes favourable towards active management, such as emerging markets, saw higher inflows to passive funds than active. These trends suggest to us that investors are not differentiating enough between asset classes in their decision to go active or passive. Active management can lead to meaningfully higher returns across a wide number of asset classes and in a low return world, investors should leave nothing on the table (see charts on the following page).

Summary of active manager performance to October 2019

% of Funds Outperforming

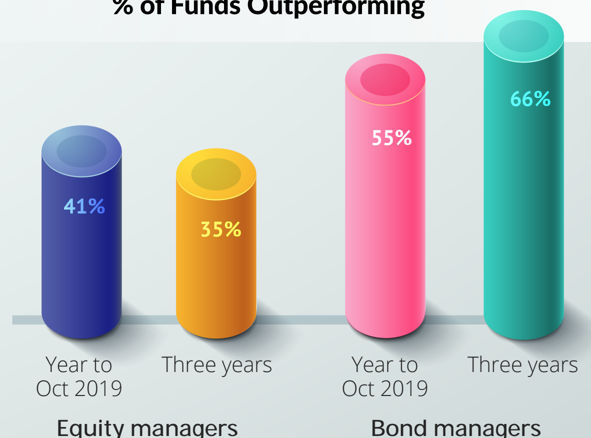
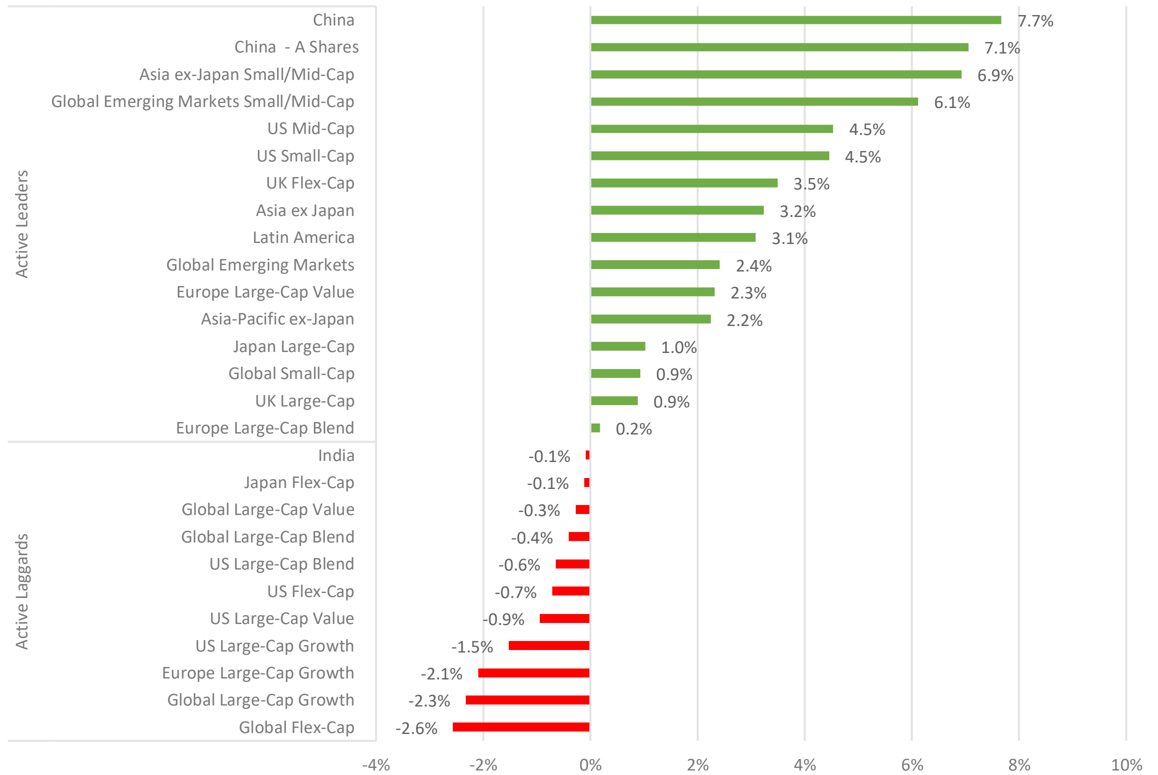
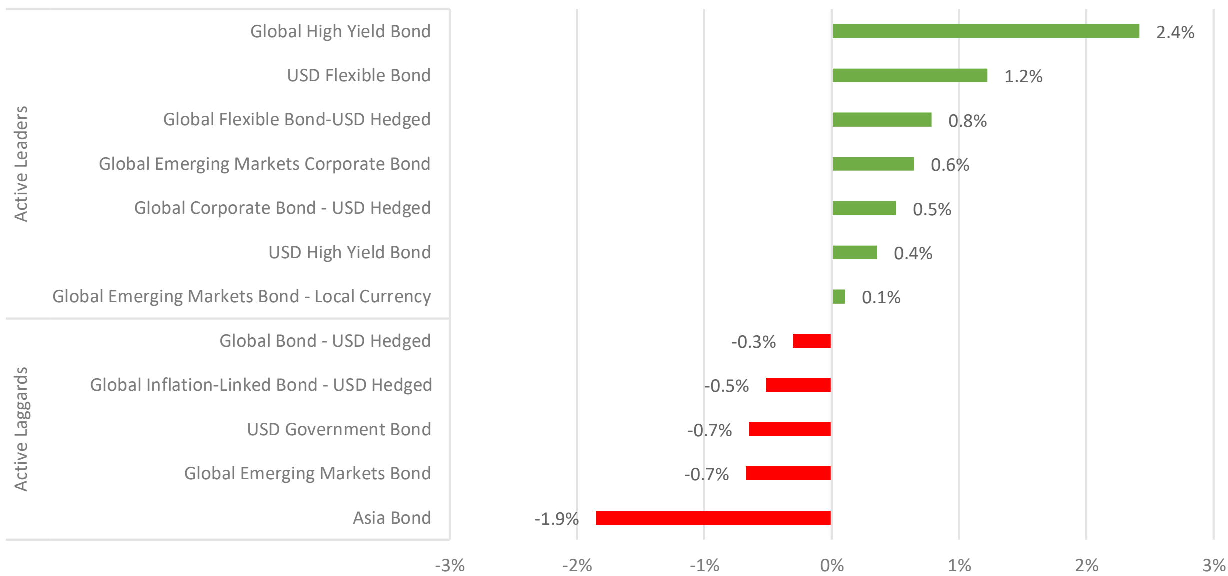


Table 1: Alpha of the Median Manager by Asset Class (2019 to Oct)

Equities



Bonds



Source: Morningstar, for periods ended October 2019. Data represent a customised peer group of funds from the Morningstar Global Investment Fund Sectors. The customised peer group includes those funds with an inception date prior to April 2016 and are not tagged as index funds, or fund of funds.

2019 saw active managers underperform in key asset classes, such as US and Global Equities. However, across many niche asset classes, such as emerging markets and small/mid-cap companies, active managers generated returns above benchmarks for investors. When an investor takes into account the potential for alpha in asset class, they can come to a very different conclusion regarding the attractiveness of an asset class. To illustrate, Chinese equities are only up 12% in the year to October 2019, compared to 19.4% for global equities. Based on this data we would conclude that Chinese equities had a poor year. But when you consider that the median active manager of Chinese equities added 7.7% percentage points of extra return this leads to a very different perspective. We estimate the median active investor in Chinese equities has generated returns of approximately 19.0% (after fees) in 2019 YTD almost the same return as the return from the global equity index.

Key Asset Classes for Active Management in 2020

In 2020 we see the environment continuing to favour active funds in more niche areas of the market. Disruption arising from trade tension, policy uncertainty (e.g. such as that arising from Brexit) and technology will continue to create dispersion across sectors, creating potential for active managers to outperform. Set against these disruptive forces, global monetary policy will be a key variable, particularly for bond investors. Central Bank support may increase correlations across fixed income markets, reducing the opportunity for managers to be rewarded for active bets. Whether growth megacaps such as Alphabet, Microsoft and Facebook continue their strong run of performance in 2020 will also be influential as active managers tend to fare better when performance is more balanced across small, mid and large-cap companies.

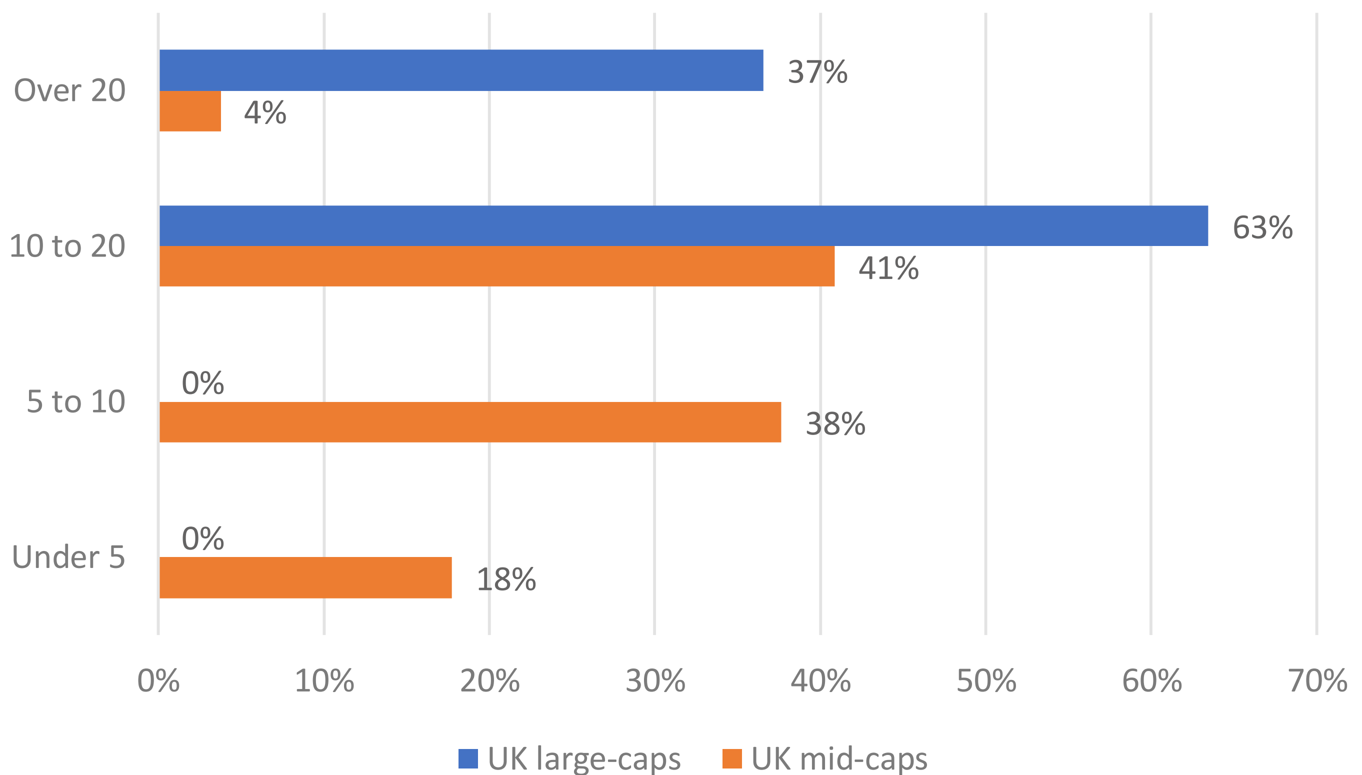
01

We suggest investors adopt an active approach to UK equities in 2020.

Typically, UK equity managers outperform their benchmarks when small and mid-cap segments of the market generate higher returns than large-cap. UK mid and small-caps offer more opportunity for portfolio managers to add value versus the index. The fact that there is less analyst coverage by sell-side analysts (see chart below) and a greater dispersion of returns helps portfolio managers outperform.

Risk to our View: A Hard Brexit or further UK political discord could lead to a change in this view.

Chart 2: Analyst coverage of UK Large-Caps vs. UK Mid-caps



Source: Bloomberg. UK large-caps represents stocks in the FTSE 100, UK mid-caps represents stocks in the FTSE 250.

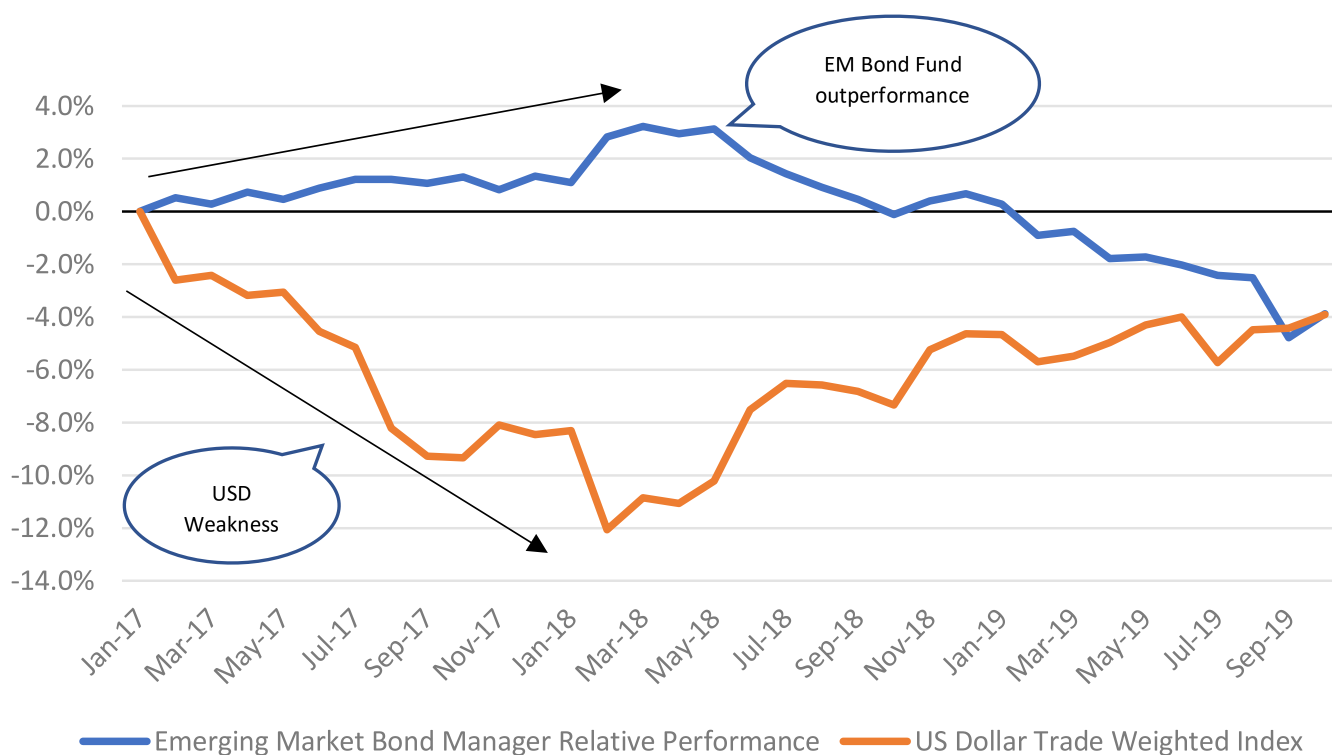
Active management in Emerging Market Hard Currency Bonds

02

Active managers in hard currency emerging market debt should fare better if, as we expect, the US Dollar weakens (or is at least flat) in 2020. Active managers are often overweight "riskier" segments of the emerging hard currency market such as countries which are reliant on external sources of financing (e.g. Turkey or Indonesia) or corporate issuers (rather than sovereign). These segments of the market tend to fare better, when the US Dollar weakens supporting the returns of active emerging market debt managers.

Risk to our view: Positive US economic surprises, or a deterioration in the Trade War could trigger a change in our active vs. passive view on this asset class.

Chart 3: Emerging Market Bond Managers perform better in periods of USD weakness



Source: Morningstar Hard Currency Emerging Market Bond peer group. Relative performance measured against the iShares USD Emerging Market Bond UCITS ETF

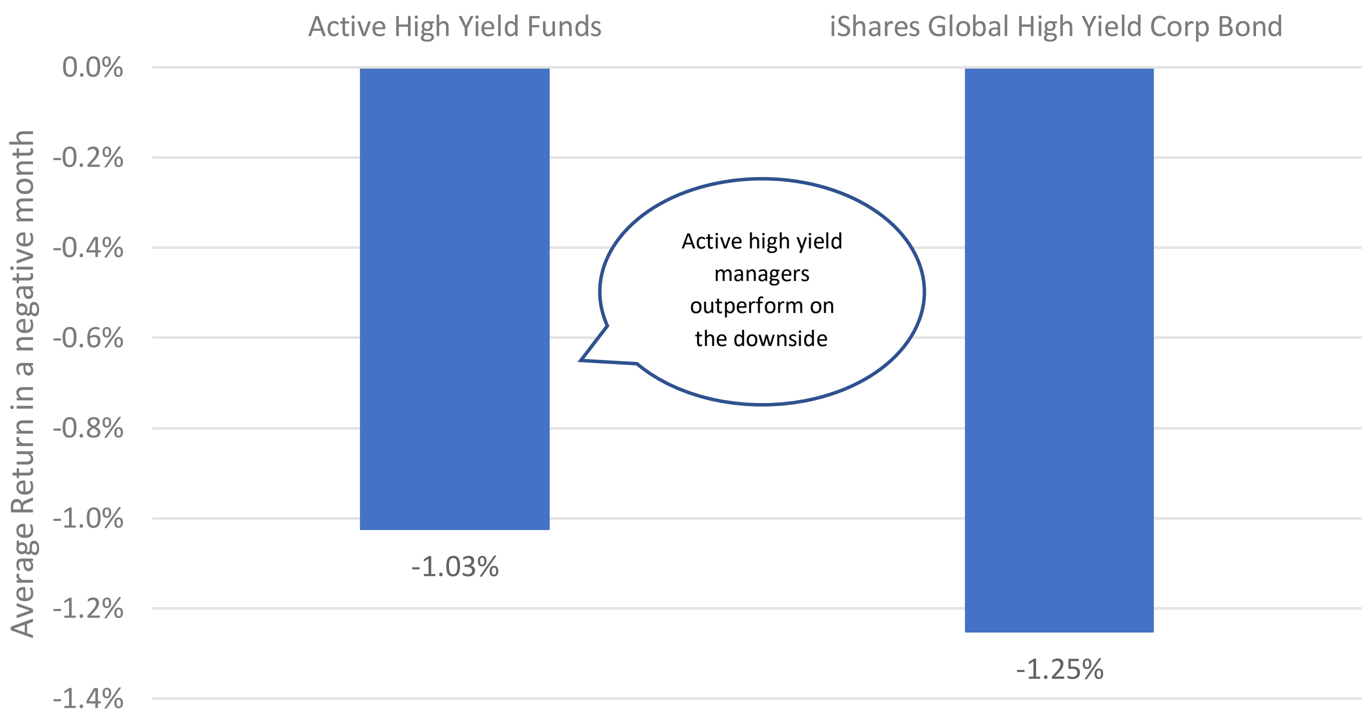
03

High Yield Bonds: Protecting on the downside

In this riskier segment of the global bond market we suggest active strategies, largely due to risk management considerations. Active managers in global high yield tend to fare better in "risk-off" environments characterised by low or negative returns to their underlying asset class. This arises as high yield managers tend to be underweight the very low quality parts of their market (CCC rated debt and lower). We are also conscious that fixed income indices tend to tilt towards the most indebted companies, as when companies issue more debt, they become a larger part of the underlying index. If the global economy does slow in 2020, investors could benefit from holding an active manager with a disciplined approach to evaluating fundamental credit risk, potentially mitigating any increase in defaults.

Risk to our view: Positive economic growth surprises, supporting weaker companies, could change our 2020 outlook for global high yield.

Chart 4: Active vs Passive High Yield in a falling market



Source: Morningstar. Active High Yield Funds measured by Morningstar peer group

Disclaimer

This update has been produced using both internal and external data with the aim to provide information. However, this is not intended to form professional advice nor should LW EH UHOLHG XSRQ VXFK DQ EHIRUH WDNLQJ DQ\ SDUWLFXODU DFWLRQ 6SHFL4F DQG SHUVRQDO advice should be obtained.

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