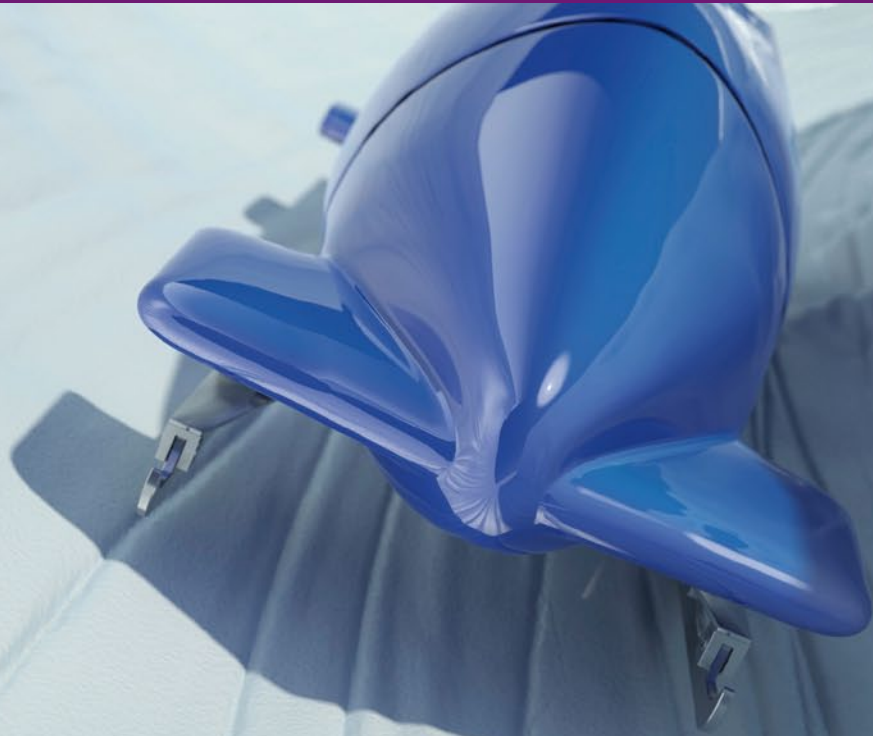


# The Synaptic guide to passive investment





**Justin Urquhart Stewart**

Director  
 Seven Investment Management



**Contact details:**

Telephone: 020 7760 8777  
 Email: [information@7im.co.uk](mailto:information@7im.co.uk)  
 Website: [www.7im.co.uk](http://www.7im.co.uk)

It was Gandhi who demonstrated the power and effectiveness of passive protesting. The active demonstrations and protests may have had all the noise and action, but all too often didn't seem to achieve their goals. Perversely is it not the same with investment? Maybe I am stretching a simile a little too far, but the raucous noises of the active fund managers often seem to hide an astonishing lack of consistency in their performance and more worryingly a level of cost that make many financially questionable.

We have for years been brought up in the world of the macho fund manager (and yes mostly male) who proudly paraded their views as the investment gurus of their day. Often they are referred to as "investors with conviction" – an especially appropriate term for some who have often lost so much of their clients' money.

I am of course being very unfair. There are some extremely talented investment managers who apply their rigour and technique to the best of their ability. However, history shows us clearly that there is no single formula or incantation of the financial warlock which can be applied for guaranteed success – if there was then we all would have done it by now. All we can say is that most fund managers cannot beat their own benchmark most of the time – and especially after their costs are deducted.

All is not lost though. There are some basic elements which we can put more reliance upon to try and fulfil the investment aims of clients.

Firstly there is the issue of broad diversification of investment across a wide range of different asset classes around the globe. This spreads the risk and, if carefully and continuously monitored, can reduce the volatility and risk of the portfolio. History shows that this discipline of asset allocation seems by far and away the largest driver for longer term return – it's not that stock selection and timing are unimportant, but if you are in the wrong asset class to start with then you may well have a fundamental problem.

Secondly – and possibly the greatest benefit for all investors – is compounding. The power of compound returns can make millionaires out of just about anybody – given enough time! We know that roughly a 7% return doubles the value every ten years, so a young fellow with £10,000 with such a return in one of the new Junior ISAs could be a millionaire when he is 70.

However, if we accept that we are in an economic world of lower and slower growth for the foreseeable future, then there is one area which we know will have a considerable impact, and one which we can actually do something about – costs and charges.

# Why Passive is Powerful

Passive investments are a powerful tool, but like all tools need to be understood and used appropriately. In a world with lower and slower growth, they are going to become a very important investment structure for us all in reducing costs and improving asset disciplines.

The investment management industry sadly has had a history of being less than totally open when it comes to its costs and charges. In times of double digit returns few bothered to question such structures: but in leaner times when every percentage point of return is seized upon, then all deductions need to be carefully assessed. To confuse matters, and of course clients, there are various levels from annual management charges, ongoing charges and even the old total expense ratios, and they all have one common factor – they reduce the returns on investments.

To address this, it was the Americans who primarily pioneered the use of passive investing on portfolios mostly to reduce costs – but with the added attraction of trying to keep the active managers honest – on the basis that if they can't beat their benchmark, then you might as well just buy the benchmark. From this came the rise of the passive industry in all its forms from trackers funds to the legion of different Exchange Traded Funds.

From their basic beginnings of just tracking a few large indices, passives have broadened out to cover all the main asset classes for investment such that we can now construct a broadly diversified portfolio almost totally from lower cost passive funds. This does not mean that the role of active managers is dead, but rather that they have to work harder to

justify their extra costs by providing better returns – surely a laudable concept. So whether it is a blend of actives and passives or a wholly passive approach, the choices are unending. But either way investors can start to reduce costs and have a far more precise asset allocation.

However, before we get too carried away, not all passives are the same and certainly not all ETFs. Like any sensible investment, their strengths, weaknesses and suitability all need to be addressed. There are plain "physical" ETFs, backed by the actual stock of the index they are replicating and there are others like "synthetic" ETFs which are supported by a more complicated swap based model.

Passive investments are a powerful tool, but like all tools need to be understood and used appropriately. In a world with lower and slower growth, they are going to become a very important investment structure for us all in reducing costs and improving asset disciplines. They are not a panacea for all investment ills, but rather a powerful and vital medicine which will act to improve all our investment portfolios of whatever size, shape and risk.

# Passive Investing – an abdication of responsibility or the future of Wealth Management?

## Contact details:

Telephone: 08707 360360  
Email: [enquiries@threesixtyservices.co.uk](mailto:enquiries@threesixtyservices.co.uk)  
Website: [www.threesixtyservices.co.uk](http://www.threesixtyservices.co.uk)

IFAs are a disparate lot. 'Herding cats' is a phrase that gets used, which I would accept as a compliment. After all, clients are all different, so why not their IFAs?

One area where these differences emerge is in Investment Strategies and the 'debate' between 'Passive' and 'Active' approaches can sometimes feel like conversations between two different religious sects.

The conversation goes something like this. Passive Advisers point out that 80% or so of Active Managers do not beat the relevant index. Active Advisers retort that so what, they pick the ones that do and Passive investing is just abdication of responsibility and a means overcharging the client. Then costs come into the conversation, with Passive advocates explaining the mantra of reduced cost investing and Actives claiming you get what you pay for, and that Anthony / Neil / this week's star manager is worth paying for and so it goes on.

None of this is helped by the noise of the retail market. 'Buy the top performing fund of the last 20 minutes' screams the headline, whilst newspapers push individual shares based on their guess of the next quarters trading figures and the News At 10 leads with '£200 Billion wiped off Pension Funds'. No wonder it's all confusing and stressful.

At threesixty we see a variety of Investment Philosophies, and a range of methodologies. There are some interesting trends.

- Firstly, without doubt, the definition of 'what are you for' has been severely tested in the last few years, and we are seeing a massive transition from 'to outperform the market' to 'preserve your wealth' and 'meet your objectives'.
- Secondly, but related to this point, is the increasing aversion to having to take moral, as well as compliance, responsibility for the behaviour of Funds and Products. If you make a definitive recommendation of a particular Fund or Fund manager, then there is increased angst when / if it goes wrong. Many IFAs are seeking to outsource this decision to create some distance, so they can be 'on the client's side of the table'. Increased use of model portfolios, DFM's, Fund of Funds and Manager of Managers all reflect this completely understandable trend.
- Thirdly, the continued low returns on equities, coupled with increasing charges on many active funds, together with the need to incorporate Wrap within the business, has put pressure on costs in a way that has not been in place in the past.



John Cromeley ACII FPMI

Head of Technical  
threesixty services LLP

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- Fourthly, the massive increase in IFA costs, ironically partially due to the pickers of 'toxic' funds via the FSCS, coupled with the need for greater client service in times of stress and uncertainty, has led to many firms seeking to migrate from a 50 basis points model towards a 100 basis points model. After all, you do all the work, and take all the risk, so why not get paid for it?

Taken together, the 'Passive' model starts to look attractive. Academically sound, increasingly easy to communicate to clients, can be facilitated via Wraps and the cost savings mean that the move to 100 basis points is relatively painless.

What's not to like? Well, many other contributors to this guide will expand on the theory and detail here, but can we give a few 'heads up' thoughts?

1. Cost saving and Passive are not the same thing. If it's cost savings alone you are after, then perhaps 'institutional / professional' share classes and ETF's will do a similar job?
2. If you are truly adopting a Passive model, then you are adopting the market. In all its ugly splendour, up and down, especially down. So think what you are going to tell clients who want you to move them when the market goes down. Because that's what you did last time.

3. Think whether 'Tactical Overlay' (AKA as market timing) fits a passive model. It may not be clear to clients that it does, and may tend to confuse your message.
4. So if you are not 'picking funds', what will you talk about at the reviews and will you need so many? Quarterly reviews to say 'hold on'? Heaven forbid you talk about the client, not just their money!
5. And most important, how will you educate the clients, hearts and minds, that your value to them is not bound up in 'picking a few funds', but in helping them achieve their life objectives and that your advice to 'do nothing' is valuable advice, backed by years of experience and education and is worth paying for.
6. We are increasingly seeing the agnostic approach of 'Core and Satellite'. Core low cost Passive, with some diversification into other markets / assets using Active funds. This seems a coherent approach, untainted by dogma, and practical. It may be worth a look.

We are sure this guide will be a help to many Advisers. But please, think through the practical implementation process.

# Putting the wheels back on

## Background

An investor investing £100,000 in the average UK Equity mutual fund will generate the following fees over 20 years:

- Annual investment management fees of £750 rising to £1707
- Annual brokerage fees / commissions / custody (trading costs) of £790 rising to £1800
- Trail commission of £500 rising to £1138 p.a.
- Annual platform fees of £250 rising to £570
- Stamp duty of c. £30 p.a. rising to £114 p.a.
- Other fund expenses e.g. fees to FSA, marketing costs, legal fees etc. of £200 rising to £455 p.a.
- Stock lending revenue in the region of £100 rising to £227 p.a.

The investor will see total growth after these costs is £127,695, giving a final value of £227,695.

The effective cost of all the deductions (the difference between the ultimate return with and without costs) amounts to a staggering £159,272.

In this example the funds industry (and associated services) is destroying more wealth (for the investor) than it is creating.

(Source: TCF Investment. Assumptions; Market growth rate of 7% pa, TER of 1.7%, portfolio turnover rate of 61% p.a. (creating 1.1% p.a. trading drag / costs.)

## RDR

The retail distribution review will have a fundamental impact on the advice and investment markets. The shift from product selling to professional advice is turning advisers into true fiduciary agents for their clients. An examination of all costs is growing in importance – from the cost of the investment component, the value of advice and the delivery platform (wrapper) used.

25 years ago the returns on a simple 4 asset portfolio (over the previous 10 years) were around 20%pa before costs while inflation over that same ten year period averaged around 7%. By 2008 the ten year return was closer to 10%pa with inflation close to 2% a year.

25 years ago the impact of 3 or 4% a year of costs and charges was a small portion of the overall returns of the portfolio and inflation was handsomely beaten. Today that gap is much smaller and higher charges may even erode the whole difference between inflation and investment returns...like walking up the down escalator.

Every pound of cost will matter – to advisers and their customers.



David Norman

Joint founder and CEO  
 TCF Investment



In other words, the total cost of holding a retail UK equity fund is c.3% per annum. And of course while this is an average, some investors will experience significantly higher costs.

### Demographics

The past ten years has seen real interest in mutual funds - the latest IMA study shows assets have more than doubled over ten years from £270bn to £580bn. The majority of this growth, both in 2010 and over the longer term (back to 1993), came from new money rather than from market returns.

Data from Lipper show that average total expense ratios have risen on UK retail funds from around 1.5% to 1.7% over the same ten years. This rise shows how little pricing power the investor has been able to exert on the industry. Despite a doubling of assets (mostly through new money) the price has risen – total investment fees have grown at an amazing 9.3% pa. This has occurred even though the total number of funds has remained almost constant. The net effect is that managers are charging more than double the amount in £s to run each fund than they were 10 years ago. Few consumers will see this as good value.

### Greed and complexity

As wealth is created and long term saving becomes increasingly important (but no longer the responsibility of employers), private savers are looking for investment options. This demand creates an inflow of money that drives a culture of 'sell, sell, sell' in the investment management industry, whose fees are charged relative to assets under management rather than on the investor returns it generates –

"big funds are more profitable than good funds". Consequently, managers focus, in an attempt to attract more money, on creating and utilising new and innovative products, whose complexities are harder to grasp by a non-professional, whilst neglecting to provide adequate operational support for these products. This rush to be the first in the market also inhibits operational standardisation in an industry that is highly fragmented.

Inappropriate operational infrastructure in turn creates unnecessary costs in the form of additional staff required to manually support the products throughout their lifetime and invites intermediaries to enter the food chain and provide services, for a fee. The costs accumulate and are then charged to the end investor as managers look to maintain margins. The rapid growth in platforms that, despite advances in technologies, are unable to move assets quickly and inexpensively between one another, are a clear example of this.

On average, UK-based equity funds now make explicit asset management charges of around 1.5% per annum. In addition to this there are other expenses charged directly to the fund that average 0.2% per annum. Trading costs (i.e. the cost of portfolio turnover) add another 1.1%. In other words, the total cost of holding a retail UK equity fund is c.3% per annum. And of course while this is an average, some investors will experience significantly higher costs. Trading costs can easily be over 2% per annum. Evidence of increasing trading activity can be

## About TCF Investments

We believe costs should reduce as funds grow in size – that’s fairer.

We believe that long term asset allocation is the key driver of returns – consistency.

We believe in understanding the detail of all the index funds we invest in – transparency.

We don’t like costs so there are no initial, switch or performance fees on our funds.

And our annual management charge is capped at a maximum of 0.4%pa.

Transparent, consistent and fair – the Total Clarity funds from TCF Investment.

found when the average holding period of US equities is examined. According to the Bank of England, the average holding period fell from seven years in 1940, to 2 years in 1987, and seven months in 2007.

This does not sound like long term investing!

## Confused – you soon will be!

The proportion of shares issued by UK companies owned by individuals has fallen from over 50% in the 1960s to just 10% today. Domestic pension funds, insurance companies, mutual funds and other financial institutions own 40% of UK shares.<sup>1</sup> In other words, only a tenth of the ownership of the UK equity market is not intermediated by a financial institution.

Many of these large organisations have a vested interest in complexity. It ensures they have more and better information about prices and risks than investors, and enables them to extract additional profits from investors by building complex systems of intermediation. They benefit from both a principal-agent problem and asymmetries of information. To put the issue more plainly, investment bankers and fund managers extract substantial fees from the creation and distribution of innovative financial structures, and collect high returns relative to the risks they face.<sup>2</sup>

## The Big Picture

The United Kingdom faces a retirement savings crisis. At 5.4% at the end of last year, the household savings ratio is running at around half the level it did twenty or thirty years ago.<sup>3</sup> At present, personal pensions account for just 4% of the income of all pensioners in the United Kingdom, while occupational pensions account for 25%. In 2009-10, the average weekly income from personal pensions was just £17 a week, against £112 a week from occupational pensions and £186 a week from State benefits. The median weekly income to pensioners from personal pensions was just £42, against £116 from occupational pensions.<sup>4</sup>

The principal investment vehicle used by defined contribution pension plans is equity mutual funds. Historically, the additional return (or risk premium) investors require to prefer investing in equities rather than the risk-free

rate of return offered by government bonds is c.4.5% per annum.<sup>5</sup> The costs currently incurred by the average UK equity mutual fund are c.2.8% per annum. So investors are paying an unavoidable 2.8% annual charge in an effort to capture an uncertain 4.5% return from UK equities. In other words, the investor is left with all of the risk in exchange for a premium that is at best small and which in many cases turns into a discount when equity values fall.

No wonder trust is so hard to build with an industry proposition that breaks down to “the customer takes all the risk and we will take all the return”.

## Summary

Many investors are trying to do the “right thing”. They are investing capital into companies to grow overall wealth and share in it. But they are facing a growing number of rising costs. Their capital is being used and abused by layers of intermediaries between their capital and the market. At every layer a little return is skimmed off, until little or none of the wealth created by their capital remains in their fund / pension pot.

The growing professionalism, fiduciary responsibility and awareness of hidden costs and complexities are rising amongst the planner and adviser community. More and more are concerned about wrapper costs, trading costs and funds costs. Many are using index funds to a far greater extent than ever before. The IMA reports that index funds have doubled their share of total retail assets over the last 12 months – from an admittedly small base.

The professional advice industry is starting to drive the average cost of investing down, which means investors will, on average, keep more of the market returns in the long run. Planners are also building long term plans for customers, which in turn is reducing trading costs, both within funds and at platform level. **By their combined actions, IFAs could well save the nation a fortune.**

## To find out more:

Website: [www.tcfinvestment.com](http://www.tcfinvestment.com)  
 Email: [support@tcfinvestment.com](mailto:support@tcfinvestment.com)  
 Twitter: @tcfDAN

1. ONS, Share Ownership Survey 2008, 27 January 2010. The exact figures at 31 December 2008 are individuals 10.2%, insurance companies 13.4%, pension funds 12.8%, unit trusts 1.8%, investment trusts 1.9%, other financial institutions 10.0%. Foreign investors own 41.5%.
2. Indeed, they are protected by more than limited liability. As the financial crisis proved, intermediaries successfully privatised profits and socialised losses. In the conventional literature, innovation in financial markets is conventionally seen as lowering the cost of capital, reducing risk and making financial intermediation more efficient. Given the excessive returns to intermediaries, and the scale and costs of the recent financial crisis, this no longer seems obvious.
3. ONS, Household sector: use of disposable income account, column NRJS. Data is for Q4 2010, updated 29 March 2011.
4. The Pensioners’ Incomes Series 2009-10, Department for Work and Pensions, page 8 (the balance is derived from state benefits (42%), earnings (20%) and investment income (8%)) and Table 2.1, page 15, and Table 3.7, page 41 and Table 3.8, page 43.
5. Dimson, E. Marsh, P and Staunton, M (2003) Global evidence on the equity risk premium Journal of Applied Corporate Finance Volume 15 Issue 4.

# Due Diligence on passive funds: a 10 point checklist to help select index funds / ETFs

As a growing number of new players enter the passive market and the number of funds being launched escalates, TCF Investment provides 10 questions advisers and planners should consider when looking to invest in an ETF or index fund

## 1. What is the fund benchmark / index?

An obvious question, but the starting point to any due diligence. In order to ensure the fund meets their investment goal and matches their risk profile. Key questions would be: what is the basis of calculation of the index (is it cap/free-float adjusted); how often is it rebalanced; what are the top holdings of the index and how has it performed over various time periods? Indices with similar sounding names can perform very differently. A classic mistake by investors is to assume a commodity index tracks the commodity spot price when in fact many track the futures price which may be very different.

## 2. What is the fund's strategy to track its benchmark?

ETFs are either launched in physical or swap based form. Both types of structures carry their own risks. It is therefore essential to look into whether an ETF holds all of the stocks in the benchmark index (physically backed), partially replicates an index or is swap-based. It is not necessarily true that physical funds are lower risk than synthetic funds.

## 3. What are the fund's investments?

Before investing in an index fund, investors should do their homework on what the fund actually holds in order to avoid any nasty surprises. This should involve reading the product brochure and fund factsheet and looking more generally on the provider's website. For example, a swap based ETF with a UK equity benchmark might have Japanese equities as collateral!

## 4. What counterparty risk does the fund take?

A swap-based fund exposes investors to the risk that a counterparty defaults. The collapse of Lehman's in the financial crisis highlighted the severity of loss for investors when counterparty

defaults. It should be noted that even with the Lehmans and AIG issues, no ETF has yet defaulted.

## 5. What is the fund's policy on securities lending?

Many index funds and ETFs use securities lending to earn extra income for the fund, something which is not always clearly documented to investors. Questions to ask when looking into securities lending are: does the fund lend securities; what indemnities does the lending agent give; how much can it lend and what assets does it accept as collateral? It is not widely appreciated how wide the practice of securities lending is – both within active and passive funds.

## 6. How well does the fund track its benchmark?

An ETF is designed to track a given index as closely as possible. It is therefore important to look at the tracking difference (difference over time between the fund's return and its index). Is the fund doing what it said on the tin? Be careful when comparing tracking errors – this is the short term movement in the fund vs. the index – so a mutual fund that prices at midday will have a higher tracking error compared to an ETF that prices at index close. That's why tracking difference over a longer period can be a better measure. Leverage and inverse funds are path dependent and can deviate substantially from the "naïve" expected return over time – they need closer monitoring but can be useful vehicles for more sophisticated strategies.

## 7. What is the tax position of this fund?

Over the last few months, ETF providers have been scrutinised for failing to make clear the tax implications of investing in an ETF. While ETFs and index funds are commonly domiciled overseas due to technical reasons,

it is important to make sure that the fund is intended for UK retail customers. Investors should also check whether it can be put in a SIPP/ISA and whether it has UK distributor/UK reporting status.

## 8. What protection does the fund give to investors?

The UCITS III rules may provide a minimum level of protection for investors, but is the fund covered by the Financial Services Compensation Scheme (FSCS)?

## 9. Which wrapper and platform providers offer the fund?

Although we are seeing an increase in the number of ETFs available on platforms, it is worth double checking whether you are able to buy the fund on a convenient platform but also what the different charges are for trading if multiple platforms are available. This becomes more important the more often the vehicles are likely to be bought and sold. Dilution levies (most often to cover stamp taxes), bid / offer spreads, depth of market and number of market makers becomes important too.

## 10. Why is the fund the best choice for you?

There will generally be a trade-off between the total cost of ownership and the degree of risk taken by the fund. Institutional index funds typically offer lower costs but do not have the trading flexibility of ETFs for tactical switches etc. Synthetic funds (and others) may have counterparty risks, but with transparency, multiple counterparties and robust custodial arrangements these can be reduced substantially. And some assets are either prohibitively expensive or impossible to track using physical means.

**The bottom line: does the vehicle capture the asset class return accurately, is it low cost and is it safe?**

# Index Investing Doesn't Have To Be Passive

The pure definition of an index tracking strategy is to create a portfolio which mirrors the performance of a specified index. There are, however, many different ways in which this can be done, all of which impact the returns investors receive.

**In the UK we often refer to passively managed funds uniformly as 'trackers' but there are numerous types which follow various indices, employing different strategies, each with varying elements that impact their ultimate performance.**

## Indexation: a low cost alternative

While there is no denying there are good and talented active fund managers who add alpha, many active managers fail to beat the index or their peer groups consistently.

Passive funds provide investors with a low cost alternative to active fund management. Indexation provides a way of reducing both manager and stock selection risk. It also provides greater certainty of return. Knowing you will achieve the market return greatly reduces the risks of significantly underperforming the market.

## A widening choice

In selecting the appropriate passively managed scheme, advisers are now faced with a widening choice. There are many tracker funds to choose from and various components that advisers should understand before making a selection.

There are around 80 collective investment schemes (also known as mutual funds) in the UK retail space that are classified by the Investment Management Association's (IMA) statistics as trackers. The majority of them follow the FTSE 100 or All-Share indices, but there is a growing number that track foreign or specialist indices such as the S&P 500 or smaller companies.

In selecting actively managed funds, advisers assess funds on many levels: from the basics of performance attribution and fees through

to the capability, expertise and talent of the individual manager. Yet even today, passive funds are often judged at a basic level alone and for this reason investors could be missing out. By choosing a fund purely on cost and short-term performance, value can be lost.

## What should advisers be looking for?

Advisers should be carrying out just as much due diligence on passive funds as they would for active investments. There are numerous fundamental aspects which warrant consideration when examining a passive fund: how it handles costs, tracking error target, the size of the fund, as well as the strategy it is employing to achieve replication. With the variety of tracking funds on offer and the different ways in which they are structured, it should not just come down to price.

Today, with the widening universe of index-tracking providers, the debate over price and the looming-presence of the Financial Services Authority's Retail Distribution Review (RDR), there is both pressure and opportunity for advisers to use trackers.

Lower cost, lower risk and lower maintenance equate to lower governance, freeing up time for advisers to spend on other important decisions for their clients.

## Types of index strategies

### Full replication

Some managers aim to fully replicate the index, holding every stock that the index does at the appropriate weightings. When the index undergoes change, so too does the fund. This approach seeks to reduce tracking error.

Advisers should be carrying out just as much due diligence on passive funds as they would for active investments. There are numerous fundamental aspects which warrant examining a passive fund

#### Stratified Sampling

Rather than attempt to hold all of an index's stocks at the exact weighting, some passive providers replicate by holding 'representative stocks'. Shares are selected by dividing the index into sub-groups, such as sectors, with representatives taken from each. This method can be done via

computer-based models. However, unlike other strategies it does tend to have greater human interaction in the selection of the 'representative' stocks.

#### Optimisation

This is the 'black-box' technique most associated with passive strategies. Managers use computer or statistical models to make buying and selling decisions. The mathematical models used in this approach are based on historical data from which a portfolio is computed that aims to move in line with the chosen index.

#### Derivatives (Futures/Swaps)

Funds can use derivatives to obtain exposure to the index rather than buy the shares. Some Exchange Traded Funds (ETFs) are a good example of this, not holding the physical stock at all. Like trackers, passive ETFs aim to mimic the performance of a particular market or index, but the vehicles themselves are traded like individual stocks, unlike passive mutual funds which follow the rules and regulations of collective investment schemes.

As with any investment strategy, there are variations and combinations on these broad classifications of passive styles, and some managers seek to enhance the base concept to demonstrate added value. For instance, a manager can aim to fully replicate but can also use stratified sampling when it is efficient and cost-effective to do so.

#### Our approach to replication

At Legal & General we aim to hold every stock in the index, whilst being mindful of the cost involved in doing so. We are pragmatic replicators. There are times when we use stratified sampling, but we take the decision based on the size of the fund and the structure of the index we are following. If a fund is large then it pays to hold as many names in the index as possible. Conversely, if it is a small or emerging index, we may use sampling, as liquidity in the underlying stocks may be poor.

Our size and methodology have enabled us to become one of the biggest providers of index-tracking investments in the UK, managing £232 billion as at 30 June 2011.

This is not a consumer advertisement. It is intended for professional financial advisers and should not be relied upon by private investors or any other persons.

Past performance is not a guide to future performance. Investments of this type and any income from them may rise and fall in value and are not guaranteed. Investors may get back less than they invest. Details of the specific and general risks associated with our retail range of index-tracking funds are contained within the Simplified Prospectus.

# Passive investing/ index funds

The number of investment houses offering 'passive' investment vehicles, also known as index-tracking funds, has grown substantially over the last decade. Once seen more as novelties, the benefits of these funds has become clearer particularly for private investors, who may be less willing to pay the fees charged on active management. Here, we will examine these advantages and assess whether passive investment is a viable option, particularly amid today's volatile markets. First, however, we will take a brief look at what distinguishes passive investing from its active counterpart.

## What is passive investing?

In essence, passive management entails following an investment strategy that tracks and so aims to match the performance of a predetermined index – the FTSE All-Share, for example. Unlike some active managers, who seek to make short-term gains from market movements and perceived inefficiencies, passive managers instead invest with the intention of capturing long-term gains while ensuring limited maintenance.

## The benefits of passive over active management

Although there is widespread disagreement over the relative merits of active and passive investing, the rationale behind the latter can be encapsulated in a small number of concepts derived from financial economic theory. Advocates of indexing point to the following:

First of all, in the long run, the average investor should enjoy average performance i.e. returns should equal the market average. This is before management costs are deducted. The higher the fees, the lower the post-cost performance will be. Champions of passive investing argue that the average investor will likely benefit more from reducing investment costs than trying to beat the average performance through active investing.

On a more technical level, adherents of passive investing cite the efficient-market hypothesis (EMH). This states that equilibrium market prices must fully reflect all available information. This assumption seems to imply that it is impossible for an investor to outperform the market on a consistent basis

## HSBC Index Tracking Funds

HSBC has been prominent in the field of index-tracking vehicles for over two decades. The combination of strong ratings, a broad product and competitive pricing help HSBC stand out in the market.

Fund Name	Benchmark	AMC (%)	TER (%)*	Rating
HSBC FTSE 100 Index	FTSE 100 Index	0.25	0.27	AAA Standard and Poors
HSBC FTSE 250 Index	FTSE 250 Index	0.25	0.27	AAA Standard and Poors
HSBC FTSE All Share Index	FTSE All-Share Index	0.25	0.27	AAA Standard and Poors
HSBC American Index	S&P 500 Composite	0.25	0.28	AAA Standard and Poors
HSBC European Index	FTSE World Europe Ex. UK	0.25	0.31	AAA Standard and Poors
HSBC Japan Index	FTSE World Japan Index	0.25	0.29	AAA Standard and Poors
HSBC Pacific Index	FTSE World Pacific Ex. Japan Index	0.25	0.37	AAA Standard and Poors
HSBC UK Gilt Index	FTSE British Government All Stocks Total Return Index	0.25	0.26**	New Fund N/A

\* As at 15 May 2011

\*\* Estimated

Source: HSBC Global Asset Management (UK) Ltd.

What seems evident is that, in the absence of definitive comparative performance data, passive management has two clear advantages. One, the lower fees charged on passive vehicles and, two, the preference for investments with a longer time horizon.

via active management. Active management proponents counter-argue, however, that this is not a correct interpretation of the hypothesis. In fact, there are several interpretations of EMH, which itself has a number of variations. The argument remains unsettled and furthermore in the realms of theory.

Remaining in the world of financial theory, the famous capital asset pricing model (CAPM) implies that, in equilibrium, all investors will hold a mixture of the 'market portfolio' and a 'riskless' asset. That is, under suitable conditions, a fund indexed to the market would be the only one investors need. However, CAPM relies on perhaps unrealistic assumptions, with active management supporters pointing out that these are far from the real experience of investing in which markets may not be in 'equilibrium' at all.

Perhaps a more intuitive argument lies with what is called the 'principal-agent' problem. The argument for passive management is that an investor (here the principal) who hands over money to a portfolio manager (in this case the agent) must provide clear incentives to the latter to run the portfolio in accordance with the former's risk-return profile, and must also monitor the manager's performance. This is costly for the principal both in terms of time and money. Passive investing does not require these efforts.

What seems evident is that, in the absence of definitive comparative performance data, passive management has two clear advantages. One, the lower fees charged on passive vehicles and, two, the preference for investments with a longer time horizon. Given the current environment of high volatility across global financial markets, a longer-term approach to

investing, one that seeks to ride out the ups and downs of market movements, can have its benefits.

### The proof of the pudding?

Of course, it could be argued that the only way to compare active and passive funds is to look at their relative performance. At this moment, the evidence seems to favour passive management, as a number of studies have shown that most actively managed mutual funds underperform the market and that those that did outperform were not able to maintain this over subsequent periods of time. Yet, the question has not been fully answered. Over what time periods should comparisons be made? Also, some active managers do considerably better than others and so achieving outperformance may be more a case of finding the right investment house rather than choosing between active and passive strategies.

Nonetheless, in light of the trouble besetting global stock markets today, and with ECB President Jean-Claude Trichet having called for reforms to reduce short-termism in financial markets, the case for index trackers looks strong. Though current equity market performance has struggled, this may not be the case in the longer term. An all-bond allocation is also unlikely to lead to strong long-term returns. Furthermore, investing in equity trackers helps provide a degree of portfolio diversification, crucial in the current volatile environment. Today, HSBC offers a range of index funds, allowing private investors to access equity markets with a longer-term view but without entailing high costs.

**Our funds are available through all major third party panels and platforms.**

For further information call **0845 602 6908** or visit [www.assetmanagement.hsbc.com/indextrackers](http://www.assetmanagement.hsbc.com/indextrackers)

# Why costs matter so much

**To understand why costs matter so much, it's worth returning to some fundamental truths of investing. The eventual net return on a given investment is made up of the gross return on the investment, less any taxes and charges.**

The long-term impact of charges can be substantial. To really illustrate what that means, let's take an example, assuming neutral growth so that the full effects of charges can be seen clearly. In our example one product has a 2% annual charge, the other has 0.25%. One's 98%; 98 out of 100, which sounds pretty good; the other, 99.8 out of 100, even better.

If you got those marks in exams, you'd be really happy, but 2% compounded over 20 years is roughly a third of your money so that 35% would disappear in charges. The person who's paying 0.2% is only going to lose 4%. At the end of 20 years it's not 98% versus 99%. It's now 65% against 96%. So the magic of compounding we all learn about when we're talking about interest payments becomes a curse if it's a charge.

## **Cost should be low**

Because costs matter so much, we believe they should be low, straightforward and as transparent as possible. How low? Vanguard's UK index fund charges range from 0.15% to 0.55%. The average fund management charge in the UK\* is considerably more at about 1.4%.

## **Costs should be straightforward**

In the UK we have two ways of expressing this charge. There is the Annual Management Charge (AMC) and there is the Total Expense Ratio (TER). The Total Expense Ratio, which isn't really 'total' at all. Many firms only advertise their AMCs, squirreling away the TER in documentation. As a result, investors

tend to miss the difference. At Vanguard, we aim to ensure that our AMC equals our TER, so if we say it's 0.25%, we mean it.

## **Costs should be transparent**

The cost of investing includes a number of hidden charges, which is why the 'Total' Expense Ratio isn't the full story. Most of those charges come out of the fund and don't have to be disclosed by the fund manager. At Vanguard we try to take a fair approach wherever practical.

Where there are costs that we can attribute to a particular investor, say an investor coming into a fund, there may be taxes or dealing costs to pay. As far as practical we charge those to that investor so that other investors aren't disadvantaged.

A particular example of that is the 0.50% Stamp Duty Reserve Tax that goes to Her Majesty's Revenue and Customs on the purchase of all UK equities. We think it's fair for that investor to pay their own tax, rather than charge it to all the other investors in the fund, so we collect it from the incoming investor, rather than taking it from the fund itself, which is the industry norm.

## **The importance of competition**

No doubt the recent announcements from several fund providers of low-cost fund launches and lowered charges has come as a result of increasing competition and awareness of the importance of costs on behalf of investors. We think these developments are good for the industry and good for investors.

We would obviously like people to invest with Vanguard than elsewhere, but we would rather see investors paying a fair price for their investments no matter where they choose to invest. So we welcome others reducing their charges because it's a great development for UK investors.

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\*Source, Morningstar Direct, as at 31 August 2011



The Total Expense Ratio, which isn't really 'total' at all. Many firms only advertise their AMCs, squirreling away the TER in documentation.



# A Passive Approach Towards A Low-Carbon Economy

The global transition to a low carbon economy has rapidly moved up the political and social agenda in recent years, creating a huge investment opportunity.

Alongside the need for reducing emissions, there is a simultaneous drive to make more efficient use of existing energy supplies and a growing number of companies are profiting from the provision of services and technology for these rapidly developing areas.

## Rising investment in clean energy projects

The severity of world climate change has already led to total global investment in clean energy projects of \$243 billion in 2010, a rise of 30% from 2009. However, much more is required over the coming decades. According to Mercer's Climate Change Scenarios report (2011), cumulative investment in efficiency improvements and the low-carbon energy market could be worth as much as \$5 trillion by 2030. This means that companies exposed to low-carbon energy, resource efficiency or waste and water management all stand to benefit from increased investment. In fact, companies are already making serious money in this industry, with climate change related revenues more than tripling between 2004 and 2009 according to an HSBC report.

## A global megatrend

Underlying this global megatrend are the twin factors of population growth and a finite supply of natural resources. More people in the world means greater demand for energy and water, particularly as a developing middle class in emerging economies is demanding higher living standards. This is having a major environmental impact and depleting finite natural resources, which in turn is driving improvements in efficient usage – including waste recycling – as well as sourcing energy from alternative technologies.

Take water as an example. Within this sector alone population growth is putting increasing pressure on what most people assume is an infinite supply. However, it is worth considering just 2.5% of the world's available water is fresh and of this, 75% is locked in the polar ice caps and nearly 25% is underground.

At present, around 2.4 billion people, over a third of the world's population, live in so-called water-stressed countries. By 2025, that percentage is expected to rise to two thirds. With only about 0.01% of the world's total freshwater resources readily available, any technology promoting efficient use for domestic, agricultural or industrial production is likely to be highly valued.

Initiatives by the Chinese government provide a good example of the momentum in this area. According to International Energy Agency (IEA) figures, China is expected to account for more than 20% of the world's energy demand by 2035. Yet it is taking steps to address the situation, recently announcing that future development must be achieved in a more environmentally efficient manner. For example, it is looking to reduce water usage by 30%.

Developed nations also have just as many issues that require investment. For instance, the Environment Protection Agency forecasts the need for a further \$500 billion investment in US drinking water and waste water infrastructure over the next 20 years.

## An opportunity for investors

There are a growing number of funds giving investors access to this story – from broad, actively managed funds to specialist funds in water or alternative energy sectors.



With the broad and ever-widening universe of these companies, passive funds are becoming an increasingly attractive option. Many investors are choosing to harness the growth of the low-carbon theme without the risk and bias of an active fund.

Certainly the story is not just about 'alternative technologies' like solar and wind-generated power or any other singular industry, it's much bigger than that. To capture the theme's full potential, investors need a fund that is diversified across a broad array of sectors, and that concentrates on companies within those sectors whose success is driven primarily by their delivery of products and services that aid the transition to a low-carbon world.

#### Why choose the passive option?

With the broad and ever-widening universe of these companies, passive funds are becoming an increasingly attractive option. Many investors are choosing to harness the growth of the low-carbon theme without the risk and bias of an active fund.

The method of passive management is therefore an important factor in investors' choice. Traditional index screens such as market capitalisation, or negative filtering of companies on the basis of pollutive or extractive activities, do not capture the full upside of pure low-carbon enterprises.

The ideal solution, we believe, is a passive fund which selects companies whose revenue and share price are specifically driven by

low-carbon activities. Only companies that understand these trends and provide products and services to shape a low-carbon world, will truly harness the power of this world-changing theme for investors.

#### Legal & General Global Environmental Enterprises Fund

The Global Environmental Enterprises Fund is based on the constituents of the Osmosis Climate Solutions Index, made up of companies generating more than 50% of their revenues from the transition to a low-carbon economy.

Our passive investment fund is not focused on one or two key themes in this area, nor is it devoted to limited areas like solar or wind power technologies. We strive to have a broad portfolio of companies involved in all aspects of this low-carbon transition, focusing on energy and resource efficiencies, water and waste management and pollution control, as well as energy alternatives.

We believe the greatest investment gains will come from companies that understand the global shift to a low-carbon economy and are providing scalable, viable products and services that make the transition an efficient one.

To find out more about  
Legal & General's Global  
Environmental Enterprises Fund:

Broker desk: 0845 070 8684  
fundsales@lgim.co.uk  
[www.landginvestments.com/bright](http://www.landginvestments.com/bright)

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Investments of this type and any income from them may rise and fall in value and are not guaranteed. Investors may get back less than they invest. The fund invests in companies in a specialist area. In addition, some of these investments will be smaller companies or companies from emerging markets. This means that the fund is higher risk than other more general equity funds. The fund invests overseas and changes in exchange rates between currencies may cause the value of your investment and the level of income from it to fall as well as rise. Details of the specific and general risks associated with this fund are contained within the Simplified Prospectus.

# The case for active management

The debate over whether an investor is better off selecting an active or a passive investment is still very much alive. It is particularly pertinent in these highly volatile times, with markets swinging up and down like a yoyo.

Graeme Abell

Director of Nationals and Networks  
M&G Investments

**A good active fund manager can often be prepared for market disruptions through the considered positioning of their portfolio, or at least react quickly when they occur. In contrast, passive investors must blindly follow the market up or down.**

Passive investors, through index 'tracker' funds or exchange-traded funds, are tied to stock and sector weightings determined by an index. Called 'passive' because no thinking is required, they aim simply to track the performance of an index. They provide a cheap and easy way of investing in the stockmarket, and with no risk of seriously underperforming the market. But so, too, there is little potential for passive funds to outperform the market either – in good times, or bad.

### Increasingly volatile markets

Markets are becoming increasingly volatile as investor sentiment can swing wildly between optimism and pessimism at each release of news. Passive investors are forced to hold the few large stocks and sectors that dominate market indices. For example, in June 2011 over half the FTSE 100 Index was concentrated in just three sectors – financials, oil & gas and basic materials (source: FTSE Group, as at 30 June 2011). This can sometimes lead to the heaviest losses, such as those from the banks that weighed heavily on the FTSE 100 Index during the global banking crisis in 2008.

It can also be very expensive for passive investors when the index rebalances, as trackers

are forced to sell departing stocks (at their cheapest), and to buy those that are entering (at their most expensive).

In contrast, actively managed funds have the flexibility to invest away from the index; and, from the start, are better able to diversify risk as they can invest across sectors and company sizes. Furthermore, they can safeguard a portfolio by nimbly moving out of riskier stocks and into safer ones as market conditions deteriorate. In the same way, they can react immediately to investment opportunities, for example, buying good value companies when everyone else is selling. They can then hold these for as long as necessary – until market sentiment improves and the stocks achieve their potential.

### Independent thinking

In the current environment of heightened risk aversion and low cash returns, it is even more important to seek out relatively safe, well-financed companies with good growth prospects. This is where the judgment and expertise of a good fund manager comes into play, particularly one who has experience of seeing many types of market conditions. Those that are backed by their own dedicated research teams enjoy a further competitive edge.

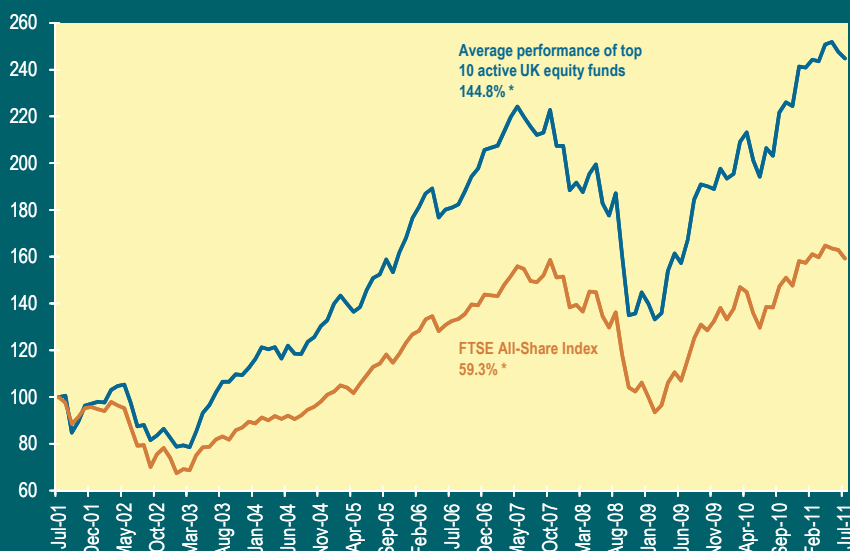
There is much made of the higher cost of investing in active funds. However, the key to substantially higher returns over the long term is independent thinking – informed, rational decision-making about companies and

## UK equity funds: active fund returns

Source: Morningstar, Inc. IMA UK All Companies sector as at 29 July 2011. Figures in GBP, bid to bid, net income reinvested.

Average of top-10 performing active funds is based on the 10 funds in the sector which have delivered the highest cumulative returns over the 10-year period.

\*Cumulative performance figures.



By choosing the right active fund manager, the gains made can generally far outweigh the costs. Take the top-10 active funds in the IMA UK All Companies sector over the past 10 years. As the chart shows, these funds have hugely outperformed the FTSE All-Share Index

their prospects. Higher management fees are required to pay for the additional expertise and resources needed for active managers to make these informed decisions. This enables them to spot inefficiencies in the market and to help protect the value of investments during downturns.

By choosing the right active fund manager, the gains made can generally far outweigh the costs. Take the top-10 active funds in the IMA UK All Companies sector over the past 10 years. As the chart shows, these funds have hugely outperformed the FTSE All-Share Index, returning 145% on average compared with 59% from the index.

As the developed world faces lower-growth prospects for the immediate future, investors need to consider carefully the various risks and potential returns of investing. Active managers can look at the bigger picture to decide which key themes and structural shifts in economies or consumer behaviour have the most investment potential. For example, they can focus on the fastest-growing parts of the world, like China and India, and invest in those companies best placed to benefit from these developments.

Also, an active investor can choose from many management styles and strategies. By picking an active fund they can set their own objectives that best reflect their investment goals and tolerance to risk. They can invest for capital growth or for a steady income; or for value; or take a contrarian approach – for

example, buying companies when everyone else is selling, and selling when others are buying. Some investors want steady, secure returns by investing in low-risk high-quality companies; others are happy to take on more risk for higher returns; some are simply looking to diversify their portfolio by investing in a wide range of companies.

### Excellent investment opportunities

The uncertainties in the global economy that we currently face – Europe's sovereign debt crisis, the size of the US deficit, slowing economic growth in the developed world – are not issues that have immediate solutions. However, indiscriminate selling in the equity markets is creating some excellent investment opportunities for active funds that, unlike passive ones, can focus on the long-term fundamentals of individual companies rather than on the volatile swings in short-term market sentiment.

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