Manager versus Machine

Active and passive funds compared

H1 2023

The active versus passive battle is increasingly being won by tracker funds, if the investment industry's fund flows are anything to go by. New analysis from AJ Bell shows why this might be the case; only 38% of active equity funds have outperformed a passive comparator over the last ten years, which isn't exactly a great sales pitch for active funds. However, there are long-running market trends which provide some mitigation for active managers, and it's important to come to measured conclusions about the benefits and drawbacks of choosing active managers. Both active and passive strategies have strengths and weaknesses, and are tools that can be happily used alongside each other in the same portfolio.

Key points

- **In the first half of this year 44% of active equity funds outperformed a passive alternative**
  - That's a lot better than 2022, when only 27% of active equity funds beat the typical passive alternative
  - Over the last ten years only 38% of active managers have beaten the passive machines
- **The popular global sector continues to disappoint**
  - Only a third of global active funds have managed to beat a passive competitor in the first half of 2023
  - The longer term figures are even worse, with only 22% of active funds in this sector outperforming over 10 years
- **Much needed improvement in UK equity funds**
  - Half (49%) of UK equity funds have beaten the passive machines in the first half of this year, a much better showing than the 13% who outperformed in 2022
- **Time to shine for Global Emerging Markets managers**
  - Three quarters (77%) of managers in this sector have beaten the passive machines so far in 2023
- **Mind the passive charge gap**
  - After 10 years, a £10,000 investment in one of the most expensive UK tracker funds is today worth £1,660 less than the same amount invested in the cheapest tracker

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Summary

Our Manager versus Machine report looks at active funds in seven key equity sectors and compares performance to the average passive fund in each sector, rather than a benchmark index. This provides a real world comparison, reflecting the practical investment choice that retail investors face, between active and passive funds. While benchmark indices are also useful comparators for active funds, investors can't buy an index; tracker funds are the nearest they can get.

The first half of this year has been much better for active managers than 2022. Last year, just 27% of active managers in our sample outperformed the typical passive fund in their sector. This year that has risen to 44%, around what you might expect as a 'neutral' outcome, allowing for the fact that the market return is in large part dictated by the activity of active managers, and so there will always be a proportion of underperformers in the mix. A big swing factor has been an improvement in fortunes for active managers in the UK, who last year endured an annus horribilis in which only 13% managed to beat a passive alternative. So far this year, that figure sits at a more comfortable 49%.

The most disappointing performance from active managers so far this year comes from the global equity sector, which happens to be the most popular investment destination with UK fund investors, and where only a third of active managers managed to beat a passive alternative in the first half of 2023. Things look even worse over a ten year horizon, where just over a fifth (22%) of active funds have beaten the passive machines. The same goes for performance from US fund returns over the last decade. On the flip side, active managers in the Global Emerging Markets sector will have a bit of spring in their step, seeing as 77% have beaten a comparative index tracker this year so far, though absolute returns have been weak.

Table 1. Percentage of active funds outperforming a passive alternative

	H1 2023	5 years	10 years	2022
Asia Pacific Ex Japan	51%	26%	39%	12%
Europe Ex UK	35%	29%	46%	43%
Global	33%	22%	22%	30%
Global Emerging Markets	77%	56%	53%	21%
Japan	34%	33%	60%	36%
North America	43%	15%	22%	40%
UK	49%	26%	50%	13%
TOTAL	**44%**	**27%**	**38%**	**27%**

Sources: AJ Bell, Morningstar, total return in GBP to 30th June 2023, 2022 data to 30th Nov 2022

Equity fund performance H1 2023

Both active and passive investors will welcome a bounceback for equity fund performance in the first half of this year, after a washout in 2022. The average fund in all regions has posted positive returns, with the exception of the Asia Pacific Ex-Japan sector. Returns have been particularly strong amongst North American funds, thanks to a resurgence in the US stock market, driven by confidence returning to the technology sector. This has also helped buoy returns in the global sector, where funds carry a high exposure to US equities. The UK is unfortunately a laggard in terms of developed markets, but at least a 2.1% return from the average fund is still in positive territory.

Looking back over ten years we can see some of the performance trends apparent in the first half of 2023 have deep roots. Emerging markets funds have failed to provide the superior returns investors would expect from their higher risk profile in both the short and long term. The UK has been towards the bottom of the performance table too, which may well explain the billions being withdrawn from funds in this sector every year, though there is something of the chicken and the egg about this dynamic. Meanwhile returns have been spectacular from the North

Table 2. Fund sector returns H1 2023

	2023 H1 Total Return %			
	Active top quartile	Active average	Active bottom quartile	Passive average
Asia Pacific Ex Japan	-0.3	-2.3	-4.7	-2.3
Europe Ex UK	9.3	7.7	5.7	8.5
Global	9.5	6.1	4.0	8.4
Global Emerging Markets	2.5	0.6	-0.8	-1.0
Japan	7.9	5.7	2.5	7.3
North America	13.5	9.2	5.0	9.9
UK	4.0	2.1	0.1	2.2

Sources: AJ Bell, Morningstar total return in GBP

Table 3. Fund sector returns over 10 years

	10 Year Total Return %			
	Active top quartile	Active average	Active bottom quartile	Passive average
Asia Pacific Ex Japan	118.1	93.9	73.8	103.3
Europe Ex UK	143.8	128.8	112.7	131.2
Global	189.5	155.3	118.8	195.1
Global Emerging Markets	80.8	61.5	45.9	60.1
Japan	120.5	104.0	88.0	99.2
North America	276.4	239.4	202.8	277.8
UK	88.7	74.3	56.8	74.5

Sources: AJ Bell, Morningstar total return in GBP

American sector, with investors in the average fund more than trebling their money in ten years. The underlying performance from US shares has had a positive knock-on impact on global fund returns too.

Indeed, investors in active North America and Global funds might not be too miffed that their fund managers aren't measuring up to a passive alternative, because fat returns from these markets have lined their pockets till they bulge. Even a bottom quartile North American fund has beaten the average fund in all other sectors, and has even wiped the floor with top quartile UK funds. This goes to show returns in the last ten years have not primarily been driven by whether you invest actively or passively, but rather where in the world you chose to put your money.

What these figures also show, is that if you are able to pick better performing funds, especially in the top quartile, then you have a good chance of beating a tracker. There is, of course, no sure-fire way to do this. But investors can tilt the odds in their favour by doing some research and weeding out some of the dross. One of the most important things to look for when picking an active manager is their performance track record. This isn't a guarantee of superior returns going forward, but the longer an active manager has been able to showcase outperformance, the more this is likely to be a result of skill, rather than luck.

The Global DUD farm

The global fund sector plays an outsized role in the poor overall showing from active managers, simply because of the sheer number of funds in this sector. If fund managers in this area were pulling their weight, rather than just 22% of them outperforming over ten years, the overall proportion of active managers beating a passive alternative would be nudging up to a more respectable 50%. It's easy to look at poor performance in this sector and conclude that most global fund managers don't have a clue what they're doing, but there are some mitigating factors which go a long way to explaining why these active funds haven't prospered compared to passive competitors over the last ten years.

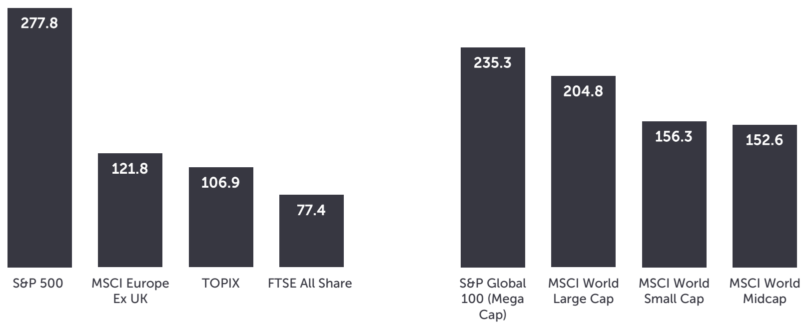
In particular, the global stock market over the last decade has been characterised by two long-running trends which have favoured a passive way of investing. Namely the dominance of both US stocks and large cap stocks, as Chart 1 shows.

Global fund managers have continually been underweight these two winning areas compared to their passive peers, as Chart 2 shows. Outperformance from these market segments has therefore boosted global passive funds relative to their active competitors, rather than it simply being a case that active managers are hopeless at picking good stocks for long term investment.

Well-rehearsed passive evangelists might object that picking the right markets, sectors and cap size is part and parcel of the job of fund management, so missing out on some measure of US and large cap returns is still a failure of active managers. However that is not how most equity fund managers think about their role. The majority will tell you that they are 'bottom up' stock pickers, rather than macro-economic forecasters. That is to say, the skill they bring to the table is picking good companies, wherever in the world they might be.

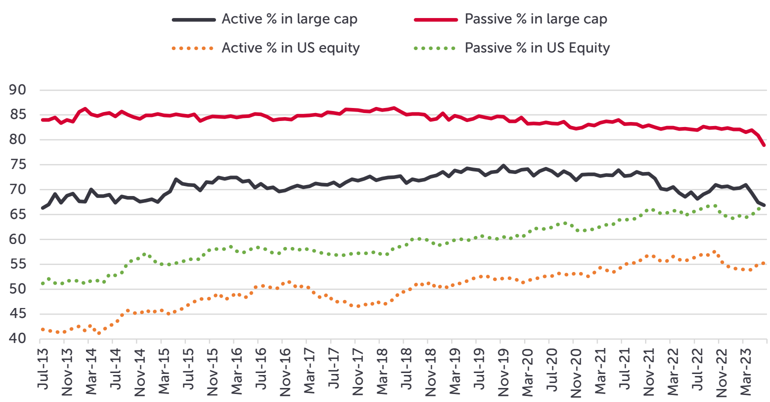
Equity fund managers therefore typically try to play to their strengths by focusing efforts on stock selection, and maintaining some kind of balance in regional, sector and cap exposures is usually part of the ancillary practices of portfolio construction and risk management. Picking stocks primarily on their individual merits rather than location will often lead managers to have a portfolio that has a different regional make up to the global benchmark indices that tracker funds follow, sometimes drastically so. Managers also tend to invest further down the cap scale than the market at large, because they're more likely to unearth hidden opportunities in paths less well trodden.

Chart 1. Global market returns dissected



Source: Morningstar total return in GBP

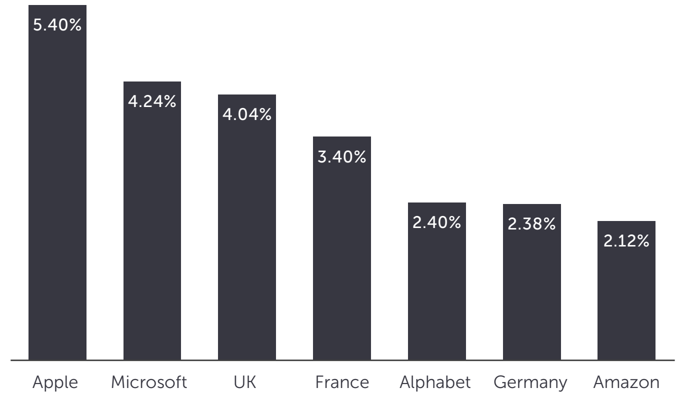
Chart 2. Average active and passive allocations



Source: AJ Bell, Morningstar

Active managers running an underweight position in US equities could also legitimately make the case that having two thirds of a global fund invested in one region is not entirely prudent from the point of view of risk management in absolute terms (as opposed to relative to the benchmark index). This is the situation global tracker funds now find themselves in thanks to the growing share of global market capitalisation made up by the US stock market (see Chart 2). If the US goes through a sustained period of underperformance relative to other markets, that will have a large impact on funds which have slavishly followed the regional allocation of the MSCI World Index. It's not even the US stock market as a whole which presents such a risk, but individual stocks within it. There are now a cluster of large technology companies which make up a larger proportion of the global stock market than European stock exchanges that have been around for centuries. As things stand today, Apple and Microsoft each individually matter more to the performance of the MSCI World Index than the entire UK stock market.

Chart 3. Tech titans' grip on global markets

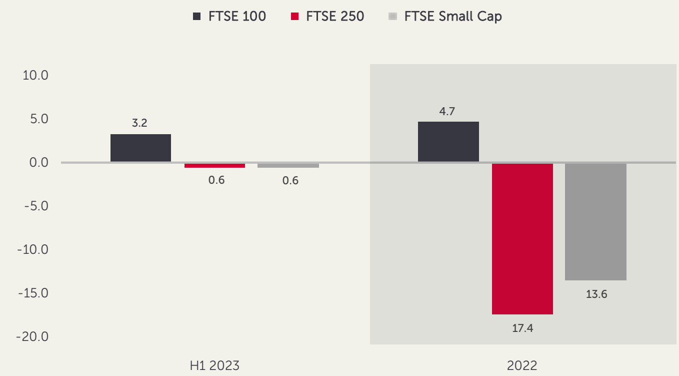


Source: MSCI, Blackrock

UK active funds back on track

This year has been much kinder to UK fund managers than 2022, so far, at least. Last year only 13% of active managers outperformed a passive tracker. This year that number has jumped back up to a much more respectable 49%. The major factor in the turnaround has been the better performance of small and mid cap indices compared to large caps. Based on portfolios at the beginning of 2022, 94% of UK active managers were overweight small and mid caps. UK active managers tend to prefer more modestly sized companies because they are less well analysed and so have a greater propensity to surprise the market. The top end of the FTSE All Share is also very concentrated in a few big names and sectors which active managers are unlikely to replicate. Mid and small caps can also offer more promising growth prospects, and provide active managers with some differentiation from the index they are trying to beat.

Chart 4. UK stock market segments



Source: Morningstar total return in GBP

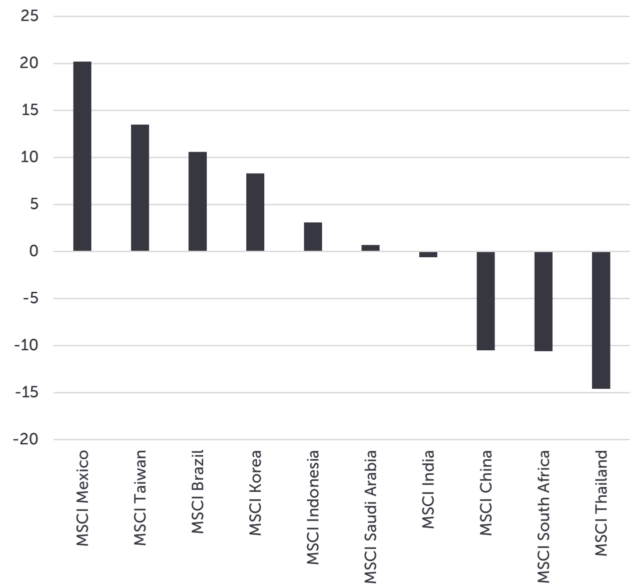
In 2022 large cap outperformance was driven by the superior returns from sectors that constitute a large part of the FTSE 100, especially energy, but also tobacco, defence and pharma. Weaker sterling also buoyed the share prices of FTSE 100 stocks more than their neighbours in the FTSE 250 and FTSE Small Cap indices, because they have more international revenues. Small and midcaps still fell behind their large cap cousins in the first half of 2023, but the magnitude of underperformance was of a completely different order in 2022, as Chart 4 shows. This made for a more level playing field between active and passive UK funds.

Active gem funds shine

Returns from global emerging markets funds have not been great, either in the short or the long term, which will be disappointing to investors who have shouldered the additional risk of investing in these regions. However 2023 has so far been decidedly positive for active managers compared to their passive peers, with 77% outperforming. This is a drastic turnaround from last year, when just 21% of active funds beat a passive alternative. The individual countries within the emerging markets universe are a disparate bunch, and consequently their performance can be strongly divergent, as Chart 5 shows. This exacerbates the potential for the overall performance of active managers to be extreme in the short term, for better or worse, as a result of relatively small regional allocation decisions.

A number of factors have contributed to active funds in the emerging markets space having a good first half of the year. Two thirds of funds are underweight China compared to the average passive peer, a market which has performed poorly in 2023 so far. Once again, active managers are also overweight small and mid caps compared to trackers, which has proved a performance tailwind in the first half of this year. A benchmarking choice has also proved favourable to active managers. The vast majority of active global emerging markets funds benchmark their funds against the MSCI Emerging Markets Index, whereas passive funds are more split between this benchmark and the FTSE Emerging Index. The MSCI index outperformed the FTSE index in the first half of the year, in part because FTSE do not count South Korea as an emerging market, thereby missing out on a positive contributor to returns.

Chart 5. Largest emerging markets



Source: Morningstar total return in GBP

Mind the passive charge gap

Part of the 'bargain' when buying an active fund is that you expect outperformance, but you pay higher fees for it. The typical annual charge for an active equity fund is currently around 0.9%, depending on which sector you invest in, resulting in a premium of around 0.75% on the average passive alternative. This is a headwind active managers need to overcome through superior performance to beat the passive machines. (All performance figures provided in this report are provided net of charges, so already take these fees into account).

Table 4. Active and passive fund charges

	Ongoing charges %		
	Average active	Average passive	Active premium
Asia Pacific Ex Japan	0.94	0.18	0.76
Europe Ex UK	0.87	0.12	0.75
Global	0.91	0.14	0.77
Global Emerging Markets	1.01	0.24	0.77
Japan	0.89	0.15	0.74
North America	0.85	0.10	0.76
UK	0.84	0.16	0.68

Sources: AJ Bell, Morningstar

But it's not just active fund investors who need to take fees into account, because there is a range of charges levied for trackers too. Unlike with active funds, there's no argument for paying a premium on the basis you are getting an exceptional manager who is more likely to deliver outperformance. Each fund in one of these sectors will be doing a broadly similar job, and so higher charges will only serve to reduce returns. Indeed there is a pretty egregious premium charged by some tracker funds in the UK All Companies sector, where the cheapest comes with a price tag of 0.05% per annum, and the most expensive charges 1.06% each year. In other words, the most expensive UK tracker costs twenty one times more than the cheapest, and these extra fees are levied year in year out.

To put this in pounds and pence, an investor who switched £10,000 from a tracker charging 1.06% to one charging 0.05%, would be £6,627 better off after 20 years, assuming a 7% gross return from the market. This isn't simply a hypothetical example. One of the most expensive UK tracker funds with an annual charge of 1.02% has returned 63.4% over the last ten years, compared to the cheapest with an annual fee of 0.05%, which has returned 80.0% for investors. So after 10 years, £10,000 invested in the expensive tracker would now be worth £16,340 compared to £18,000 from the cheaper option, a £1,660 difference. Both do the same job of tracking the FTSE All Share, so those invested in the expensive tracker are simply watching money leak out of their nest egg for no good reason.

Table 5. Passive fund charges

	Passive funds ongoing charges %			
	Most expensive	Average	Cheapest	Range
Asia Pacific Ex Japan	0.32	0.18	0.11	0.21
Europe Ex UK	0.13	0.12	0.06	0.07
Global	0.62	0.14	0.12	0.50
Global Emerging Markets	0.41	0.24	0.20	0.21
Japan	0.31	0.15	0.08	0.23
North America	0.30	0.10	0.05	0.25
UK	1.06	0.16	0.05	1.01

Sources: AJ Bell, Morningstar

Conclusion

The mood music has improved for active managers in the first half of 2023, which comes as no real surprise given their dire showing in 2022. A year's performance is not sufficient to accurately judge the merits of active management, and so more emphasis should be given to the longer term figures in this report. Even then, in a market which has been dominated by the same trends for such a lengthy period of time, it's possible to identify factors which have acted as a headwind to active managers in key sectors, and which go some way to explaining disappointing performance.

Active fund investors will also typically hope to improve their chances of outperformance by selecting fund managers with established and successful track records, which is no guarantee of success, but significantly better than picking funds with a blindfold and a pin. Passive fund investors also need to be alert for high charges which are eating their returns, and which can be avoided by switching to a cheaper alternative.

The decision to invest in active or passive funds is, perhaps surprisingly, not binary. Unlike disciples of passive or active styles, private investors needn't be dogmatic in their use of either strategy. It's possible to mix and match active and passive funds within a portfolio, perhaps picking active managers you have a great deal of confidence in, and then gap-filling using tracker funds. It's also worth noting there are some areas that are not well-served by passive funds, or where outright performance is not the only goal, which probably favour an active approach. For instance, looking for opportunities in smaller companies, investing for income, or reducing volatility. Either way, active and passive funds are tools at investors' disposal, rather than a rigid lifelong doctrine they need to cleave to.

Manager versus machine methodology

Our report analyses the performance and charges of over 1,000 open-ended funds across seven popular equity sectors which are identified as the primary share class, using the median average performance of passive funds as a hurdle for active managers to beat. When calculating the performance of the average passive fund we have excluded ESG and smart beta passive funds which include an element of active selection at an index level. Over longer time periods, the performance data does contain some survivorship bias, because underperforming funds will have tended to be closed or merged. The report analyses historical fund data, and while past performance can provide an insight into long running trends, it is never an entirely reliable guide to the future. This report was published in July 2023.