GOING AGAINST THE FLOW
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WHY UK INTERMEDIARIES PREFER ACTIVE FUNDS
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Mark King
Investment Editor

Introduction: An independent opinion

For the past 10 years, the debate over the relative merits of active versus passive funds has raged with no conclusion. Yet few have canvassed the views of the UK’s financial intermediaries, who control where private clients invest their money. In fact, our research shows that financial intermediaries overwhelmingly prefer actively-managed funds to passive.

85% of the intermediaries we surveyed at the beginning of 2016 reported allocating clients’ assets mainly or only to active funds. They believe that active management provides an opportunity for greater capital growth than the stock market as a whole, while protecting against losses when the market falls. Interestingly, they’re lifting allocations to active funds in 2016, expecting them to outperform.

However, some intermediaries do use passives for asset allocation purposes if clients are risk averse, or if cost is an issue.

These findings are clearly against the trend. Passive investing has surged in popularity. Tracker funds saw record net UK retail sales of £5.4 billion in 2015. Their overall share of industry funds under management rose to 12.4%, up from 6.6% in 2005.1 What’s more, ETFs listed in Europe attracted US$82 billion in net new assets in 2015, a 33% jump from the previous record of US$61.8 billion gathered in 2014.2

Interestingly, the better qualified intermediaries were also those who most emphatically supported active management. Discretionary fund managers, who often have large fund research teams, tended to be more supportive than financial advisors from less well resourced organisations.

Carried out in January,3 our research questioned 192 financial intermediaries from across the advice

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2 etfgi.com: ETFs/ETPs listed in Europe gathered a record 82 billion US dollars in net new assets in 2015, according to ETFGI, 14 January 2016.
3 Online study conducted from 25 January to 1 February 2016.
spectrum.\textsuperscript{4} We commissioned \textit{Research in Finance} to carry out the survey on our behalf.

The study was based on five key questions:

1. What proportion of assets is invested in active and passive funds?
2. What influences the choice of active funds versus passive funds?
3. What are the perceived advantages and disadvantages of both approaches?
4. Are some markets seen as better suited to active or passive funds?
5. Have views changed over the past 12 months?

The following pages will give you greater insight into why intermediaries continue to overwhelmingly favour actively managed funds and why.

\textsuperscript{4} 129 IFAs, financial planners, restricted advisors, 43 discretionary fund managers, 17 paraplanners, 3 other (analyst/Head of research/wealth development manager).
Executive summary: Our key findings

- 85% of intermediaries believe that active funds are the best option, investing their clients’ assets mainly or only in active funds.
- Two-thirds, 66%, of intermediaries expect active funds to outperform passive funds in 2016 discretionary fund managers and wealth managers are particularly firm in this opinion.
- Advisors and wealth managers also favour active funds for their ability to avoid market distress and to exploit market inefficiencies.
- Most, 87%, of intermediaries incorporate some passives into portfolios. They often use passive funds with investors who are more risk-averse or on a tight budget.
- Lower costs are seen as passive funds’ primary advantage.
- More than half of intermediaries, 53%, prefer a passive approach in the US market, believing its efficiency leaves less chance for active managers to outperform.
- Four out of ten discretionary fund managers or wealth managers have increased allocations to active funds over the past 12 months.
- Nearly two-thirds, 58%, of discretionary fund managers and wealth managers express concern that the growth of passive funds is distorting markets. There is a risk of paying for active management and getting benchmark huggers.
Who took part in the research?

In order to get an accurate view of opinions in the intermediary community, we questioned fund selectors in a range of roles: analysts, paraplanners, restricted advisors, independent financial advisors, financial planners and discretionary fund managers.

Then we divided our 192 respondents into two groups:
1. ‘discretionary fund managers/wealth managers’ (DFMs)
2. ‘advisors’, which included all the other roles.

The DFMs tend to work for larger firms, measured in terms of both assets under management and the number of registered individuals authorised to manage and advise on investments. Some 51% of DFMs work for firms managing £1 billion or more. Just 12% of DFMs work for firms managing up to £100 million. Only 19% of DFMs work in firms with five or less registered individuals.

Among the advisors, just 9% work for firms managing £1 billion or more, while 53% manage up to £100 million. 57% work for firms with five or less registered individuals.

Separating out the two types of respondents in this way allowed us to see how their views differed.

'What roughly is the size of the firm you work for in asset terms?'

<table>
<thead>
<tr>
<th>Size Range</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Up to £100m</td>
<td>12%</td>
</tr>
<tr>
<td>£101m-£250m</td>
<td>21%</td>
</tr>
<tr>
<td>£251m-£500m</td>
<td>12%</td>
</tr>
<tr>
<td>£501m-£1bn</td>
<td>5%</td>
</tr>
<tr>
<td>&gt;£1bn</td>
<td>51%</td>
</tr>
</tbody>
</table>
Advisory

<table>
<thead>
<tr>
<th>Range</th>
<th>Percentage</th>
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<tbody>
<tr>
<td>Up to £100m</td>
<td>53%</td>
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<tr>
<td>£101m-£250m</td>
<td>24%</td>
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<tr>
<td>£251m-£500m</td>
<td>9%</td>
</tr>
<tr>
<td>£501m-£1bn</td>
<td>5%</td>
</tr>
<tr>
<td>&gt;£1bn</td>
<td>9%</td>
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</tbody>
</table>
1. What proportion of assets is invested in active and passive funds?

Financial intermediaries invest more of their clients’ money in actively-managed funds than in passive ETFs or index funds. Both DFM and advisor respondents shared this bias towards active investment. Some 86% of DFMs say they invest in ‘active funds only’ or place the ‘majority’ of clients’ assets in active funds; this compares with 85% for advisors.

However, more DFMs than advisors say they only invest in active funds (19% compared with 11%).

None of our respondents say they invest solely in passive funds. Just 7% of DFMs and 5% of advisors declare they invest the majority of clients’ assets in passive investments.

Roughly what proportion of assets across your PERSONAL client bank do you have in active vs passive funds?

<table>
<thead>
<tr>
<th></th>
<th>Active funds only</th>
<th>Majority in active funds</th>
<th>Equal split between active and passive</th>
<th>Majority in passive funds</th>
<th>Passive funds only</th>
</tr>
</thead>
<tbody>
<tr>
<td>Overall</td>
<td>13%</td>
<td>72%</td>
<td>9%</td>
<td>6%</td>
<td></td>
</tr>
<tr>
<td>DFM</td>
<td>19%</td>
<td>67%</td>
<td>7%</td>
<td>7%</td>
<td></td>
</tr>
<tr>
<td>Advisory</td>
<td>11%</td>
<td>74%</td>
<td>9%</td>
<td>5%</td>
<td></td>
</tr>
</tbody>
</table>
2. **What influences the choice of active versus passive?**

Some intermediary firms have defined processes that dictate the passive content of portfolios – generally speaking, the more risk-averse or cost-conscious the client, the higher the proportion of assets allocated to passive.

“The more risk-averse the client, the more passive content they receive,” asserts one DFM. Others said they would consider passives for “more cost-conscious clients”. The inclusion of passive funds can also depend on the size of an investment portfolio. “Less money, more passive funds,” explains another advisor.

One thing that’s not usually taken into account is clients’ preferences, although it appears that they rarely express their views. The active versus passive debate, it seems, has not lodged itself in the consciousness of ordinary investors. “In general clients are not that interested in the nuts and bolts, and more in the performance and risk. We choose what we feel best suits them at that moment,” is a typical response.
3. What are the perceived advantages and disadvantages of both approaches?

Belief in active management

The ‘potential for above-market capital growth’ is seen as the greatest possible advantage of active investing. When presented with six possible advantages of active investing and asked to rank them in terms of importance, our respondents ranked this quality as top. On a scale of one to seven, with one being not important and seven very important, 70% of those answering the survey gave it a six or seven. Nearly three out of four (74%) DFMs awarded these high scores compared with 70% of advisors.

On a scale of 1-7, how important are the following possible advantages of active investing?

| Potential for above-market capital growth | 9% 18% 36% 34% |
| Ability to avoid areas of distress in an index | 4% 11% 24% 33% 27% |
| Access to certain types of investment for which there is no passive equivalent | 4% 11% 24% 37% 20% |
| Ability to exploit market inefficiencies | 4% 13% 22% 31% 27% |
| Potential for above-market dividends | 7% 19% 31% 22% 17% |
| Ability to divest from companies for ESG or ethical reasons | 19% 15% 29% 15% 10% 8% |

The ‘ability to avoid areas of distress in an index’ ranked as the second most important advantage. Given the market volatility at the start of 2016, this will have been at the forefront of many advisors’ minds. Being fully invested in an index means, of course, that trackers follow the market down as well as up.

DFMs valued the ability to avoid areas of distress in an index, so escaping losses, particularly highly. Two-fifths (40%) gave it a top score of seven and another 33% awarded it a score of six. Advisors were not quite so enthusiastic. Almost a quarter (23%) thought avoiding areas of distress a very important possible advantage of active investing, awarding a seven score. A further 33% gave a six.

Giving further evidence of their faith in active management, DFMs placed great importance on the ability of active funds to exploit market inefficiencies. 72% of DFMs awarded this potential advantage one of the two top scores, compared with 53% of advisors.

The design of passive investments can be a problem whether markets are rising or falling. Most index tracker funds are based on market capitalisation weighted indices such as the FTSE 100, where the largest stocks in the index by market value have the biggest influence on the index’s performance. Diversification is often compromised by the index being highly concentrated: around 20% of an investment in a FTSE 100 tracker fund, for example, will be allocated to the banks and oil companies.
Passives best on cost

Unsurprisingly, all of our respondents believe lower costs are the primary advantage of passive funds. Some 43% of them gave this a ‘very important’ score of seven and another 31% gave it a six (72% together). Looking into the two different groups’ responses, advisors placed the greatest emphasis on cost – 77% awarded a six or seven score. This compared with 68% of DFMs giving it a six or seven.

‘No risk of paying active fees for benchmark huggers’ ranked second. This reflects common concerns that some active funds are closet trackers, simply emulating the make-up and returns of the benchmark index they follow. Some 70% of the total sample agreed with this statement.

On a scale of 1-7, how important are the following possible advantages of PASSIVE investing?

Crucially, Less than a quarter agree with the statement that passive funds will outperform active funds. Just 10% of DFMs gave this a high score of six or seven, and just 12% of advisors.

In terms of disadvantages, nearly two-thirds (58%) of DFMs agree that ‘the growth of passive funds is distorting markets’. During the market turmoil at the end of 2015 and beginning of 2016, many market participants blamed ETF selling for amplifying the volatility.

Such concerns are much lower on the agenda among advisors, with only 21% agreeing that passive investing distort markets.

Overall, just under a third of respondents (29%) viewed market distortion as a potential problem of passive investing (see chart below), while 22% disagreed with the statement.
To what extent do you agree/disagree with the following statements?

The benefits of a blended solution

When we asked intermediaries how they invest clients’ money, most said they had a bias towards active funds but were open to using passive investments. To explore this point, we asked for their opinions on the benefits of combining active and passive funds in clients’ portfolios.

The perceived benefits of a blended solution included cost management. Some of the key comments included:

- “Use passive funds to create a core portfolio and reduce costs, active funds to diversify and tailor portfolio.” A Financial Planner.
- “Blending both approaches allows us to couple broad, market exposure with tactical/thematic investment.” An IFA.
- “Risked mix can give smoother returns.” An IFA.
4. Are some markets better suited to active or passive funds?

For which of the following markets would you most likely recommend/invest in active funds, and for which would you most likely to go passive?

When asked why they might consider both active and passive investments, a number of respondents argued that some markets are better suited to passive investment. One IFA said: “There are certain markets such as the United States where passives outperform most of their active counterparts.”

The view that it is not worth paying for active funds in highly researched, relatively efficient markets, particularly the US, is widely held. In fact, the US is the only market where our intermediary sample said they would most likely go passive, with 53% selecting that option and only 24% saying they would definitely recommend active funds. In the UK, by comparison, only 15% favour passives and 59% active funds.

DFMs were firmer in their conviction that active is best outside the US. 68% stated they favoured active funds in the UK, 80% in Europe and 83% in emerging markets. The corresponding figures for advisors were 57% in the UK, 60% in Europe and 63% in emerging markets.

DFMs also expressed the strongest belief in index tracking in the US. 76% of them said they favoured passives in the world’s biggest stock market. This compared with 47% of advisors.
5. Have views changed over the past 12 months?

Intermediaries generally expect active funds to outperform passive funds in 2016. This was the view of 66% of the intermediaries we interviewed. Three quarters (75%) of DFMs held this opinion, saying the expected active funds to outperform, net of fees.

Despite this, the majority of intermediaries (62%) have not changed their mix of active and passive investments over the past 12 months.

How was the mix changed in the last 12 months, if at all?

However, DFMs are markedly higher. 40% of DFMs reported moving more of their clients’ portfolios into active funds over the past 12 months. Only 5% of this group have a higher proportion of clients’ assets now in passive funds.

By contrast, advisors have moved their clients in the opposite direction: almost a quarter (23%) have lifted clients’ allocations to passive funds, while 13% have increased their exposure to active investments.
Conclusion

Ever since the first index fund was created in 1976, there has been a spirited debate about the merits of passive versus active management. Yet it is one that has often generated more heat than light.

The public debate has been dominated by outspoken advocates who see the world in black and white terms: passive good, active bad or vice versa.

Our research shows clearly that intermediaries retain their faith in active management.

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They believe that active management provides an opportunity for greater capital growth than the stock market as a whole, while protecting against losses when the market falls.
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