Government Actuary's Department

Investment News

Monthly Bulletin from the Investment & Risk Team

October 2015

Last Month in Brief

September was a volatile month for equities, with news dominated by Volkswagen's admission that it had installed software in its vehicles that allowed them to pass emissions tests, while emitting many times the legal limit. Its share price has tumbled by 40%. The September close marked the worst quarter for the FTSE 100 since 2011. There was, however, some good news for the UK economy as the latest productivity figures showed the biggest quarter-on-quarter rise in four years.

The Bank of England once again voted to hold interest rates at a record low of 0.5%, in an 8-1 vote by the Monetary Policy Committee, with only the hawkish Ian McCafferty voting for a rise of 0.25%. Mark Carney also chose to speak out on the threat of climate change. In a speech to insurers at Lloyds of London he said investors face "potentially huge" losses that pose a great risk to global stability.

Elsewhere the Eurozone re-entered deflation, with inflation of –0.1%, raising expectations that the ECB might increase the pace of its quantitative easing programme from €60bn euros per month. Alexis Tsipras was also re-elected Greek prime minister as Greece prepares for negotiations on debt relief later this year, in which he will attempt to get a nominal haircut for Greek debt.

Chart 1: Equity Indices

Equity markets ended the month lower

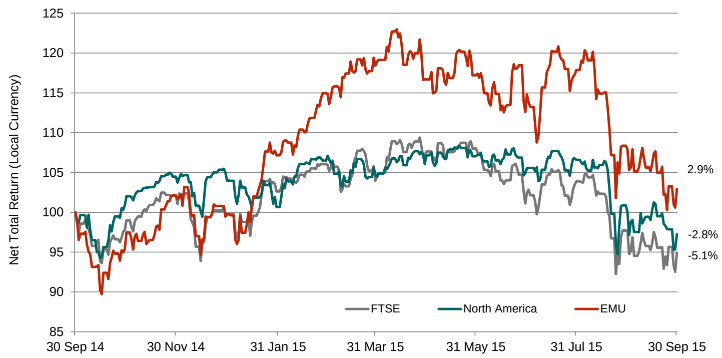


Chart 2: Sterling Credit Spreads

Credit spreads widened throughout the month

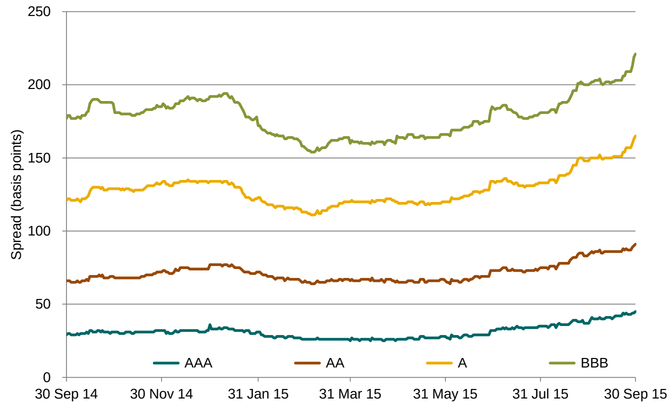


Chart 4: Gilt Spot Curves

Gilt yields fell during the month

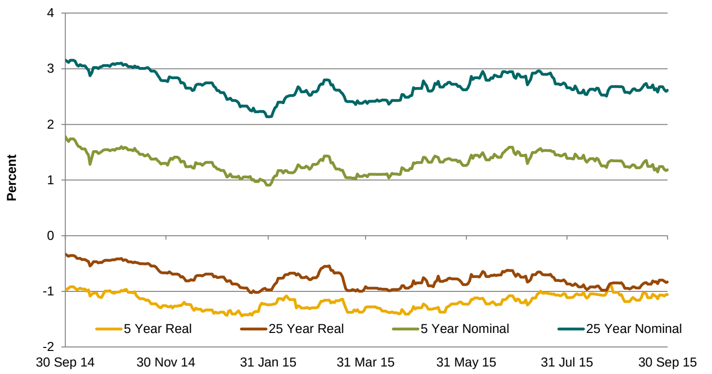
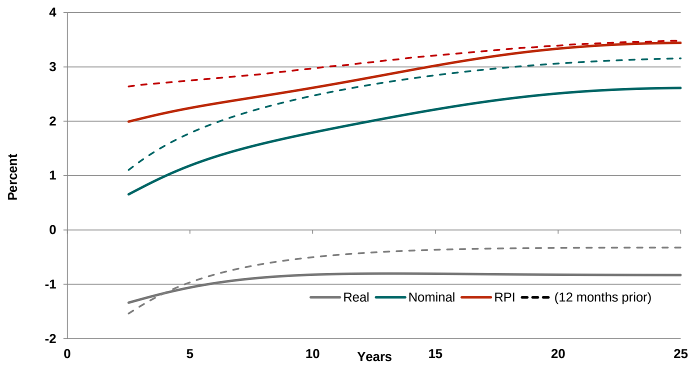


Chart 4: Gilt Spot Curves

Yield curves remain upward sloping



Source: Financial Times, MSCI, Merrill Lynch Bank of America, & Bank of England

	Latest	Previous		Latest	Previous
CPI increase (annual change)	0.0%	0.1%	**Base rate**	0.5%	0.5%
PPF 7800 funding ratio	81.6%	83.2%	**$/£ exchange rate**	1.51	1.54
Halifax house prices (monthly change)	2.7%	-0.6%	**VIX (volatility) index**	24.50	28.43

For monthly published indices "Latest" and "Previous" refers to the two most recently published statistics, otherwise numbers are quoted as at the month end.

Government Actuary's Department, Finlaison House, 15-17 Furnival Street, London, EC4A 1AB **Telephone +44 (0)20 7211 2601**

Active or passive investment management?

Whether you are a pension fund, an individual investor, or anyone else, you face the choice between whether to invest passively or actively. But what are these and why choose one over the other?

The difference

Passive investment strategies aim to track the track the return of a certain index, such as the FTSE 100. As such, these strategies typically involve very limited buying and selling, and do not rely on manager discretion.

Active trading, on the other hand, exists in an attempt to make a return greater than the market average. It generally exists in the form of professional fund managers making investment decisions about when to buy and sell assets, and which type of asset to invest in. Individual investors may also take an active investment strategy.

Reasons for a passive strategy

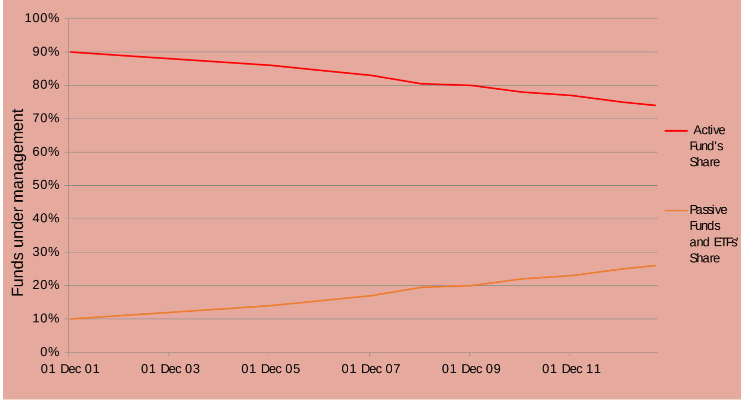
The justification for passive investment comes mainly from a number of financial economics theories. For example, studies imply that the average investor will have an average before-costs performance equal to the market, in the long run. Therefore investors will benefit more from reducing investment costs than from trying to beat the average, as what matters to investors are returns net of fees.

Passive mandates are cheaper as they do not require a skilled manager to run. According to Jack Bogle, founder of Vanguard, the average active share fund's total costs are 2.27% p.a.. There are a number of FTSE 100 trackers that charge less than 0.2% p.a.. An investigation into the LGPS's management costs found that a move to passive management could save £230m p.a., with an initial cost of £215m, without materially affecting performance.

A passive strategy is consistent with the belief that markets are efficient and that market prices reflect all available information. As such, it suggests that an investor cannot outperform the market by stock selection or market timing. In essence: it is not possible to beat the market. However belief in the 'efficient market hypothesis' relies on a number of assumptions and there are differing views as to its reliability — hence the continued use of active funds. Investors may also struggle to give the fund manager the correct incentives to run the portfolio in accordance with their risk-return preferences.

Box 1: Which is more popular?

Currently there are over 2,000 actively managed funds but fewer than 100 passive funds listed by the Investment Association. Nicolas Firzli, director general of the World Pensions Council, estimated that a typical pension or insurance fund or insurance company has 55-70% of its assets actively managed. Firzli also estimates that 14-16% of total worldwide assets are invested passively. Other data points to a picture of a shift towards a greater use of passive options, in recent years (source: Business Insider).



Box 2: Other considerations

- **Index trackers can struggle to mirror their indexes**: index trackers can find it quite difficult to keep the make-up of the fund the same as the index. Over the long term this can result in weaker performance than the index itself.
- **Different levels of risk taking:** often in comparing passive to active management we are not comparing like-for-like. This is because of differing levels of risk taking between the two strategies, which results in differing levels of volatility. If the level of risk is corrected for the results may change significantly.
- **Buying high, selling low:** trackers usually follow a major index, such as the FTSE 100. As such they must purchase shares so as to continue to match their holdings with the index they follow. This can cause them to buy high (when a company enters an index) and sell low (when they exit).

Reasons for an active strategy

Evidence is hard to collect and can be found to support both approaches. A key reason for an active investment strategy is the flexibility it allows. For instance actively managed funds may have a strategy of taking on a high risk to increase return, or may exist purely to protect capital, particularly if markets fall. Active management will also allow a fund manager to move money according to whether certain regions or industries appear to be on the up or down.

Investors may also believe that the fund manager they have chosen is skilled and therefore able to out-perform the market. They might also be sceptical of the efficient markets hypothesis, which underpins the theoretical argument for a passive strategy. Many, but not all, fund managers beat the passive benchmark, and investors are essentially betting that their manager will be one of these.

Evidence?

According to Standard & Poor's Index Versus Active quarterly scorecards only a minority of active funds do better than the S&P index benchmark, and this falls further as the time period considered increases. Furthermore due to index tracker's lower fees it is possible for an active fund to outperform the market but still return less than a tracker (see box on other considerations).

However a study by FundQuest considered 31,991 US-based mutual funds and matching passive indices, from January 1980 to February 2010. It found that active management outperforms passive in bull markets, but not in bear markets. These results were found after correcting for risk and fees.

Contact Information

Colin Wilson
Deputy Government Actuary
T: +44 (0)20 7211 2672
E: colin.wilson@gad.gov.uk

Matt Gurden
Investment & Risk Actuary
T: +44 (0)20 7211 3498
E: matt.gurden@gad.gov.uk

Andrew Jinks
Investment & Risk Actuary
T: +44 (0)20 7211 2655
E: andrew.jinks@gad.gov.uk

Chris Bull
Investment & Risk Actuary
T: +44 (0)20 7211 2739
E: christopher.bull@gad.gov.uk