

Striking the right balance

▣ Lynn Strongin Dodds considers how global events and market volatility are impacting investors' decisions between an active versus passive approach

Over the past few years, passive funds have stolen a march on their active counterparts but, as market conditions have changed, they are coming back into favour. However, institutional investors are treading cautiously, continuing to focus on cost and their acumen to generate returns across these more turbulent markets.

There is no question though that volatility spikes and uncertainty are the perfect breeding grounds for active managers but, as Hargreaves Lansdown head of fund research, Victoria Hasler, notes, time will tell as to whether they can prove their mettle. "Markets rallying and selling off indiscriminately are tricky in the short term, but the hope is that good managers can use this volatility to better position themselves for the long term," she adds. "At some point, though, we need investors to get back to rewarding the good companies. With markets still very jittery, it may take a bit of time to really tell who the winners are."

One of the biggest changes is the role that geopolitics is playing in investment decisions. In the past, many active managers adhered to Warren Buffett's well entrenched philosophy of ignoring

them but this is much harder given the ongoing conflicts in the Middle East and Ukraine, as well as President Trump's vacillating tariff policies.

"For a long time, the wisdom of active managers was that geopolitics did not matter and that the focus should be more on cashflows," says WTW global head of manager research, Chris Redmond. "The real question today is whether it is different this time around? We can't take it for certain that we will return to a rules-based world order."

As a result, there is a sharper focus on both performance as well as "avoiding the blow ups," says TwentyFour Asset Management partner and head of sales, Alistair Wilson. "In the past, managers were able to beat the index more consistently and make bolder choices. That is not the case today and the opportunities are more niche and in different asset classes such as fixed income and multi asset credit."

Royal London Asset Management head of multi asset, Trevor Greetham, echoes these sentiments. He believes that active managers can build resilience to shocks by casting the net more widely



▣ Summary

- Active management is slowly coming back into favour especially in fixed income and small cap stocks.
- Passive management will continue to dominate large cap equities as it is difficult to beat the benchmark.
- Geopolitics has come into sharper focus due to the impact world events are having on markets.

when deciding which asset classes to include in a fund. "Active tactical asset allocation between and within asset classes can be particularly beneficial in shorter, more pronounced business cycles," he adds. "Different asset classes offer their best returns at different times. A disciplined model-based framework allows the manager to take advantage of this phenomenon, rather than passively rebalancing exposures."

To date, the asset class that is causing the most buzz in the active sphere is fixed income as well as the ability to align pension funds' objectives with risks in areas such as market structure, credit deterioration, dislocations, sustainability

and dispersion. This is not always the case with index tracking strategies. Also, there has been widespread disappointment with the higher fees and systematic underperformance of many of their active equity cohorts.

Morningstar's Q1 Europe Open End and ETF flows report reflects these trends. It showed that active funds enjoyed their strongest quarterly gain since 2021 and fifth consecutive quarter of inflows. Bond funds led the charge, amassing €264 billion in the past year while equities, which collected €79 billion, accounted for the bulk of the passive inflows. Overall, passive funds continued to grow, comprising nearly 30 per cent of total net assets in Europe, a milestone already surpassed in the US fund market.

"It is very difficult for managers to outperform a benchmark such as the S&P 500," says Morningstar director of research, Monika Calay. "These trackers are widely followed, and investors are using them for their core allocation. Fixed income fund managers adopting active strategies are having a higher success rate due to the changing macro-economic environment."

Invesco head of client investment solutions for EMEA, Georgina Taylor, agrees that attitudes have shifted with the higher rates. In the past, she notes that bonds were seen as largely defensive plays, but fund managers have become increasingly dynamic, taking duration and credit risk to generate additional alpha.

This does not mean the end of active equity management. "One of the problems is that many active managers have been under pressure to keep up with an increasingly concentrated benchmark" Taylor adds. "Now that the benchmarks are less concentrated, active managers have more freedom to express their views and be rewarded for them."

The most interesting prospects are in the smaller cap universe because active managers have a better chance

of adding value. This is underscored in Morningstar's US Active/Passive Barometer Report for 2024 which showed this group boasted a 43 per cent success rate compared to their average passive peer and 37 per cent against mid and large cap active managers.

Although the 37 per cent figure represents a four-percentage point increase from 2023, the long-term record of the US large-cap equity active market demonstrates their challenges. Only 7 per cent of these funds survived and outperformed their average passive rival over the decade through December 2024. This contrasts with the 22 per cent and 26 per cent success rates for active mid- and small-cap managers, respectively.

Against this backdrop, it is no surprise that investors are looking beyond the US stock markets which have dominated flows over the past few years due to the strong returns of the magnificent seven – Alphabet, Amazon, Apple, Meta Platforms, Microsoft, Nvidia, and Tesla. Different regions as well as sectors are now on the investment radar screen.

For example, State Street Global Advisors managing director and the Europe head of investment strategy & research, Altaf Kassam, points to "Europe as a ripe hunting ground because it is less concentrated than the US and there is more dispersion. On a fundamental basis, active managers should be able to find pockets of opportunity in emerging markets especially among smaller companies. However, in both cases it is not just about stock picking but also looking more at the different sectors and countries in terms of the impact the tariffs will have."

Adoption of active management also differs between defined benefit and contribution schemes, according to Mercer partner and head of UK wealth strategy, Tessa Page. She notes that DC members may not be in the scheme long enough to benefit from active management while the cost pressure

is also a significant factor. "Everything in a portfolio has to earn the right to be there," she says. "For DB schemes, there is a greater focus on liability management, and we are seeing a more blended approach between passive and active. It depends on every asset class. For example, you can't be passive in private markets where we are seeing greater interest from pension funds."

Page also believes that pension funds need to do their homework when selecting an active manager "It's important to select the right manager," she adds. "They need to kick the tyres to understand what their process is and whether it aligns with their objectives."

In many cases, there is still a divide between the fundamental stock picker and quantitative manager although there have been moves with varying degrees of success to combine the two. The former involves analysing a company's financial health while the latter relies on data and mathematical models. Whichever path is taken, the goal, according to RBC BlueBay Asset Management portfolio manager, Neil Mehta, is to have access to the best information, separate the good from the bad news, and analyse the policies and politics.

"Active managers should also be more aware of social media and adapt to the new environment," he adds. "However, they should also go straight to the source and have more direct dialogue with policy makers."

Looking ahead, there is a lot of talk about hybrid products such as active exchange traded products and enhanced indexing strategies which systematically capture market returns while aiming to leverage well-rewarded factor premiums for additional benefits. Redmond believes they are more suited to retail investors and that institutional investors will opt for a more balanced mix in terms of styles, risk profiles, and returns.

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