PRESENTER: We’ve all seen the headlines and we’ve all heard the arguments. Depending on who you’re talking to, such as passive funds can mean missed opportunities, or the only justification for actively managed funds is either more returns or less risk, and in today’s environment it can be argued that neither are forthcoming. So here at asset.tv we thought we’d thrash it out with the experts. Joining me, we have on the active side James Lynch, Investment Manager for Downing. And on team passive we have Richard Whitehall, Portfolio Manager for Morningstar. And giving overall market commentary is Jake Moeller, Head of Lipper UK and Ireland Research. Right, Jake, let’s start by setting the scene. And we have assets under management here in Europe over the past 10 years, so what are we seeing here and what are the drivers behind this would you say? JAKE MOELLER: The great news is that the Pan European - and this includes the UK - mutual funds industry is generally in very good health. We’ve passed the €10trn mark in 2016, and that’s great. There’s only been two years where average growth has been negative. That was 2008, the global financial crisis, 2011 the Greek crisis, but since then growth has been steady, so we’ve passed the €10trn. And the interesting thing is in terms of active and passive, the passive fund component of that has increased over the last 10 years from 6% of total assets under management to the end of 2016 12%, so there has been a commensurate increase in the proportion of total assets which are held with passive providers. PRESENTER: Well looking at this graph here, and obviously active has the lion’s share there, but then again passive is at the top here. So maybe, James, if I start with you, what’s your case for active? JAMES LYNCH: From my perspective, it’s actually quite a good thing that passive investing has gained such popularity and so much coverage of late. Because it really shines a light on some of the larger institutions that are focusing more on asset gathering rather than generating performance for investors. I think there are market inefficiencies out there. As a small cap specialist we work with these every day. I know that I can get an informational advantage over the market in the small cap space and I can buy these assets at a discount to the market. So looking at the micro-cap space you can get up to a 30% discount in some of these assets. And at the same time these businesses have zero analyst coverage. So we know that there are inefficiencies out there that can be exploited. In order to really capture those consistently over the longer term it’s important that an active fund manager has a defined and repeatable investment process. PRESENTER: Well, James, I’m going to pick out some of the things you said about that a little bit later on, but first off, Richard, tell me about passive, what’s the advantages of that? RICHARD WHITEHALL: Yes, I think for us the most important thing there is the fees. We’ve done a lot of proprietary work at Morningstar and cost is the single most important factor that affects fund performance. And therefore obviously with passive investing comes very low fees and therefore there’s a huge benefit for investors to be able to access an asset class. They know exactly what they’re investing in and they can do that at low cost. Therefore in general we think that that is the best option for many investors and allows them to gain that access and gives them the best chance of accessing the returns from the market itself. PRESENTER: So let’s see what the numbers say, and here we have the best performing active fund against the best performing broad-based tracker. So, Jake, what’s the takeaway from this? JAKE MOELLER: So I’ve looked at the Lipper UK equity sector, and this is a point that Richard’s alluded to with the comment about fees, and also James mentioned about outperformance. I often remind investors to look at it from an opportunity cost perspective. So if you invest in a tracker you’ll get this. But if you’re looking for that outperformance you’ve really got to go with an active fund, and that outperformance can be quite marked. So towards the end of 2006 for the UK sector, the best performing active fund outperformed the best performing tracker in the same sector over five years by a massive 110 percentage points. So you have to make that decision, is it worthwhile trying to seek that outperformance? Obviously it’s difficult necessarily to pick that fund. PRESENTER: I mean you’re quite right Jake, but when you look at the best performing funds it does really raise the question how can you pick the best performing funds? And then also when you’re looking at fact sheet for example, I mean there is that mantra of past performance doesn’t necessarily, it isn't an indicator of future performance. We've all seen that, so I mean how relevant is that actually? JAKE MOELLER: I think there's a few points there. I mean obviously you have to have some trust in the gatekeepers, such as James, so hopefully that they're able to pick some funds. But you're right: there is a negative element to it. But it's not just a random distribution, so not all the funds are distributed normally, not all distributions in all sectors are normal. So there is an element of trying to find that persistency of outperformance. And that can be, you know, we had a look at the Lipper Fund Awards, the winners from three years ago, 70% of those funds are still first or second quartile. I did the same thing for the Investment Week Awards, which has a qualitative overlay. Some of you may be judges on it. It was again a similar figure: over three years 71% of those funds were still in first or second quartile. So you take something like that, which is a simple isolated metric on its own, and add in a good gatekeeper, there is some chance that you'll be able to whittle your universe away from that tail of underperforming active funds and push more towards the active funds that are doing well. It's not just a random selection. PRESENTER: And what do you think, Richard, do you think the chances of picking a best performing fund are quite good? RICHARD WHITEHALL: It's certainly possible. We've got a big team at Morningstar who are, that is their job to do that, and the way they do that is through very much a qualitative process. We've got 5Ps - everyone's got Ps, we've got five - looking at people, process, portfolio, the performance, price. And that's the way we think it's possible to do that. But the big thing is the point you made I think is another P and that's persistency. Because it's very easy to have an average outperforming over time, but if that's different funds that are at the top and then next at the bottom, then that's going to create probably some bad behaviour in investors. And they're going to look to maybe sell out when the fund has done badly, and they'll buy in when the fund has done well. And another thing we've found at Morningstar is that is exactly the worst behaviour as well. So I think active funds, yes, it is possible to do that. But you've got to have the behaviour that goes with that to make sure that you benefit from selecting a good fund. PRESENTER: So looking at the worst performing funds then, active funds, I mean what went wrong there then? JAKE MOELLER: So what that's actually showing is that distribution isn't normal. So the worst performing active fund has actually lost less money than the best performing active fund has made you money. So what that means is that it's not a normally distributed set of returns. So that at any given period an investor has to be comfortable with the fact that in some markets passive and tracker funds will naturally outperform the market, and we saw that in 2016, and in some periods active funds will have a greater chance of outperforming the benchmark. So what that shows is that there's no symmetry necessarily to the best performing active fund and the worst performing active fund. It does depend a lot on what the market's doing as well. PRESENTER: Well, James, as I mentioned in my introduction, I mean looking at headlines, the FT wrote that active managers have mostly had a terrible recent track record of beating their comparative track records. I mean would you agree with this and why is this? JAMES LYNCH: I think, if you look at the active management space as a whole, there's been a huge inflow of assets within active management, of the course the larger institutions, and with fund scale comes quite a large problem. The more assets you have the harder they are to invest. And in order for an active manager to be successful they need the 5Ps of course as you've said Richard. But from my perspective I would say you need to have a market inefficiency, and you also need to have a process around it so you can continue to exploit that inefficiency, but you also need to have a fund scale that is appropriate for the size of that inefficiency. So if any of those three elements are out of kilter, then it's unlikely that an active manager will outperform. PRESENTER: And what do you think Richard, to that? RICHARD WHITEHALL: Yes, I think some of the issues more recently have shown some of the problems that active managers have. They tend to have certain styles in which they invest and can outperform. So we were talking about UK equity, and a good example there is the fact that most UK equity managers will have a large mid cap and small cap bias. And if that reverses and those big giant cap stocks in the UK index do well, then active managers are going to struggle. And that brings one of the problems of investing in active management, are you getting the risk characteristics which you think you are when you're investing? And you may think UK equities are a great attractive opportunity, you invest in it, but actually what you get is a portfolio that doesn't necessarily reflect those characteristics. It's one of the factors. I mean actually some active managers who did position themselves well pre-crisis came out of that very well and attracted a lot of assets. But I think the broad point is valid. But I would also say that I think RDR and some of the more recent regulatory comments, particularly around fees, have really shone the light onto active managers and said yes you're going to give us exposure, but are you actually going to reward us for the fees you pay? And is that reward necessarily symmetrical? If you're going to charge X and you're only going to give us on average a return of less than that, is that fair to investors? PRESENTER: Well you've mentioned fees, and I actually think this is probably the main point when it comes to the active/passive debate, because people will be looking at the asset management industry and they think it's one of the best paid industries in the world. And you're bound to argue the active side because of course you would be without a job if it wasn't for active management. I mean what would you say to people who are thinking that? JAMES LYNCH: I think when we come to talk about fees it's important to make the distinction between price and value. By talking about fees in isolation, we're assuming that all else is equal. We've already seen from some of the data that there's quite a broad spread in the active management universe. So for an investor looking at that area they have to ensure that they're getting value for money. If you are being charged a fee, you need to ensure that you are getting the outperformance that's warranted from that. There are of course a number of funds within this space that will charge these fees and are ultimately closet trackers, and in that case an investor isn't getting value for money. JAKE MOELLER: But there's been a lot of fee compression post-global financial crisis, and a lot of that has been driven by the passive entrance, and I think that's great. But I agree, if the opportunity cost of not investing, the fees pay for themselves that's a good thing. But also the alignment of interests, I think there's a number of fund groups out there that have re-devised the performance fee structures, which bring them more into line with the investor outcomes. So if they're not earning, if they're not generating alpha for their clients, they're not earning fees, because there has been a lot of revision already in the market. RICHARD WHITEHALL: Yes, I think the active share point is a very important one. That you should be paying for someone who's genuinely going to be active. But I think from the investor's point of view they have to understand where those positions are coming from, how they're taken, and sometimes there may be a better way to gain access to that. So just running back to the same example, for some UK equity funds actually an investor might be better off splitting their money with a 100 tracker and a 250 tracker and getting a similar outcome. But equally yes there are definitely funds out there who are long term, high conviction and can justify their fees. PRESENTER: Well I want to draw your attention now to comments that enaud de Planta, he's the Chairman of Pictet Asset Management, and he wrote in The FT, and I thought it was interesting because he forecast that if passive funds were to continue their present growth trajectory, they'd own all listed stocks by 2030, which could threaten the free market economy. I mean for me this seems almost easy for an active manager to say of course, but what's your thoughts on this? Does anyone want to go forward with that? JAKE MOELLER: I think you can't assume that the growth rate will stay as it is. I think there will probably be some sort of market correction long before then. But the whole dynamic with any market where one assumes that there is perfect information, and another investor assumes that there isn't, you need that dynamic in order to drive any sort of potential performance for alpha, and also keep the tracking investors happy as well. It's a well thought comment but I don't know whether we have to wait that long for something to happen. RICHARD WHITEHALL: I think it's quite interesting, because I mean passives give you an exposure which you know what you're going to get, and that I think is very important. But the increase of flows does make me wonder whether actually there should be increasing opportunities for active managers. If everyone, or a lot of new money is going into the market and chasing yesterday's price, then for someone who is a long-term investor can sit back and genuinely think about the price in five years' time, then I think theoretically, philosophically this should be a great opportunity. But just to bring it back to fees, they've got to make sure that they're charging an attractive fee which gives an asymmetric risk for them and their investors. PRESENTER: Well, when it comes to passive, why do you think in the media, I mean I've mentioned The FT quite a few times now, why do they seem to have this louder voice than the active would you say? RICHARD WHITEHALL: Well I don't know whether it's going to sell many papers and hit many headlines if you start defending very well paid fund managers. It's just simply something that's not going to happen. I suppose also as well the journalists are going to try to take down those big names, which is arguably part of their role. And also don't forget that the active managers spend a lot of money on advertising, so there's a reasonable amount that they're saying as well which maybe the press are counteracting. JAMES LYNCH: I think the advertising point is a really noteworthy one, especially when you look at those active managers that have these large funds that are out there. And they have significant marketing budgets that go alongside them. So you've got that coupled with the likes of the passive managers that are putting huge resources behind marketing campaigns, which again kind of leads back into that self-fulfilling prophecy as assets gather you're buying investments you already own and then prices inflate so the prices become disconnected from the fundamentals. And that's when you need to start being, well thinking very carefully about where you're placing your money. JAKE MOELLER: I think active fund managers are being far too diplomatic in this. It's not the passive fund providers who are being pejorative in this debate; it's actually other commentators who are again probably chasing the headlines. But the active fund managers could do more to sell what worth they provide to the industry. I think they're a little bit too quiet. I think they should be funding some different types of academic studies. There's a lot of flaws with the scorecard. Fund managers underperform over 10 years. There's a lot of academic flaws, but no one's really articulating those, and I certainly think the fund managers, the active fund groups could be a little bit more vocal. RICHARD WHITEHALL: Yes, they didn't help themselves I think as well. I think they tend to be quite short term I would say. You see a lot of adverts out there saying this is where we are in the XYZ peer group over the last one year or three years, maybe five years. But are they, do they end up pushing funds which they know have had a nice tailwind of performance, while they might have a rocky time. And unsurprisingly that actually therefore actually worsens the long-term performance. So, yes, I think the points are valid but I think, and absolutely asset management industry can do more to help itself, and I think one of the things it could do is it can take a longer term view of the performance of its own funds. JAKE MOELLER: I kind of agree with you, but fund groups now, certainly post GFC are a lot better at soft closing their funds. And you mentioned the capacity issue before James. Fund groups, active fund houses are closing their large funds a lot sooner. And all of a sudden they're generating goodwill from the press for doing so. That wasn't the case before. So I agree with what you're saying but I think fund groups have actually got a lot better at protecting those alpha generating funds, soft closing them or indeed hard closing them, and then thinking OK well we can't market this right now, so they have to then think of something else to market. So it's a nice problem to have, but I think the industry has got a lot better since 2008 at policing itself. PRESENTER: Well their marketing's obviously working, because look at our last graph and we have here the net sales over the last 10 years. I mean, Jake, what would you say this can tell us moving forwards? JAKE MOELLER: Well I think it's very interesting, net sales over the last four years have, three years have sort of declined, so generally speaking net sales are down. But as a proportion passive funds have done much better, and I refer to ETFs in that as well. So 2015 was a cracking year for passive with nearly a third of assets written in 2015 net. Pan Europe went into passive providers, half into ETPs, ETFs, half into traditional index funds. And that's again backed up in 2016: 26% of net flows went, Pan Europe went into passive. And the first quarter of 2017 has been an absolute cracker. 2016 wasn't great for sales, but 2017 Q1 is almost up to the sales, total sales of 2016, and passive funds again holding their own with 20% of flows. So I think that's a combination of the fact that there are more passive options to invest in, more ETFs, more factor investments, all that sort of thing. Whether or not that's sustained, I would like to see a couple of more years of data before I predict the death of active funds. RICHARD WHITEHALL: I think there is an interesting point from this of a lot of passive funds have only ever been run at inflow. And there's a question mark as to how they will manage to run at outflow, and this brings up one of my big bugbears, which is a phrase that I've used the whole way through and that's passive investing. I don't think there actually is any such thing as a passive investment. If you're making a decision to buy a tracker fund that is an active decision. And I would just really encourage investors to do as much research on a passive fund as they would do on an active fund as well and not just simply make an assumption that every passive fund is the same. JAMES LYNCH: As long as there continues to be inefficiencies with the market, there will always be a place for active managers: those managers that can drive outperformance over the long term. And from our perspective looking at the UK small-cap part of the market, that inefficiency has been consistent over the last 10 to 15 years, and we can't see it changing any time soon. So for us I'm afraid we're not going anywhere. PRESENTER: So active isn't dead, passive hasn't reached peak territory then. So I'm kind of getting a feeling that really in this industry there's a place for both. Would you agree Jake? JAKE MOELLER: Yes I reluctantly agree to that. Because I do believe that if you want to save 50 basis points for 110%, well I don't think that's a good trade-off. I think there is some value to looking for an active fund manager that can outperform, and that can do so regularly, and I think it comes down to philosophical belief: can you find that? PRESENTER: And whether you're willing to take that risk. JAKE MOELLER: Yes, my personal view is that you can find those funds that are little gems of outperformance, whether it's - and I don't care so much whether it's a factor or a capitalisation or market momentum or value or growth or whatever, as long as it's outperformance I'll take it at a slightly more expensive price than a tracker fund. PRESENTER: So a place for both and is active worth the risk would you say? RICHARD WHITEHALL: Yes, I think for us it's what your baseline is. And I think given where fees are at the moment, given that for most portfolios the vast majority of performance is linked to asset allocation. If you're making an asset allocation decision in many cases to access that cheaply is incredibly important. But yes I mean certainly Morningstar definitely believe that there are areas across the markets where you can find good active managers. You need to look deep into the fund, the company, the process, and you need to do it very much from a qualitative perspective. PRESENTER: Yes, well going against the media rhetoric I'm going to give an active manager the final say. So, James, what would you say, a place for both? JAMES LYNCH: I think there is a place for both. Like I said from the outset I think that there's a strong case for what we do in the active management space. I think there are continued market inefficiencies that can be exploited. So I think it would be remiss of an investor to overlook that opportunity as we've said throughout, ensuring that there is good value for those additional fees is very important. But so that it should be part of a blended portfolio, you shouldn't have all your eggs in one basket of course. PRESENTER: Super, gentlemen thank you. Well you can join the debate by Tweeting your thoughts to @assettv, and for more videos please do visit our website asset.tv. Thanks for watching and see you next time.