WHAT TO LOOK FOR IN AN ACTIVE INVESTMENT MANAGER

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The rise in managed funds has been an important part of the investment landscape over recent times. Investment in managed funds can be segmented into active and passive managers. Here's a guide to the key characteristics of an active manger that investors should look for.

AN ACTIVE FUND MANAGER CONTINUOUSLY monitors the defined investment market for opportunities to protect and add value to the capital of the fund. This may be in the form of selling assets that have a risk of declining in value or purchasing assets that the manager anticipates are likely to increase in market value. In contrast, a passive manager does not actively pursue opportunities to enhance or protect the fund. The passive management philosophy adopts the position that over the long term an active manger won't repeatedly add value over and above the general fluctuation of the market. The passive management approach assumes that it is better to be continuously invested in the market, in preference to withdrawing or entering specific market positions in response to economic conditions — either security specific or macro-economic.

The passive approach is typically lower cost than an actively managed fund. Passive managers argue that the lower cost structure enhances investment returns over the long term as returns are not eroded by higher fees.

What are the key characteristics that investors who are seeking an active manager should look for?

ABSENCE OF INDEX HUGGING

Most active funds' performance is benchmarked against an index. As the benchmark index is a reference point for a manager's performance on a positive and negative basis, the manager may closely replicate the composition of the index with only minor deviation (Index hugging or closet indexing). In this situation, the portfolio is likely to reflect the index's performance. This is a safe strategy for the manager to take as it is unlikely that the 'active' manager will significantly underperform the index with a large peak to trough decline in the fund's market value (referred to as a 'drawdown'). As well as the fund's volatility substantially reflecting the index, the effect of index hugging is that there is minimal chance of outperformance. As the active share of the portfolio is very low the ability to outperform is also very low. To generate returns distinct from the index it is necessary for the manager to take positions that have a low correlation with the index. This approach to investment management is referred to as index unaware.

APPROPRIATE COST

The manager's costs inevitably impact on investor returns. If a manager is adopting positions that do not deviate significantly from an index, then the manager's fee structure should not be based on an assumption that the manager is applying superior tactical and strategic portfolio management skills. This is particularly the case when an investor can access a similar investment offering at a lower cost.

PREPAREDNESS TO ACCEPT VOLATILITY AND MAINTAIN CONVICTION

Volatility is the price that is paid for superior returns. An active manager is very unlikely to consistently achieve outperformance from period to period in the short term. Often investments take time to mature and achieve full potential. On this basis, investment returns will lag or may mark to market on a negative basis over the short term. A manager that shows conviction won't be panicked into abandoning those positions they strongly believe will produce results that outperform the relevant index.

OVERLAY OF INVESTMENT JUDGEMENT

Many investment managers take a quantitative approach to investment management. They use statistical analysis and the application of rules based criteria to initiate buy and sell transactions. This tool has screening benefits for an active manager, however it is unlikely that a quantitative approach can capture all of the subtleties or assess a dynamic change in factors influencing a market. Effective active management should be able to assess a change of this nature. Recently monetary easing has been of such a magnitude that the ability of an active manager to add value has been largely overwhelmed. Global monetary policy is now becoming desynchronised and this should allow active managers to create additional value.

FOCUS ON INVESTMENT FUNDAMENTALS

Ultimately security values are driven by the cash flows that can be derived from them, rather than temporary sentiment or accounting conventions. A successful active manager will appreciate the importance of fundamental valuation, particularly in respect to the minimisation of downside loss potential. In more volatile markets greater opportunity should exist to look through current prices and invest for longer term wealth creation.

CULTURE

Investment should be always driven by the objectives of the client, rather than that of the investment firm itself. "Client first" should be prominent in the principles and implementation of investment strategy. Tailoring the investment portfolio to client expectations and risk tolerance whether active or passive is a key consideration in the ultimate success of a strategy.

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