WHY DO WE PREFER PASSIVE INVESTMENTS?

After many years of investing money for our clients we came to the conclusion that choosing predominately passive funds for our client portfolios would generate better returns than using active fund managers. In the 10+ years subsequent to this decision we believe the returns for our clients have improved markedly.

Within this note we will cover:

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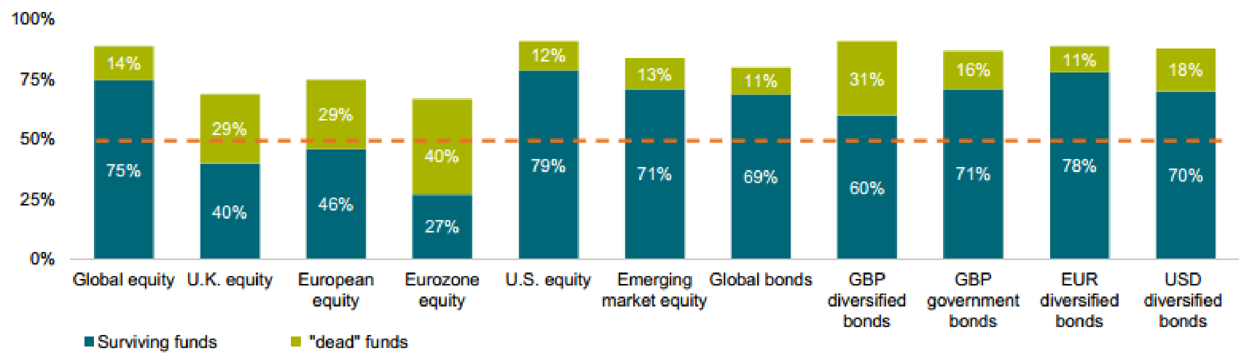
1. WHAT IS PASSIVE INVESTING?

Passive investing is the use of very low cost collective investments which simply buy the market index. There are thousands of indexes throughout the world of investing, however, most UK investors will have heard of the FTSE 100. This is an index of the UK's biggest 100 shares by capital. A passive investor can buy a collective fund which matches the FTSE 100 returns (less costs of the fund) for an annual cost of .2%.

Our main sources of fund manager are companies such as Dimensional, iShares, Legal and General, Aviva and Vanguard. These firms are committed to professionally maximizing index replication at very low costs.

2. ACTIVE FUND MANAGERS DO NOT OUT-PERFORM THE MARKET

Underperforming active funds: Percentage of active equity managers underperforming their benchmark, 10 years to end-2016

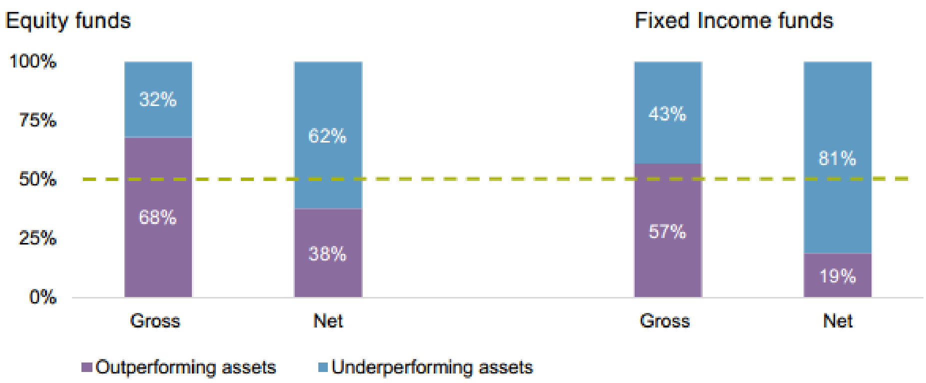


Past performance is not a reliable indicator of future results.
Sources: Vanguard calculations, using data from Morningstar, Inc.
Notes: Fund universe includes funds available for sale in the UK, filtered according to the description above, from the following Morningstar categories: UK equity – flex cap, large-cap blend, large-cap growth, large-cap value, mid-cap, small-cap; Europe equity – Europe OE: flex-cap, large-cap blend, large-cap growth, large-cap value, mid-cap, small-cap; Euro zone equity – flex-cap, large-cap, mid-cap, small-cap; Global – flex-cap, large-cap blend, large-cap growth, large-cap value, mid-cap, small-cap; US equity – flex-cap, large-cap blend, large-cap growth, large-cap value, mid-cap, small-cap; Emerging markets equity – emerging markets; Europe bond – EUR diversified; US bond – USD diversified; Global bond – global un-hedged bond; UK bonds – UK diversified, UK government.
Performance is for periods ending on 31 December 2016. Performance is calculated relative to prospectus benchmark. Fund performance is shown in GBP terms, net of fees, gross of withholding tax, with income reinvested, based on closing NAV prices.

First of all, active fund managers usually base all their statistics on funds which are alive at the end of the survey period. however many funds (which are unsuccessful) are merged or wound up. Taking UK equity as an example, 69% underperformed the benchmark of which 29% were closed during the 10 year period.

3. ACTIVE MANAGERS CHARGE TOO MUCH FOR THEIR SERVICES

Odds of success (asset weighted)



Past performance is not a reliable indicator of future results.
Sources: Vanguard calculations, using data from Morningstar, Inc. Notes: Fund universe includes funds available for sale in the UK, filtered according to the description above, from the following Morningstar categories: Emerging Market equity, Europe equity – large-cap, mid/small-cap; Global equity – large-cap, mid/small-cap; UK equity – large-cap, mid/small-cap; US equity – large-cap blend, large-cap growth, large-cap value, mid-cap, small-cap; Emerging Markets fixed income (FI); Euro FI; US FI; Global FI, Sterling FI; High Yield FI; Inflation linked; Other FI. Performance is for 10 year rolling periods starting in January 2003 and ending on 31 December 2016. Performance is calculated relative to prospectus benchmark. Fund performance is shown in GBP terms, both gross of fees and net of fees, gross of withholding tax, with income reinvested, based on closing NAV prices.

The above illustration shows the effect of funds charges on a rolling 10 year cycle starting in 2003 and ending in 2016. For equity funds, 68% of actively managed funds outperformed the index if no charges were deducted, but only 38% outperform the market when you take into account fees. The position with fixed interest funds is even worse with only 19% outperforming when fees are taken into account.

4. FURTHER STATISTICS

The principal reason for active fund managers is to add value by outperforming the market (i.e. the index which passive funds follow).

Not unsurprisingly, research against fund managers is difficult to come by in a market dominated by fund managers, however:

- Over 10 years, 62% of equity managed funds will underperform their benchmark (Vanguard 2016).
- 60% of active equity managers underperform on a yearly basis, over 20 years the figure rises to 80% (Charles Ellis).
- Over 10 years, 81% of bond investments underperform their benchmark (Vanguard 2017).
- In 2014, the UK Government recommended the Local Government Pension Scheme be moved to passive management, thus improving performance and saving £420 million in charges.

The following table confirms the number of active fund managers who actually beat their index benchmark for the period 1999 to 2013.

% of Fund Managers who beat their equivalent index 1999 to 2013.
(Includes funds wound up)

Sector	%	That is a one in
Global Equity	17.00%	6
UK Equity	35.00%	3
European Equity	22.00%	5
Eurozone Equity	18.00%	6
US Equity	20.00%	5
Emerging Markets Equity	25.00%	4
Global Bonds	18.00%	6
GBP Diversified Bonds	21.00%	5
GBP Government Bonds	8.00%	13
Euro Diversified Bonds	1.00%	100
USD Diversified Bonds	1.00%	100

Chance of beating the index!

(Vanguard approx. calculations using Morningstar data)

As you can see there was a 1 in 5 chance that an active fund manager would have beaten the US index, and a 1 in 100 chance of an active fund manager beating the index of Euro Bonds.

The following table shows the past performance results for actively managed funds over 3 and 5 years. It compares how many actively managed funds have actually beaten the index.

IMA SECTOR	Chances Of A Fund Outperforming Their Index Over:	
	3 Consecutive Years	5 Consecutive Years
UK All Companies	1 in 9	1 in 26
UK Corporate Bond	1 in 8	1 in 24
North America	1 in 9	1 in 90
Europe (x UK)	1 in 7	1 in 36
Pacific (x Japan)	1 in 5	1 in 37
Japan	1 in 21	None

With all these statistics why would anyone buy actively managed funds?

5. WHY DO ACTIVE FUND MANAGERS UNDER-PERFORM?

Perhaps an excellent analogy is the weather forecast. The UK Met Office has extensive resources, a vast array of historical data and computer modelling to work with, yet how often do they correctly predict the coming week's weather, let alone 3 or 6 months hence?

5.1 The Efficient Market Theory

The market price of equities is created by supply and demand. If you believe that in today's world the markets are efficient (i.e. that they correctly reflect the perceived value of a particular stock or asset) then why pay a manager to second guess what might happen in the future?

The fact that money managers are not beating the index does not mean they are stupid, quite the opposite. The large investment banks and fund management houses employ many of the brightest brains around, however, these very bright people are all analysing the same corporate data and the same economic statistics. The huge numbers of people doing this work in effect help to create the efficient market which negates any long term added value from their service.

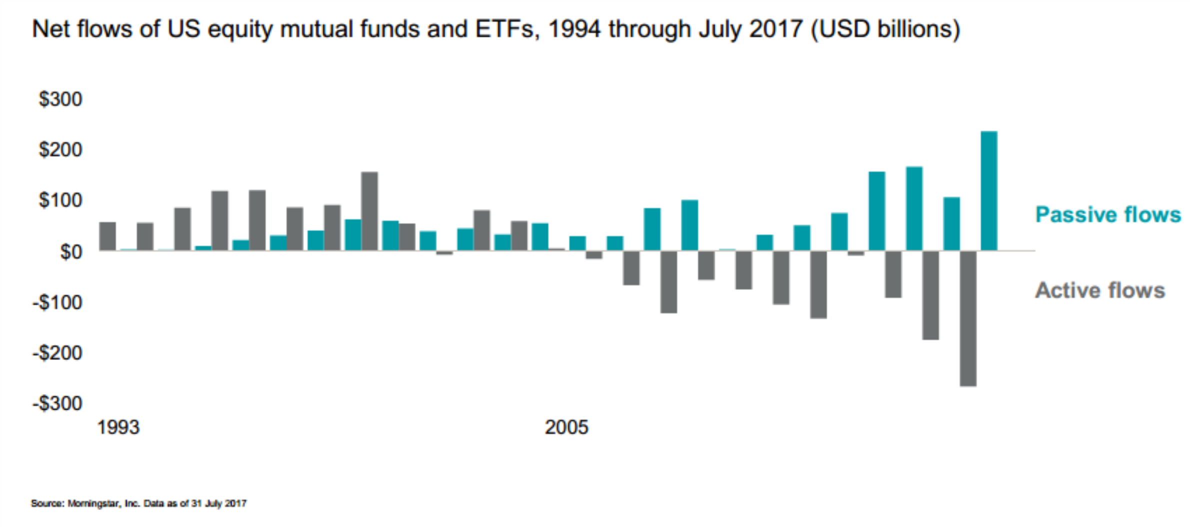
5.2 Stock Turnover

Managed funds either end up as closet trackers or they try and beat the index with a very high turnover of stock. It is not at all unusual to have an annual stock turnover in a portfolio of greater than 100%. This level of short-termism rarely generates above par returns and the costs of buying and selling mean there is a huge mountain for the manager to climb to beat the passive alternatives.

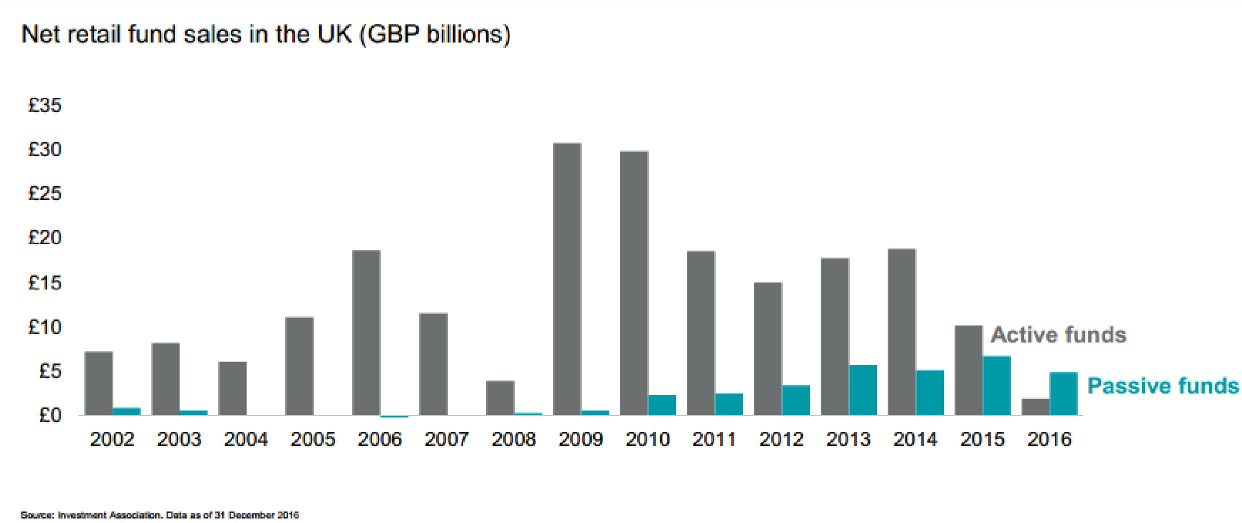
5.3 Costs

Managers need to be paid (a lot!) as do researchers and all the paraphernalia that goes with them. This means that active funds may have to produce between 1% and 3% returns before they even start in order to match the performance of the market. This is an incredibly tall order.

6. PASSIVE IS BECOMING THE NORM RATHER THAN THE EXCEPTION



And the UK is not far behind:



7. ASSET ALLOCATION

Empirical research shows that when a portfolio contains more than one asset class (i.e. equities, property and bonds) the performance of the asset classes determines the return of the portfolio. The fund choice has very little additional value.

- The Myners Report in 2001 said, "Institutional investors may be devoting insufficient resources to asset allocation which may contribute the majority of their investment performance".

- The Sandler Report in 2002 said, "For the individual investor the asset allocation decision is by far the most important factor determining returns."

- The Ibbotson Kaplan review showed that asset allocation (Beta or passive) provides 90% of the return of a portfolio.

If 90% of your return is down to where you invested (i.e. equities, fixed, etc) then 80% of any performance above the benchmark is down to Factors, ***not*** fund choice.

See our notes "An Introduction To Asset Allocation" for a full explanation of asset allocation.

8. EXCEPTIONS PROVE THE RULE

For some sectors (Bricks and Mortar commercial property for instance) we have to use managed funds, however we tend to choose funds where the manager has been in situ for many years and has a consistent track record of over-performance.

We also try not to be dogmatic about any investment area and as such we have a select group of thematic and specialist (healthcare for instance) active funds we have supported for many years. These provide a higher risk, higher return segment to portfolios.

9. SUMMARY

We choose passive or index funds as the bedrock for all of our client investments.

It is worth noting that perhaps the greatest living investor 'says it all', "The best way to own common stock is through an index fund" (Warren Buffett). Or if you prefer Charles Schwab, "Most mutual fund investments I have are index funds".