Manager versus Machine

Active and passive funds compared

December 2023

2023 has been a more positive year for active fund performance than the washout of 2022, but not by much. Just over a third (36%) of active managers in our sample of funds across seven key equity markets have outperformed a passive alternative in the year to date, up from 27% last year. At the same time active management remains under the pump as inflows are anaemic and investor confidence is low. Passive funds meanwhile continue to show more resilience in the face of cost of living pressures and the constraints thereby placed on consumers' ability to invest in funds.

Key points

- **36% of active equity funds outperformed a passive alternative in 2023**
  - That's up from 27% in 2022
  - Over 10 years, just 32% of active equity funds have outperformed the passive machines, compared with 56% in 2021
  - Weak relative performance from UK equity funds explains the slump in the long run figures
- **Global active funds continue to disappoint**
  - Only a quarter (25%) of active global funds managed to outperform the passive machines in 2023, and this falls to 22% over 10 years
  - This is the most popular fund sector with retail investors, and so failure here has widespread repercussions
- **UK funds are back from the brink in 2023**
  - 44% have outperformed a passive alternative in the year to date, compared to just 13% in 2022
  - Just 36% have outperformed over 10 years, compared to 85% in the ten years to the end of 2021
- **Outperforming active funds tend to have lower charges**
  - This is especially marked in the global sector looking at 10 year performance, where the average charge for outperforming funds is 0.86% and for underperforming funds is 0.99%
- **Tracker fund investors need to be a bit active**
  - Over 10 years the difference between the best and worst performing global tracker fund is 76%
  - There is a wide variation in passive fund charges, especially in UK equities
- **Active management under the pump**
  - In the last five years active funds have seen £9 billion of net retail outflows, compared to £75 billion of net inflows into passive funds, according to AJ Bell analysis of IA data
  - Active fund launches in 2023 are on course to hit their lowest level since 2008

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Manager versus Machine in detail

Our Manager versus Machine report looks at active funds in seven key equity sectors, and compares performance to the average passive fund in the same sectors, rather than a benchmark index. This provides a real world comparison, reflecting the practical investment choice that retail investors face, between active and passive funds. While benchmark indices are also useful comparators for active funds, investors can't buy an index; tracker funds are the nearest they can get.

Active v passive performance in 2023 YTD

In 2023 so far, 36% of active funds have outperformed the average passive alternative (see Table 1). That might not sound like a lot, but it's an improvement on 2022 when just 27% of active managers beat the passive machines. The weak overall showing in 2023 was heavily influenced by poor active performance in the global sector, where only 25% of active managers outperformed the typical global tracker fund. The global sector is the most popular with retail investors, and so active underperformance here can be expected to be widely felt amongst fund buyers. The global sector is also populated with so many funds that it makes up over a third of our one year performance sample, and so exerts a large gravitational influence on the overall figures for active management.

Table 1. Active outperformers

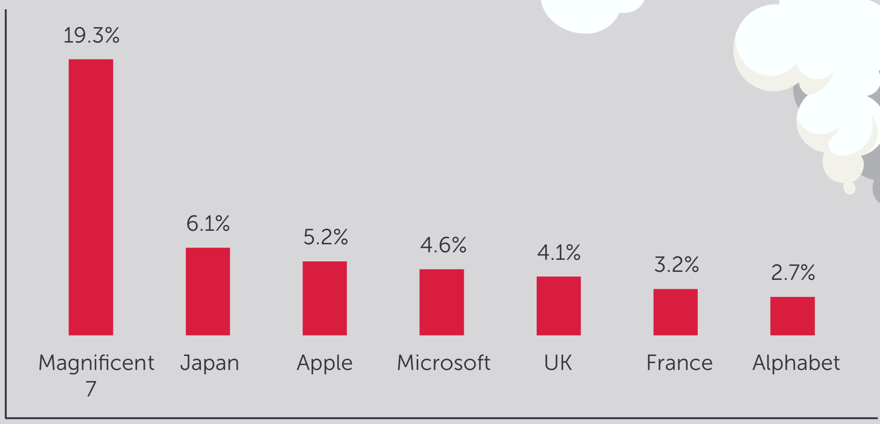
	% of active funds outperforming			
	2023 YTD	**5 Yr**	**10 Yr**	**2022**
Asia Pacific Ex Japan	38%	29%	39%	12%
Europe	39%	40%	46%	43%
Global	25%	21%	22%	30%
Global Emerging Markets	57%	62%	44%	21%
Japan	25%	38%	47%	36%
US	40%	23%	17%	40%
UK	44%	35%	36%	13%
Total	36%	32%	32%	27%

Sources: AJ Bell and Morningstar to 30th November 2023

In aggregate active global funds have struggled to beat the passive machines partly because of a long running underweight position in both US shares and large cap companies. These have been winning areas of the global stock market over the last decade, driven in large part by the success of the 'Magnificent Seven' tech titans of the S&P 500. Active managers might find themselves underweight these areas due to their bottom up stock selection process which leads them to invest in companies outside the US, or in more modestly-sized, less analysed companies where active managers can feel like they have more of an edge. Value-orientated funds within the global fund universe have probably also baulked at paying the premium valuations attached to the Magnificent Seven.

Meanwhile some active managers may feel that the current benchmark global indices followed by passive funds aren't sufficiently diversified at a regional or stock specific level. More particularly, around two thirds of the MSCI World Index can be found in the US stock market, and around a fifth in the seven biggest stocks in the S&P 500 (see Chart 1). In order to express a positive view on these areas that differentiated them from the benchmark, active managers would have to invest even more than the index in these areas, which some may feel is too high a level of concentration at a regional, industry or stock level.

Chart 1. % of MSCI World Index



Sources: MSCI and Blackrock

The longer view

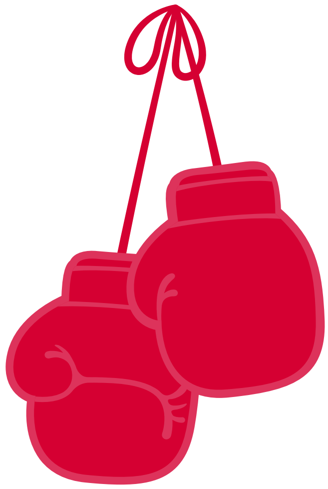
One year is a short time over which to judge active management, as temporary trends can distort the picture, for better or worse. However even on a 10 year view, only around a third (32%) of active managers in our sample have outperformed the average passive alternative (see Table 1). Indeed in the Global and US sectors, the average passive fund has even beaten some top quartile performers amongst active funds (See Table 2). What's quite interesting is the big difference we have seen in these long term numbers since our first Manager versus Machine report in 2021. At that stage, over a 10 year period, a more reassuring 56% of active funds had outperformed the passive machines.

Much of this comes down to a turnaround in fortunes for UK equity funds. In our 2021 report, 85% of UK equity funds had outperformed the passive machines over a 10 year period, and that has now fallen to just 36%. This sea change has been driven by the propensity of UK active managers to invest further down the cap scale, combined with weak performance from small and mid cap indices compared to the big beasts of the FTSE 100 (see Chart 2).

Table 2. Active v passive 10 year performance

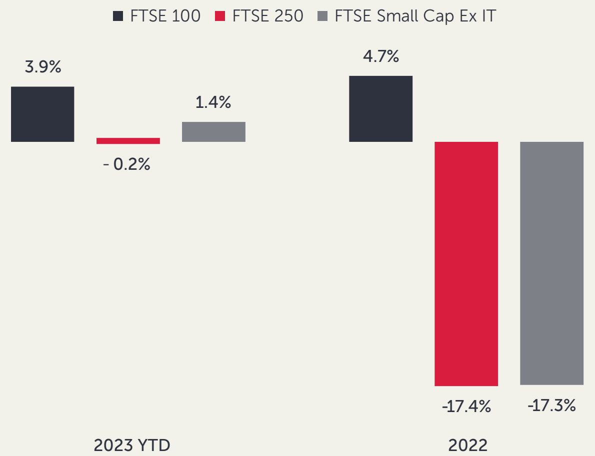
	10 year returns %			
	Active top quartile	Active average	Active bottom quartile	Passive average
Asia Pacific Ex Japan	117.5	90.3	71.8	97.6
Europe	126.4	105.9	88.5	108.4
Global	177.2	141.2	107.9	187.4
GEM	78.7	56.5	44.6	60.5
Japan	121.4	99.3	88.6	101.4
US	261.6	227.5	186.3	272.7
UK	69.7	54.6	40.6	61.3

Sources: AJ Bell and Morningstar to 30th November 2023



The performance differential between the different segments of the UK stock market has significantly moderated in 2023. As a result 44% of active UK equity funds have managed to outperform a passive alternative so far in 2023, up from just 13% in our 2022 report. However the damage to the 10 year performance figures was done last year, and until mid and small caps stage a comeback, we can expect active managers plying their trade in the UK to continue to post disappointing longer term returns versus the passive machines.

Chart 2. Mid and small cap drag



Source: FE total return to 30th Nov 2023

Outperforming active funds tend to be cheaper

We also note that charges tend on average to be lower amongst active outperformers when compared to active underperformers over a 10 year period (see Table 3). This trend occurs almost across the board, and is particularly pronounced amongst global funds, where 10 year underperformers charge on average 0.99%, and 10 year outperformers charge on average 0.86%. The exception to the rule seems to be in the US sector, where underperformers are 1 basis point more expensive on average than the outperformers. However there are only a small number of outperformers in this area, which means individual fund charges can exert a greater influence on the average.

It might seem obvious that higher charges are associated with weaker long term performance as they can be relied upon to continually erode returns. But there is a line of argument that higher charges are attached to premium managers who bring with them the skill to deliver superior performance. The data in Table 3 reflects only one point in time, and while the differences between the average charges for outperformers and underperformers are notable, they aren't glaring in most sectors. In and of itself this data isn't enough to demonstrate a causal relationship between lower active charges and better performance. However it does undermine the idea that higher charges are associated with better performance from active funds.

Table 3.

	Ongoing charges %	
	10 year outperformers	10 year underperformers
Asia Pacific Ex Japan	0.90	1.00
Europe	0.86	0.88
Global	0.86	0.99
GEM	0.99	1.05
Japan	0.88	0.91
US	0.86	0.85
UK	0.82	0.85

Sources: AJ Bell and Morningstar to 30th November 2023

Tracker fund investors need to be a bit active

It's a different picture when looking at passive funds, because for funds tracking the same index, one of the key differentiators will be the charges levied, as there should be no question of outperformance or underperformance because of manager skill, or lack thereof. Looking purely at performance, it's clear there can be a wide dispersion of returns from passive funds within the same sector, as shown by Table 4. Partly this is a reflection of the different indices that can be tracked within each sector, for instance the FTSE 100 or FTSE All Share in the UK.

Index selection goes some way to explaining the 76% return differential between the best and worst performing global funds (S&P Global 100 versus FTSE All World Ex-UK respectively). But charges also play a part in the performance differential of passive funds, especially over the long run. While the choice of index to be tracked is of course important, reducing passive charges is a more concrete way for passive investors to boost their returns. No-one knows which indices will perform best over the next 10 years, but once you've chosen an index, choosing a cheaper fund is almost certain to deliver better returns.

Table 4.

	10 year passive fund performance %		
	Best performing	Average	Worst performing
Asia Pacific Ex Japan	101.4	97.6	67.2
Europe	109.0	108.4	106.2
Global	234.7	187.4	158.7
GEM	66.6	60.5	53.0
Japan	106.6	101.4	97.7
US	280.3	272.7	259.4
UK	65.7	61.3	48.5

Sources: AJ Bell and Morningstar to 30th November 2023

Table 5.

	Passive funds ongoing charge %			
	Most expensive	Average	Cheapest	Range
Asia Pacific Ex Japan	0.32	0.19	0.11	0.21
Europe	0.13	0.11	0.06	0.07
Global	0.64	0.14	0.12	0.52
GEM	0.41	0.24	0.20	0.21
Japan	0.31	0.15	0.08	0.23
US	0.30	0.10	0.05	0.25
UK	1.06	0.16	0.05	1.01

Sources: AJ Bell and Morningstar to 30th November 2023

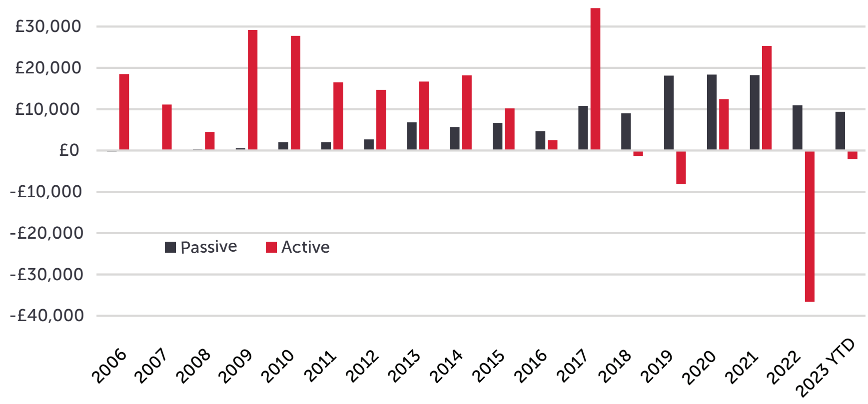
Table 5 shows the range of passive charges within each sector. Unlike with active funds, there can be no suggestion of even the fig leaf of superior performance for more expensive funds to hide behind, seeing as funds in the same sector are doing a very similar job. The comparison is especially stark in the UK equity sector where the cheapest tracker fund charges 0.05%, and the most expensive charges 1.06%. These two funds track slightly different indices (FTSE All Share and FTSE 100 respectively) and so direct comparison is not quite like for like. The cheapest FTSE 100 tracker costs just 0.06% per annum however, and has returned 64.3% to investors over 10 years. That compares to the tracker fund charging 1.06%, which also tracks the FTSE 100, and has returned just 48.5% to investors over the last 10 years. There is no discernible reason, apart from inertia or simply being unaware of the damaging effect of charges, which prevents investors switching from the higher cost tracker to the cheaper option. Even passive investors need to be a bit active when it comes to their fund selection.

Active management under the pump

It is a bleak time indeed for active management. This is reflected in the investment trust industry by discounts reaching a record high, according to the AIC. Amongst open-ended funds, flow data paints a grim picture of the state of active management. Across the last five years, £9 billion has in aggregate been withdrawn from active funds, compared with £75 billion going into passive funds, according to AJ Bell analysis of Investment Association data. Chart 3 shows that flows in 2022 were particularly shocking, but even in 2023 remain negative. We should also bear in mind that active flows over the last five years have almost certainly been flattered by the ESG fund craze, which has helped paper over the cracks. Cost of living pressures are no doubt partly responsible for the fund exodus, but then again, passive funds still seem to be hoovering up enough cash to keep the lights on.

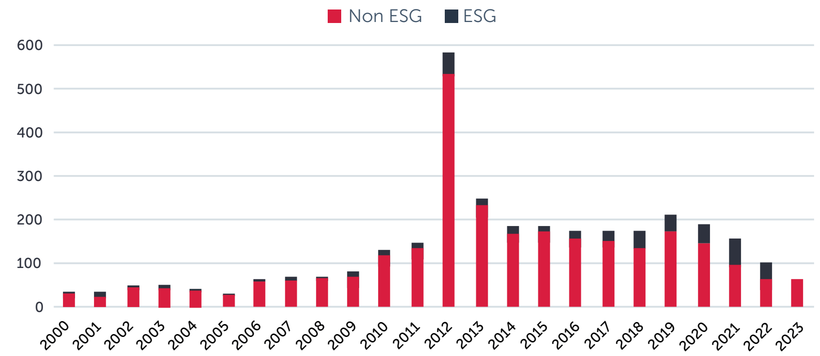
Weak investor demand almost certainly explains why fund groups haven't been launching many funds in 2023. Fund launches this year are running at around 40% of the average for the previous five years, as shown in Chart 4. We can also see the effect the ESG frenzy has had on fund launches, adding significantly to the total in recent years. With one month to go until the end of the year, in 2023 active fund launches are on course to hit their lowest level since 2008. (The 2012 spike is likely a combination of RDR and pensions auto-enrolment).

Chart 3. Net retail sales £ million



Source: Investment Association

Chart 4. Active fund launches

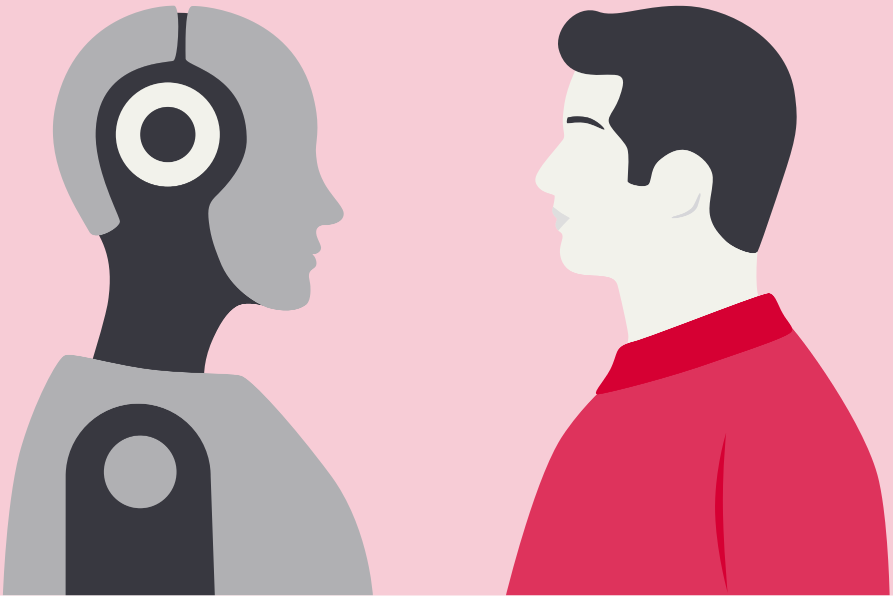


Source: Morningstar to 30th November 2023, data includes only currently trading funds and not funds which have previously been wound up or merged

Conclusion

The performance of active managers has improved from the horror show of 2022, but the passive machines are still winning the battle, and the war, in terms of both returns and flows. Active performance in 2023 has been heavily influenced by a poor showing from the global sector, which is subject to the long-running hegemony of US tech stocks, aside from a blip in 2022. Meanwhile the long term performance figures for active funds have been adversely affected by poor returns from UK mid and small caps compared to the big blue chips in the last two years.

Investors in active funds clearly expect outperformance, but statistically not all active funds can deliver this. Investors can tilt the odds in their favour using some judicious active fund selection and ensuring they have a high conviction in the skill of the managers they are trusting with their money. Using a combination of active and passive funds investors can achieve diversification, keep charges down and also back managers in whom they have a high degree of confidence. Passive fund investors shouldn't be complacent about the rise of the machines. Ultimately some human decision-making is still required. Partly that's to choose an index, but once chosen, it's also a question of selecting tracker funds which are competitively priced. The result of not doing so can be to significantly fall behind the pack, which is totally at odds with the creed of passive investing.



Manager versus machine methodology

Our report analyses the performance and charges of over 1,000 open-ended funds across seven popular equity sectors which are identified as the primary share class, using the median average performance of passive funds as a hurdle for active managers to beat. When calculating the performance of the average passive fund we have excluded ESG and smart beta passive funds which include an element of active selection at an index level. Over longer time periods, the performance data does contain some survivorship bias, because underperforming funds will have tended to be closed or merged.

The report analyses historical fund data, and while past performance can provide an insight into long running trends, it is never an entirely reliable guide to the future. This report was published in December 2023.