Manager versus Machine

Active and passive funds compared

2022 has been an annus horribilis for active equity funds, especially those plying their trade in UK shares. In a year when stock markets have faltered, active managers might have expected to nudge ahead of the tracker funds that simply passively follow the index, but our 2022 Manager versus Machine report shows any such hopes have been dashed.

Key points

- **Just over a quarter (27%) of active equity funds have outperformed a passive alternative in 2022**
  - That's down from 34% in 2021
  - Looking over 10 years, 39% of active equity funds have outperformed a passive alternative, down from 56% in our 2021 report
- **Active managers investing in UK equities have had a real stinker of a year**
  - Only 13% of funds in this sector outperformed a passive alternative, down from 41% in 2021
  - Exposure to mid and small caps explains the why active managers failed to match the machines
  - In the longer term the UK has been a bright spot for active managers, with 60% outperforming over 10 years
- **US active managers have had a relatively good year**
  - 40% of active managers outperformed a passive alternative in 2022
  - That's up from 19% in 2021
  - The longer term picture is much bleaker for active US managers, with only 17% beating the passive machines
  - UK investors have been given a get out of jail free card by weaker sterling
- **The most costly UK tracker fund is 21 times more expensive than the cheapest**
  - Passive investors should ensure they hold competitively priced products
  - An investor switching £10,000 from the most expensive to the cheapest UK tracker would be £6,627 better off after 20 years, assuming 7% gross annual growth

Laith Khalaf, Head of Investment Analysis, AJ Bell

Laith Khalaf is Head of Investment Analysis at AJ Bell, and specialises in researching and writing about funds, markets and investing. He has over 20 years of industry experience, covering a wide range of roles across pensions and investments, analysing and providing commentary on key issues for both DIY investors and financial advisers.

Summary

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.

Overall our 2022 report shows it's been a poor year for active managers, with the machines doing even better than in 2021. Just 27% of active managers have been able to beat a passive alternative in the year to date (to 30th November 2022). That's down from 34% over the same period in 2021. The longer term performance of active funds is more encouraging, with 39% outperforming over a 10 year period. That's still considerably less than half of course, and this figure will be flattered by survivorship bias, as underperforming funds tend to be closed down or merged into others.

Table 1. Proportion of active funds outperforming the average passive fund

IA sector	2022 YTD	5 years	10 years	2021
Asia Pacific Ex Japan	12%	19%	47%	26%
Europe Ex UK	43%	40%	51%	53%
Global	30%	21%	20%	25%
Global Emerging Markets	21%	36%	44%	50%
Japan	36%	37%	49%	47%
North America	40%	17%	17%	19%
UK All Companies	13%	27%	60%	41%
TOTAL	27%	26%	39%	34%

Sources: AJ Bell, Morningstar, total return in GBP to 30th November 2022, 2021 data to 1st Dec 2021

One year is far too short a time frame over which to judge active managers, especially given some of the headwinds they have faced in 2022, which we outline below. However the longer term performance figures suggest there are certain sectors where active managers have performed better than others, so investors might consider being selective around where they opt for passive exposure, and where they might have better success with an active manager at the helm.

Where they do select active managers, it's also clear that investors need to tilt the performance odds in their favour, by conducting research to pick out managers with a proven track record of outperformance. That's no guarantee going forward of course, but if an individual active manager has delivered outperformance over a long period, that suggests they are skilful and not just lucky. That skilful active managers exist is not incompatible with a large proportion of active managers underperforming a passive alternative.

Equity fund performance in 2022

Whether you're an active or passive investor, it's not been a good year to be in the markets, period. Returns from the majority of funds have been negative, with even many top quartile funds in each equity sector trading in the red in 2022. The UK stock market has been a relatively bright spot for performance this year, though in absolute terms, returns have still been disappointing. This is compounded by the fact that many active funds in this sector have failed to beat a tracker fund, with the average active fund returning -8.7%, compared to 1.9% for the typical passive fund.

The longer term picture looks much healthier, with active and passive investors enjoying strong returns from equity fund investment over the last ten years, even after this year's disappointing performance. This shows the long term benefits of being invested in the stock market, even though you can regularly expect to experience poor years like 2022. Indeed, despite the bear market in the S&P 500 this year, US passive fund investors have still enjoyed a 15.9% annualised return over the last 10 years, and that's also fed through into the global sector, where funds have a high weighting to US stocks. There's no doubt the US stock market has been the place to be over the last decade, but as detailed below, fund returns for UK investors this year have been flattered by currency movements.

Table 2. Active and passive fund performance

	2022 YTD Total Return %			
	Active Top Quartile	Active Average	Active Bottom Quartile	Passive Average
Asia Pacific Ex Japan	-4.3	**-8.6**	-13.5	**0.4**
Europe Ex UK	-4.6	**-8.1**	-14.7	**-6.9**
Global	-4.8	**-9.8**	-15.8	**-5.8**
Global Emerging Markets	-9.8	**-13.2**	-16.2	**-8.1**
Japan	-1.8	**-8.1**	-15.2	**-5.9**
North America	-3.0	**-7.5**	-15.3	**-6.0**
UK All Companies	-1.5	**-8.7**	-17.6	**1.9**

Sources: AJ Bell, Morningstar total return in GBP to 30th Nov 2022

	10 Year Total Return % (per annum)			
	Active Top Quartile	Active Average	Active Bottom Quartile	Passive Average
Asia Pacific Ex Japan	8.9	**7.7**	6.4	**7.8**
Europe Ex UK	10.2	**9.1**	8.4	**9.1**
Global	12.3	**11.0**	9.2	**12.5**
Global Emerging Markets	6.1	**5.0**	4.0	**5.3**
Japan	10.7	**9.3**	8.7	**9.3**
North America	15.5	**14.5**	13.4	**15.9**
UK All Companies	8.0	**6.9**	5.8	**6.5**

Sources: AJ Bell, Morningstar total return in GBP to 30th Nov 2022

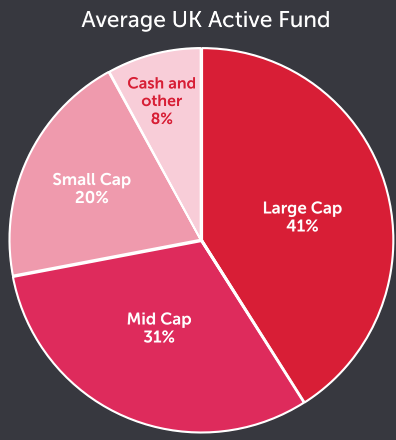
UK managers suffer small cap drag

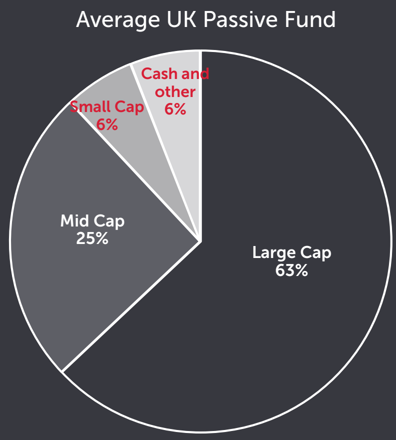
As the results above show, it's been a pretty dismal year for active managers in the UK. Just 13% have beaten a passive alternative, with the average active fund returning -8.7%, compared to 1.9% from the average passive fund. Indeed active performance has been so poor that even some top quartile active funds have underperformed the average passive fund.

While it may be easy to use this data to suggest active managers in the UK aren't worth their salt, to do so would be mistaken. Over the long term, active managers in the UK have actually performed well on the whole, with 60% outperforming a passive alternative over ten years. And it is the same driving force behind their strong outperformance in the long run which also explains their poor showing in 2022.

Based on portfolios at the beginning of this year, 94% of UK active managers were overweight small and mid caps. UK active managers tend to prefer more modestly sized companies because they are less well analysed and so have a greater propensity to surprise the market. The top end of the FTSE All Share is also very concentrated in a few big names and sectors which active managers are unlikely to replicate. Mid and small caps can also offer more promising growth prospects, and provide active managers with some differentiation from the index, which they are trying to beat.

As the performance figures below show, exposure to small and midcap stocks has been a useful performance kicker for active managers over the long term. But in 2022, that picture was turned on its head, because the big blue chips of the FTSE 100 performed significantly better, leading to some substantial small cap drag on active portfolios. Large cap outperformance has been in part driven by the superior returns from sectors that constitute a large part of the FTSE 100, especially energy, but also tobacco, defence and pharma. Weaker sterling has also buoyed the share prices of FTSE 100 stocks more than their neighbours in the FTSE 250 and FTSE Small Cap indices, because they have more international revenues. However, the longer term performance of these indices shows that mid and small caps are a healthy place to be, and we can expect this size bias to be a tailwind for active managers in the long run. Though in 2022, it was most definitely not.





Source: Morningstar, Morningstar equity style categories, portfolios in Jan 2022

Table 3. UK Index Performance

	Total return %	
	Year to date	**10 years**
FTSE 100	6.3	88.6
FTSE 250	-16.3	106.1
FTSE Small Cap	-14.0	151.8
FTSE All Share	1.8	92.8

Source: FE, total return to 30th Nov 2022

Techlash boosts US active managers

This year has seen a techlash damage the share prices of big US technology stocks, which make up such a large part of the S&P 500, and consequently, the passive funds that track it. 40% of active equity funds investing in the US have beaten a passive alternative in 2022. That statistic may not have the ring of resounding triumph, but it compares favourably to 2021, when only 19% of active US funds managed to outperform the passive machines, and to the long term picture, which shows that only 17% of active funds have outperformed over a ten year period. Against this backdrop then, it's been a positive year for active managers investing in the US stock market.

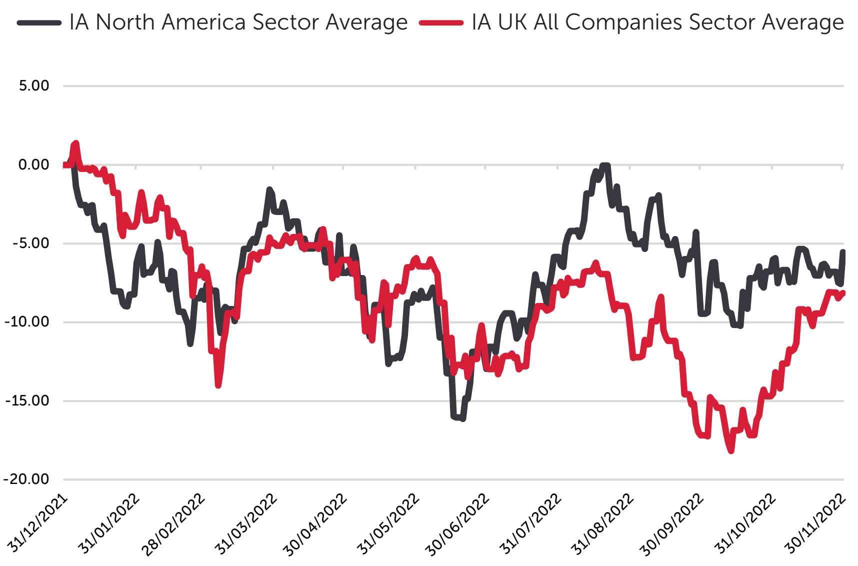
The S&P 500 fell into bear market territory in 2022, dropping by more than 20% in the first six months of the year. But a little appreciated fact is quite how much UK investors have been insulated from this downdraft by weaker sterling. The pound has tumbled from $1.35 at the beginning of the year to around $1.22 now. A falling pound has basically handed UK investors a get out of jail free card, as the world's biggest stock market has gone into meltdown. The S&P 500 has produced a dollar return of -13.5% in 2022 to date. However, in sterling terms the S&P 500 has returned -1.6%, a significantly better result. UK investors conducting an end of year review of their US holdings might well wonder what all the fuss is about.

UK fund managers, on the other hand, must be tearing what's left of their hair out. This is the first year since 2016 when the FTSE All Share has beaten the S&P 500 (barring a tremendous reversal of fortunes in the last few weeks of the year). Yet because of mid and small cap exposure dragging down the performance of UK active funds, and at the same time weaker sterling pushing up the performance of dollar denominated stocks for UK investors, the average US fund has still outperformed the average UK fund, as the chart below shows. In the year so far, the IA UK All Companies sector average has returned -8.1%, while the IA North America sector average has returned -5.6% (including both active and passive strategies).

Table 4. Techlash in numbers

	2022 YTD Share Price Change %
Alphabet Inc	-29.9
Amazon.com Inc	-42.1
Apple Inc	-16.6
Meta Platforms Inc	-64.9
Microsoft Corp	-24.1
Netflix Inc	-49.3
Tesla Inc	-44.7
Average S&P 500 stock	-8.1%

Source: Sharepad to 30th Nov 2022



Source: Morningstar total return in GBP to 30th Nov 2022

Passive charges can eat your pension too

Of course, active managers charge higher fees for their services than passive funds, or at least, most passive funds. The ongoing annual charge levied for active funds is typically around 0.9%, a premium of around 0.75% on the average tracker fund. This is an ongoing headwind active managers need to overcome through superior performance to beat the passive machines. (All the performance figures in this report are provided net of charges, so already take these fees into account). But it's not just active managers who charge a premium over the average tracker fund, some passive funds do to. The range of charges levied on passive funds varies from sector to sector, but there is a pretty egregious premium charged by some tracker funds in the UK All Companies sector, where the cheapest comes with a price tag of 0.05% per annum, the average passive charge is 0.18% per annum, and the most expensive charge levied for a fund in this sector is 1.06% per annum. In other words, the most expensive UK tracker fund costs twenty one times more than the cheapest. And these ongoing fees are levied year in, year out. Unlike with active managers, there can be no attempt to justify higher charges through superior performance potential, seeing as these funds are doing a very similar job of tracking an index. If they do this precisely, the net return delivered to investors will be the index performance, minus charges. To put this in pounds and pence, an investor who switched £10,000 from the most expensive UK tracker fund to the cheapest would be £6,627 better off after 20 years, assuming a 7% gross return from the market. There can be little reason for investors not to make such a rewarding switch.

Table 5. Active and passive fund charges compared

	Ongoing charges %		
	Average active	Average passive	Active Premium
Asia Pacific Ex Japan	0.95	0.16	0.79
Europe Ex UK	0.87	0.12	0.75
Global	0.91	0.14	0.77
Global Emerging Markets	1.00	0.24	0.76
Japan	0.89	0.15	0.74
North America	0.85	0.10	0.76
UK All Companies	0.84	0.18	0.66

Source: AJ Bell, Morningstar

Table 6. Range of passive charges

	Passive Funds Ongoing Charges %			
	Cheapest	Average	Most expensive	Range
Asia Pacific Ex Japan	0.11	0.16	0.33	0.22
Europe Ex UK	0.06	0.12	0.50	0.44
Global	0.12	0.14	0.64	0.52
Global Emerging Markets	0.20	0.24	0.42	0.22
Japan	0.08	0.15	0.33	0.25
North America	0.05	0.10	0.29	0.24
UK All Companies	0.05	0.18	1.06	1.01

Source: AJ Bell, Morningstar

Conclusion

It's been a poor year for both active managers and tracker funds, but overall the active managers have come off worse. Active fund performance should not be judged over a period of just one year however, and as this report shows, short term deviations between active and passive fund performance can often be explained by stylistic differences, which may have different effects in the short and long term.

It is the longer term picture which is more important for investors, and here active managers have fared better. Though with only 39% outperforming over a ten year period, there is clearly some work for investors to do in sorting the wheat from the chaff. We should also recognise that even when looking at cumulative performance over a longer time period, results are heavily influenced by recent returns. For instance, when looking back over ten years from the end of 2021, things looked much better for active funds, with 56% outperforming.

While the statistics might suggest that overall picking an outperforming fund is close to a coin toss, investors can tilt the odds in their favour. They can split their portfolios between active and passive funds regionally, depending on where they see the most chance of active fund success and the greatest rewards. Researching individual funds should also provide investors with a good idea of which active managers have produced outperformance in the past. While this is no guarantee of future success, if delivered over a long time frame, outperformance suggests the manager is skilful, and not just lucky.

Unlike the most vociferous disciples of active or passive management, investors can afford to be pragmatic, not dogmatic, in their fund selection. By picking competitively priced tracker funds, and supplementing this with a bit of judicious active fund selection and diversification, they can give themselves a good chance of achieving portfolio outperformance in the long run, through a combination of both active and passive strategies.

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 2022.

Notes to editors:

Past performance is not a reliable guide to the future and some investments need to be held for the long term.
This content is intended for journalists only and should not be relied upon by individual investors.