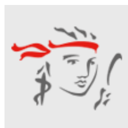
PRUDENTIAL
INVESTMENT MANAGERS



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The case for active investment management

Any discussion over the merits of active versus passive investing is liable to quickly turn heated as investors and wealth managers tend to decisively favour one strategy over the other. In this article, the first in a series on active and passive investing, we'll examine active investing which – as its name implies – relies on an active, hands-on approach from a portfolio manager. This compares to passive investing, which typically uses index tracking funds and Exchange Traded Funds (ETFs).

Objectives of an active investment strategy

The objective of active investment managers is to use their expertise to select individual stocks or securities with the goal of outperforming a specific benchmark chosen by the client.

How active management works

Active managers like Prudential take a proactive approach to investing. They use data gathered by teams of investment research analysts, and their experience, to make the best possible decisions about which assets to buy, sell or hold. They believe that short-term price fluctuations are important and can be used to add value to client portfolios by buying or selling when these prices move lower or higher than they judge they should be. They buy undervalued securities and sell overvalued securities.

Advantages of active investment management

Flexibility

Active managers have the flexibility to select and combine different securities like stocks, bonds and money market instruments, across a wide range of industries and geographies. Unlike passive managers, they have the power to ignore specific securities within an index, thereby avoiding the fallout from corporate disasters (such as those recently experienced in South Africa). Active management requires involved decision making, which includes keeping abreast of factors such as changes to taxation, laws and politics which could affect investments. Even more importantly, these managers follow company decision-making closely, with the ability to understand each step in a company's growth path and to vote on the important decisions affecting the company's future with shareholder interests at heart.

Risk management

Being able to manage risk is another key benefit to active management. There are two aspects to this risk management. The first involves the actual longer-term structure of a portfolio, where the active manager decides how much overall risk will be allowed for the entire set of holdings, and each individual security, over time. For example, they may set a lower limit on the credit rating of bonds the portfolio can hold (like no "junk bonds"), or an upper limit on the maturity of debt securities (such as no more than 3 years). The second involves the portfolio's shorter-term management: the manager will continually monitor a fund's actual risk measures. They can then either increase or cut back on the risk within the investment at any time. And, if a particular stock becomes too risky and shows the potential for permanent capital loss, the manager can sell it before serious damage is done.

What's more, experienced active managers can skilfully navigate market volatility by selecting undervalued high-quality investments with the potential for longer-term growth. The result is that active managers help limit the downturns in their funds' value during times of market volatility, cushioning losses.

Efficient capital allocation

Active management is based on the in-depth analysis of relevant information and thus allows for efficient allocation of capital. This means that, in theory, the "best" companies, with the highest returns on investment, get the most financing, through either borrowing (issuing bonds) or selling shares. This has the potential to create significant value for investors over the long term.

Use of qualitative data

Active management allows for the use of quantitative and qualitative data, including company social responsibility ratings which consider both financial returns and social/environmental benefits which can bring about positive change.

Disadvantages of active investment management

Fluctuating short-term returns around a benchmark

On a relative basis, actively managed funds will record higher highs, and lower lows, against their benchmark than a passively managed fund. The latter will never beat its benchmark.

Over the past 20-30 years, it has been shown globally that there are periods during which it is easier for active managers to outperform their benchmark index, and also times when it is more difficult. This will depend on global and local market conditions, as well as the inherent abilities of active managers. Fund managers like Prudential consistently outperform their benchmarks, including fees, over many different periods. However, there will always be periods of underperformance due to changing market conditions or other short-term factors. This is why it's important to choose a fund manager with a strong long-term track record for outperformance of their benchmarks.

Equally, it's important to know what investment time horizon your chosen fund is managed to. Generally speaking, if you want to avoid much investment volatility you should choose funds with more bond and cash exposure and investment horizons of up to three years or so.

Fees

Besides the basic administration fees incurred by all different types of investments, actively managed funds include additional fees to

pay for the professional teams that manage them and to cover the transactional costs incurred by more frequent trading.

The active bottom line

The bottom line is that in South Africa, unlike some much larger financial markets, there are quite a few well-known active investment managers who consistently outperform their benchmarks, market indices - and therefore passive investments - over time, *including all fees*. Of course there are periods in which passive managers can outperform the majority of active managers as well, so there is room in everyone's portfolio for both solutions. However, it's difficult to argue against the benefits of tailored investing by the experts, which takes into account not only the investment fundamentals, but also complex factors such as the economic and political environment, social and environmental responsibility and corporate governance practices. Prudential has an array of actively managed funds by highly regarded and experienced portfolio managers. To find out more about our funds contact our Client Services team or email us at query@prudential.co.za.