

FUNDAMENTALS

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TWO events happened last week that are representative of a seismic shift in the way money is managed now. The first was the announcement by an ex-fund manager that he was launching a new wealth management company and the second was a takeover. The significance is that both are moving from active to passive management. The fund manager used to be an advocate of star fund managers who claimed to beat the market, but his new company will only use passive funds. The takeover was the acquisition by BlackRock, an active manager, of the BGI division of Barclays that mostly uses index funds.

The divide between active and passive fund management is about as fundamental as it gets. The first believe that stock markets are inefficient and that it is possible, through skill and research, to beat the index. In contrast passive managers think that companies reporting four times a year with an army of analysts, salesmen, portfolio managers and arbitrageurs to analyse them means that everything that can be known about a stock is already in the price.

That makes it difficult to beat the index. This theory evolved in the US in the sixties and seventies although

Glaswegians would say Adam Smith had the same idea two hundred years earlier when he outlined the benefits of price discovery through free markets. Passive fund managers like to say that it is only North Koreans, Cubans and active fund managers that claim markets are not efficient.

Alan Miller made two fortunes from running active fund management companies at Jupiter then New Star. However, the latter company's implosion last year, and the dire performance of all its funds, has left the concept of a "guru" looking rather jaded.

Mr Miller now agrees that the bulk of an investor's returns actually come from the choice of asset class rather than shares. His new firm will only allow his clients to invest in ETFs, easily traded passive funds, and his input will be limited to decisions on asset allocation.

Barclays built up a vast asset management business called Barclays Global Investors that manages \$1.5bn and has 360 ETFs.

Last year it earned £595m, largely escaping the carnage that affected the rest of the bank. This simple and transparent business also made it for Barclays one of the few assets that could be easily sold to raise much needed cash, at a time when it is harder than normal to value banks' businesses.

A distressed sale of such a large fund manager was too tempting for BlackRock, the world's largest publicly traded fund manager, which agreed to pay £8.2bn for it.

So why are the traditional active managers migrating to the passive approach? Two reasons: cost and performance. The aftermath of the credit crunch means all investment returns are going

to be lower.

Paying 1% to your adviser and maybe 1.5% to the fund manager doesn't leave much for you, the investor. Worse, three-quarters of those active funds don't even give the return of the index so it is far better to pay less in a passive fund and get a reasonable return without the risk of losing a lot more.

Mr Miller and BlackRock are not alone in making this transition. This writer knows at least one investment bank that uses passive funds for its own pension fund, and one passive manager who looks after the personal finances of several hedge fund managers and analysts.

If the people who run the industry are using passive funds for their own money, why are they so keen to sell active management to the public?

