Week 19 Questions

MCQ

1. All are TRUE of Exchange traded funds (ETFs) except:
   a. **They allow Fund Managers to temporarily exit the market if investment conditions appear uncertain**
   b. They are listed and traded as individual stocks on a stock exchange.
   c. Their value is based on the underlying net asset value of the stocks held in the index basket.
   d. They are indexed rather than actively managed.

2. Which of the following is not a strategy by which Active Fund Managers are trying to combat the popularity of Passive/ETF investments.

a. Investing in infrastructure and property.
b. Increasing the Active component of their portfolios
c. **Bringing in 3rd party investment advisors**
d. Deploying quantitative computer driven strategies

3. Closet - Index Funds refers to

a. Supposedly “active” fund managers which do not change their investment straegies as often as they should

b. Supposedly “active” fund managers which who have a high proportion of actively managed stocks

c. Supposedly “active” fund managers who deploy smart quantitative strategies

d. Supposedly “active” fund managers which “hug” or stay close to their benchmark index instead of actively managing their fund.

4. If Government Bond prices fall, the gold price is likely to
    a. rise
    b. **fall**
    c. display a delayed response to the bond price movement

5. In April 2020 WTI oil prices fell to minus $40 per barrel. The main reason for this was

a. A lack of demand for oil due to Covid-19
b. A computer pricing error
c. **An oil storage related issue**
d. Because investors oil priced via Brent international benchmark

Q1. Explain the main influences on the price of oil.

- Oil is priced in ‘dollars per barrel’ with the largest producer of the commodity being OPEC.
- Global economic growth has a big influence on the demand for oil whilst supply has a number of influence.
  - OPEC stands for the Organisation of Petroleum Exporting Countries. It consists of 15 countries and is led by Saudi Arabia. OPEC’s mission is to control the price of oil. OPEC member countries control the vast majority of world crude oil reserves and nearly half of natural gas reserves in the world.
  - OPEC began capping supply with Russia and several other countries in 2017 and 2018 to force up the price of oil.
  - The advent of new technology, especially ‘fracking’ in the United States has had a major effect in increasing US oil production.
- Brent crude is the international benchmark for crude oil prices.

Q2. Discuss Gold as a means of investment.

- Gold is regarded as a ‘safe haven’ investment. It has been around for 5000 years as a medium of investment**.**

- Gold does not pay any interest nor have obvious capabilities for capital appreciation, however, investors buy gold when financial markets are falling or if there is a strain on the financial system**.**

- Gold is priced in ‘dollars per ounce’ and the gold price therefore has an inverse relation with the dollar i.e. when the dollar strenthens, all other things being equal, the price of gold will fall. When the Dollar weakens, the price of gold will rise**.** This price relationship maintains gold’s intrinsic value.

- At the height of the Financial Crisis, when demand for gold was strongest, the price of gold reached over $1,900 per ounce.

Q3. Discuss active and passive investments. Are investors currently shifting towards passive or active strategies, and why?

Active vs Passive Investment - Active

What is active investing? – Aim to outperform a specified index/benchmark = **Alpha**

How? – Individual investment styles and stock selection identifying attractive/unattractive stocks using Qualitative & Quantitative tools

Benefits

- Investment Managers make informed decisions
- Active funds may significantly outperform the benchmark
- Flexible mandates allow movement in and out of stocks/markets
- Can provide downside protection in bear markets

Drawbacks

- More costly to run so higher fees
- More concentrated with fewer securities
- Significant under-performance may occur
- Requires ability to select those active managers who can outperform

Active vs Passive Investment - Passive

What is passive investing? – Tracks a specific market or section of the market by replicating the underlying index – NO forecasting, stock picking or market selection

How? – Exchange Traded Funds (ETFs) or Index Managed Funds

Benefits

- Lower cost due to lower associated resource requirements
- Removes emotional element of gaining exposure to the underlying market
- Investors can still influence their investment portfolio through asset allocation decisions rather than individual stock picking
- Gain broad access to market sentiment

Drawbacks

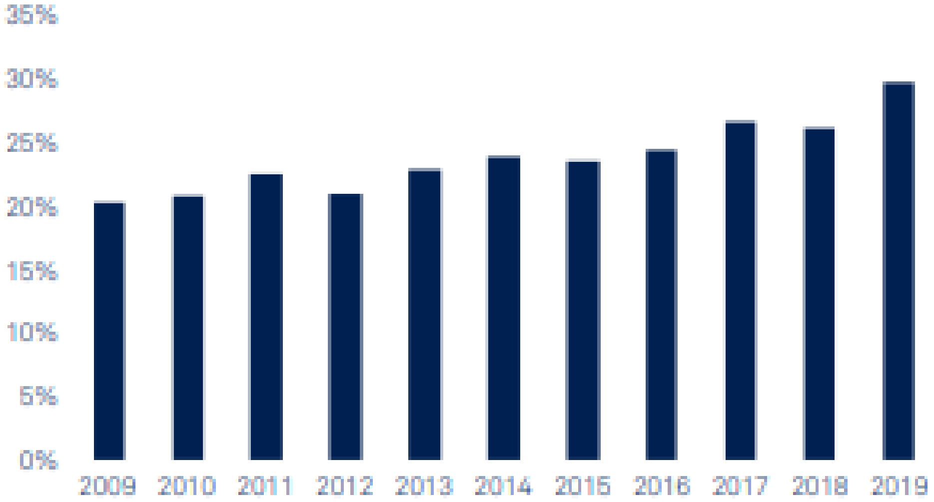
- No outperformance of underlying benchmark possible
- No control of individual asset exposures –hold same weighting as benchmark
- As most indices are market capitalisation weighted passive investments tend to increase exposure to stocks that are performing well and reduce exposures to those that aren't regardless of future outlook or valuation
- Difficult to gain exposure to illiquid asset classes e.g. hedge funds /private equity

AT THE END
OF 2019, INDEXING
STRATEGIES ACCOUNTED FOR

30%

OF TOTAL AUM

CHART 15: INDEXING STRATEGIES AS PROPORTION OF TOTAL UK ASSETS UNDER MANAGEMENT (2009-2019)



Active vs Passive Investment – Two Key Points

- **Fees –** Passive products are on average four times cheaper than actively managed alternatives
- **Performance –** Active Managers have a history of **NOT** outperforming Passive Managers
- 2016 - The S&P 500 Price index returned 9.84%
- Just 19% of large-cap mutual fund managers achieved a return that exceeded their benchmark
- **Therefore, active managers are not justifying their higher fees hence the rise of passive investing**

The Pressure is on Active Investment Managers

- Index-tracking funds have increased their share of assets in the US by $2 Trillion since 2013
- Passive funds now account for a third of mutual fund assets up from a quarter 3 years ago
- *Passive Funds have grown 4 times faster than Active Funds since 2007 at $6 Trillion*
- Passive Market Leaders: Blackrock, Vangard & State Street

The Pressure is on Active Investment Managers

- Schroders “Index-tracking funds are the dictionary definition of **‘dumb money’.** They undertake no research. They do not care about the quality of a business or its management team or whether or not it has debt or whether or not it is cheap.”
- “We believe most long-term investors are better off relying on the capable hands of a trusted, and active, investment adviser.”
- They would say that !!! Schroders only runs active funds

How Are Active Managers Responding

- Fidelity, Janus Capital, Franklin Templeton launched their own benchmark tracking products

Develop investment strategies and offer funds that are difficult to replicate in a passive format e.g.

- Offering investment options on alternative asset classes: Infrastructure, property, private equity and direct lending
- Fixed Income /Asset Backed Securities
- Quantitative strategies, whereby active managers run highly diversified, computer-driven portfolios that invest in a large number of stocks
- Increase the Active component of the portfolio

Q4. What are Closet Index Funds and why are they a concern for regulators?

- Supposedly “active” fund managers which “hug” or stay close to their benchmark index instead of actively managing their fund.

Why is this an issue?

- Misleading – investors thought buying an actively managed fund
- Investors could have put their money in a dedicated index tracker at a fraction of the cost
- overcharges investors via relatively high Active management fees compared to low Passive management fees.

The attraction for the Fund Manager – charge higher active management fees whilst paying for the resource cost of running a passive fund!