Will this be the year when fund managers thrive?

Heightened market volatility theoretically favours stock pickers over passive investing

Active funds are increasingly facing serious competition from the lower cost, passive side of the market such as tracker funds and exchange traded funds. However, current market conditions are ripe for skilled stock pickers to thrive.

It is fair to say that 2017 could see significant volatility on global stock markets. The UK has to contend with Brexit negotiations; the US has a very unpredictable new leader; and Europe has numerous elections to navigate.

Conventional wisdom suggests active managers are better positioned to take advantage of the volatility which tends to accompany events like these, as they are free to buy and sell assets when they see an opportunity.

Passive investments, on the other hand, generally aim to mirror the performance of a benchmark so cannot offer this level of discretion.

UNCERTAINTY ABOUNDS

'There is clearly scope for geopolitical instability in 2017,' says Russ Mould, investment director at AJ Bell. 'We have a new US president with strong views on domestic and internal policy. Then there are elections in Germany, France, the Netherlands and possibly Italy. And we are still working out what Article 50 will mean for the UK.'

One effect of what has become known as the 'Trump trade' is the rotation out of defensive stocks into cyclical stocks.

'Anything considered a bond proxy was a popular theme over the last year or so, but sharp reversals caused by moves to cyclicals could add to volatility,' explains Luc Simoncini, senior equity investment specialist at asset manager Kames Capital.

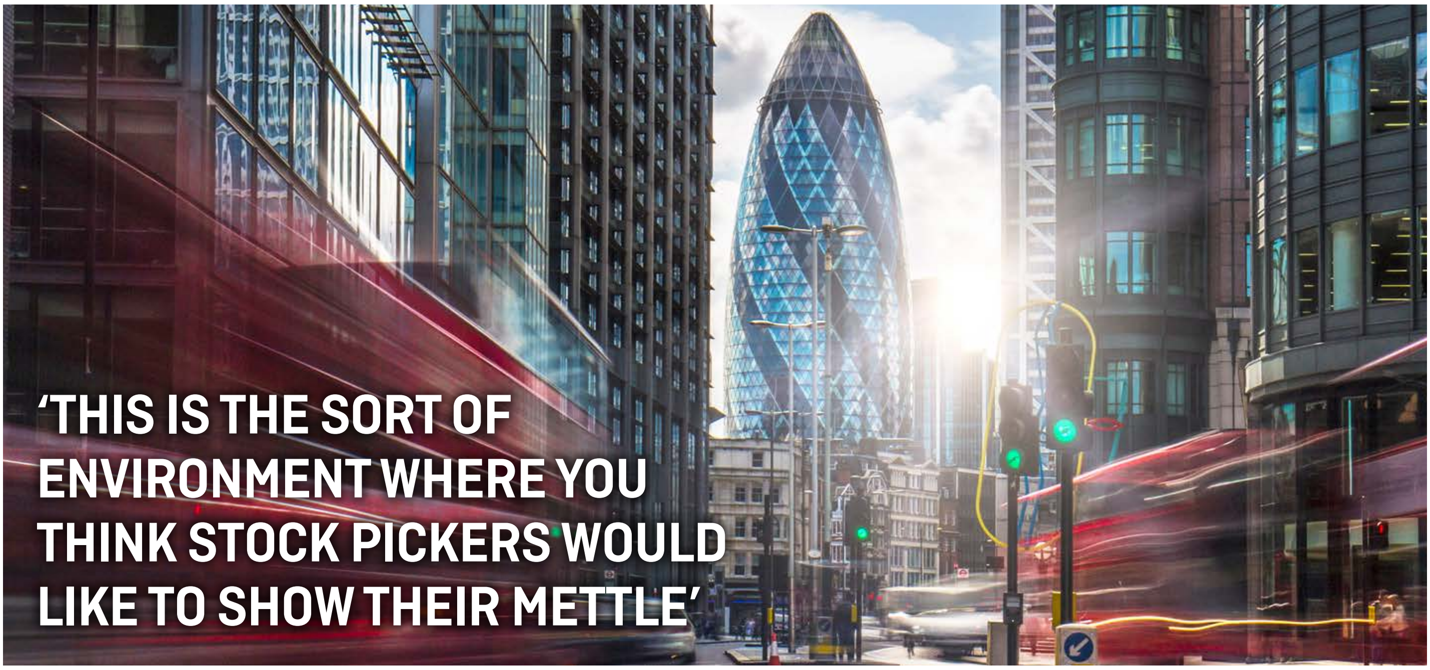
'We are also waiting to see what the US Federal Reserve is going to do,' says AJ Bell's Mould. He quotes the old Wall Street saying 'three steps and a stumble' which implies that the stock market falls after the Federal Reserve raises interest rates three times.

As things stand, the Fed is expected to increase rates for the third time in the current cycle at some stage this year.

Rising interest rates may cause further volatility as investors shift their money out of fixed income according to Nathan Mead-Wellings, director at financial adviser Finmura Partners. 'Once rates start moving, the bond market will be sent into a real state of flux. You will see a lot of people rushing for the exit and the question is where do they put their money?'

ADVANTAGE ACTIVE?

'This is the sort of environment where you think stock pickers would like to show their mettle,' says AJ Bell's Mould.



He cites the huge dispersion of performance in the FTSE 100 last year as an example. The best performing stock was up over 200% while the worst performer was down 50%.

'Value investing came back into fashion, and if the Trump trade and inflation pan out, you might expect value to dominate again in 2017.'

Kames' Simoncini is more cautious. He says: 'Volatility creates opportunities but it also creates challenges.'

If it is driven by macroeconomic or geopolitical events, large sections of the market react in a similar way, so differentiating between companies becomes tougher.

VOLATILITY PLAYS

If value stays in favour, Mould suggests investment fund **Jupiter UK Special Situations (GB00B4KL9F89)** might benefit.

'Ben Whitmore has been running the fund for a long time and has a terrific reputation. He has a knack of finding well run, financially sound businesses that other investors tend to shun.'

The Jupiter fund's five-year annualised return is 12.63% and it counts **BP (BP.)**, **Aviva (AV.)** and **Tesco (TSCO)** among its largest holdings.

Should the market turn particularly choppy, Mould recommends **Henderson UK Absolute Return (GB00B5KKCS68)**, a long-short fund with an annualised return over five years of 6.1%.

'If the market goes higher, it will not knock out lights, but if you are worried about a down year, it provides some protection while also giving scope for capital gains.' The fund's biggest holdings include FTSE 100 media group **RELX (REL)** and insurer **Legal & General (LGEN)**.

Simoncini at Kames also believes absolute return funds are worth considering. He advises focusing on market neutral vehicles which are less volatile than other asset classes and are negatively correlated to their performance.

'It is useful to have a building block like this in a balanced portfolio with a different return profile to shares and bonds, as it reduces the overall volatility and risk while producing incremental gains regardless of the market conditions,' he says.

DIFFERENCE OF OPINION

It is important to note that absolute return funds aren't guaranteed to protect your money. Several well-known absolute return funds suffered losses in 2016; one was even down by 25% in the year.

Many market experts have negative views towards absolute return funds as a lot of products have underperformed for years, not just 2016.

Overall, the key point to consider is that stock market volatility can be unpleasant yet markets have historically have had good and bad periods.

Don't spend hours looking at share prices day in, day out. Instead, diversify at the portfolio level via a range of funds whether they are passive or active and invest over the longer term to reduce risk. (KM)