# ACTIVE-PASSIVE **INVESTING**

## Harnessing the power of divergent approaches

# CONTENTS | JUNE 2016

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# It's Not Just One or the Other

## Active and passive approaches both a have a place in an investment portfolio

It's one of the great philosophical discussions of the investment world. Are you willing to bet on active investment management? Or do you think it's better to embrace a passive approach? Of course, the answer is never straightforward, because even those who believe in active can often see the benefits of passive.

"I see many parallels to the health care industry," said Vinay Nadkarni, senior managing director at ClearBridge Investments. "Doctors don't just prescribe generic drugs. They don't just prescribe branded drugs. The choice usually comes down to the idea of efficacy and the issue of cost."

Passive investing offers some obvious advantages. "It's easy to understand," said Chris Marx, senior portfolio manager-equities at AB. "It's a low-cost way to gain access to market exposure and alleviates the challenge of selecting effective active managers."

The math proves the point. Citing a paper by William F. Sharpe written in 1991, "The Arithmetic of Active Management," Craig Lazzara, global head of index investment strategy at S&P Dow Jones Indices, said, "In aggregate before costs, the average passive dollar earns the same return as the active average dollar. And after costs, the average passive dollar earns more."

But that doesn't mean that an individual active manager can't provide a different outcome.

"If you have a strong belief that a manager is able to add value there's no theology that says it's impossible to do," he said. "The arithmetic of active management only says that it can't be done in the aggregate."

S&P produces a scorecard that compares a database of active managers against S&P indexes in a variety of sub-asset classes. The SPIVA report shows that for the past five years, active managers have underperformed in the aggregate. "Investment in passive has grown massively, particularly in the years since the financial crisis," said Lazzara.

That's not surprising since the market rallied sharply after the financial crisis. And even though stocks haven't done much this year, the SPIVA scorecards still haven't shown any outperformance.

But markets have revalued on the back of easy central bank policy, which has raised a question about valuation opportunities in equities. While it can be hard to see value in passive equity investing in absolute terms, "equities are very attractive relative to bonds," according to AB's Marx. "So if you aren't going to sell your equities and buy bonds, then you are stuck in a pickle if equities aren't returning much."

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When an asset owner has a strong belief that a particular investment manager has the ability to generate excess return — alpha — over time, it makes sense to add active management to the mix. The question is how to optimally mix active and passive.

One issue that asset owners and consultants have identified is the active manager who is a closet index manager. "One problem we got into as an industry," said Marx, "is that we ended up with a lot of active services that looked a lot like the benchmark."

Partly, this is an unintended consequence of over-concern with tracking error. By looking to manage risk by imposing a tracking error constraint that is too tight, an investor can end up paying active fees for what is really passive exposure. It's also possible to end up in a similarly difficult situation by diversifying the pattern of active managers to such an extent that the performance is close to benchmark.

But this outcome can be avoided.

"We see investors moving from having a highly diversified, low-tracking error active strategy out to the other two ends of the spectrum," said Marx. "At one end, they say, 'I'm going to pay very little for passive exposure,' but pair that with a high conviction, high active share strategy at the other end of the spectrum."

In other words, investors could use passive strategies in markets where there is potentially less alpha opportunity — for instance, U.S. large-cap stocks. Then they can spend both risk and fee budget in parts of the market where there is opportunity — emerging markets and small-cap stocks.

This theory is often cited as the underpinning of an active-passive strategy. At S&P Dow Jones Indices, Lazzara offers some insight on why investors need to tread carefully here.

"Our SPIVA records show that small-cap managers have just as hard a time outperforming as large-cap managers do," he said. "While the perception is that small-cap is less efficient — and that is probably true — the lack of research on small-cap stocks means that there is a greater likelihood of mispricing for small-caps than large-caps. But that doesn't mean there is a greater likelihood that small-caps will be underpriced."

The issue here is dispersion. Active managers have a greater potential for success when there is a greater dispersion of returns around a market index. Dispersion can best be thought of as the spread between the best and worst performers in a market. In today's market, and for the last three years, said Lazzara, dispersion has been low.

"And that puts a burden on active managers."

Investors are also using active not just as a pure alpha-generating strategy, but also as a way to lower risk and provide downside protection. It's another example of asset owners understanding the role of the strategy in an overall portfolio.

"Investors have had a historical focus on tracking error as a measure of risk," said Marx at AB. "But that's relative risk, as is an information ratio. Now we are seeing investors looking more closely at the Sharpe ratio, or in other words, the absolute level of risk."

By focusing on absolute rather than relative risk, investors such as pension funds can think about the objective — the payment of liabilities, for example — that drives their portfolio construction. This is driving a focus on strategies such as low volatility that allows investors to gain some upside, but also a measure of downside protection.

"A pension fund may ask whether they have a return that is going to get them to an asset level where they can meet their liabilities with a level of risk that they can tolerate along the way," said Marx.

Investors are also facing the implications of a lower-return environment. Many have not yet truly adjusted their return assumptions, and while it has been possible for several years to meet those assumptions with passive equity returns, that period may have passed. So investors may be looking to construct portfolios and embrace strategies that work with somewhat lower return expectations.

"Investors do want active strategies," said ClearBridge Investments' Nadkarni, "but they want both high alpha and consistent alpha, and there's a trade-off here. High active-share strategies with downside protection involve an opportunity cost." That downside protection will mean returns won't be as good in rising markets.

Strangely, some active managers are seeing clients going to passive but then increasing their allocation to alternatives.

"That suggests that those investors still believe that there is alpha out there," said AB's Marx. Absolute risk is more important than relative risk when moving to a higher conviction equity strategy. But having the passive allocation can allow balance in the portfolio.

Choosing successful active investment managers requires skill and resources in significant measure, and not all investors have the ability to choose properly.

"The issue that is driving this decision today is not just the cost of implementation, which is obviously important," said Nadkarni. "It's the cost to resource your team to make those decisions. But importantly, it is also a behavioral issue. Many investors choose an active strategy when it has outperformed, not when it's gone through a period of short-term underperformance."

But Marx at AB said asset owners are getting smarter.

"Since the financial crisis, boards and investment committees have become much more sophisticated," he said. "The hard part is that there is a lot of fee pressure. But what really tries people's patience is when they pay active fees for what is ultimately an index portfolio. However, the shift toward considering absolute risk and return, and how active and passive strategies can be used together to produce returns with appropriate risk and fees — that is becoming a more common approach." •

**It's possible to combine both high conviction active strategies with passive ones to keep costs down, while still meeting the portfolio goals."**

Vinay Nadkarni
Managing director at ClearBridge Investments

# Yesterday

**$305 billion**

Highest rate of estimated flows to actively managed mutual funds over the last 10 years (2009)

**$195 billion**

Highest rate of estimated flows to passively managed mutual funds over the last 10 years (2015)

**$230 billion**

Highest rate of estimated flows out of actively managed mutual funds over the last 10 years (2015)

**Over the Last 10 Years:**


of large cap managers underperformed their benchmark on a relative basis


survival rate of actively managed diversified emerging-markets funds

# Today

## 2016* Money Flows:

**$56 billion**

out of actively managed funds

**$75 billion**

into passively managed funds

# Tomorrow

**$30.8 trillion**

estimated global AUM in active mutual funds 2020

**$10.5 trillion**

estimated global AUM in passive mutual funds 2020

Sources: Morningstar Inc., PwC * Through April 30

# EXECUTION FRAGMENTATION

**With the advent of dark pools and high-frequency trading, sourcing liquidity and minimizing trading costs is an ever-more important element of both active and passive equity investing**

The cost of investment management — always an important consideration for asset owners — is most often linked to the fees charged by the investment manager resulting in the perception that passive investing is cheaper than active investing.

Asset owners would be well-advised to more closely consider the cost of trading for any type of investment strategy, be it passive or active, to find out where alpha may be leaking. Regulatory changes, technology innovations and changing sell-side business models have driven more trade execution into the hands of buy-side managers. Some 65% of all trade orders are now self-executed in the U.S., which means that buy-side traders have more control than ever before over execution.

That, in turn, means that traders at investment management firms are deciding how, when and where to access liquidity — decisions that have become increasingly complicated and difficult. Especially as they have become responsible for best execution and ensuring that trading costs are minimized both on an implicit and explicit basis to adhere to the lowest cost passive execution and to protect alpha generation in active strategies.

Asset owners need to understand how changes to best execution practices are influencing cost and performance of their portfolios. The keys are market structure, time of day, liquidity and due diligence.

"From an equity market perspective," said Nanette Buziak, managing director at Voya Investment Management, "asset owners and managers need to be focused on market structure, understanding the mechanics of various venues and most importantly, when, how and why (or ask why) their orders are being routed to such venues and in what routing sequence."

That's all due to the number of trading venues, which has proliferated, with more than a dozen exchanges and well over two dozen alternative trading systems (ATSs) open for business. Each has its own distinct approach, fees and business model. Add to that high-frequency traders, a group of market participants that participate in various capacities in markets across all asset classes. Their participation remains a hot topic of debate — do they help or hurt other investors? And so, as regulators keep a keen eye on these developments, market structure continues to evolve.

"The development of dark pools/ATSs and HFT has impacted liquidity in that institutional traders need to know that there is a time and a place for when you may or may not want to interact with the various venues and participants," said Buziak. "In cases when we have high order urgency in implementing an investment decision, we want HFT in the marketplace as they play the role of liquidity facilitator that we need to get our investment idea implemented. If they are not there in those instances, our investment ideas may never get realized into our portfolios and therefore our expected returns never captured."

She explained that the ongoing challenge traders face is in not exposing the firm's "footprint" in the marketplace. In other words, not exposing to other market participants that there is a large institutional order being worked.

"When that occurs," she said, "our order can get exploited in the market to the detriment of our client portfolios not realizing the alpha inherent in the investment decision."

For asset owners, the implications of execution are best understood in the context of cost. On any given day, no single trading venue or exchange often accounts for more than 20% of total market volume, and the average trade size is just under 200 shares. The result is that sourcing liquidity has become increasingly complex, which means smaller, more frequent trades and the potential for increased costs.

The nature of a trade — whether part of a passive or active strategy — does impact the venue and execution strategy a trader might use.

"Passive strategies, such as index funds, excluding cash flows, only trade during times where the index itself has a change and/or is rebalancing and are traded typically by brokers in the form of principal trades, which offer some form of outperformance relative to the effective date of those index changes, either in the form of zero commission trades and/or outperformance versus the close," said Voya's Buziak.

"For actively managed strategies, we pay close attention

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to the time the trade is sent to the trading desk, the liquidity profile in a given name both at the time of order arrival as well as historical trading pattern, expected trading costs and lastly but most importantly, to the investment thesis driving the trade," she added. "Execution strategy and venue are then typically determined at that point, usually by first absorbing natural liquidity in various block trading venues and dark pools and then, if the order urgency is high, by actively working the order with various brokers. We also may be self-trading during the price and liquidity discovery phase, and our decision on venues to trade with often gets determined by the time of day that we are trading. Midday tends to be most costly in terms of exposing our footprint to the marketplace so we generally prefer to passively source liquidity in dark pools by keeping our orders undisclosed to the lit markets to the extent we can."

Liquidity is increasingly important, particularly as trade sizes continue to decline.

"In the past, the liquidity profile of a stock was often referred to as a smile — equally high at the beginning and end of the trading day," said Buziak. "Now it's much more of a 'J' shape, in that it is active in the first half hour of trading, quiets down once Europe closes and then picks up aggressively in the last hour of trading."

Transaction cost analysis is another key element. "We look at our transaction cost analysis on all trades on pre-trade, real-time and post-trade bases," said Buziak. "When looking back, we want to see if we achieved fair value versus our expected cost, and will also look at the trade on a T+1 basis to see whether there was any mean reversion in our executions that contributed to costs." She also pointed out that it is important to step back from the day-to-day and look at weekly and quarterly data to identify market trends and glean lessons learned.

Due diligence is important when it comes to hiring any investment manager, but today more than ever, asset owners need to inquire about the capabilities and structure of the trading desk.

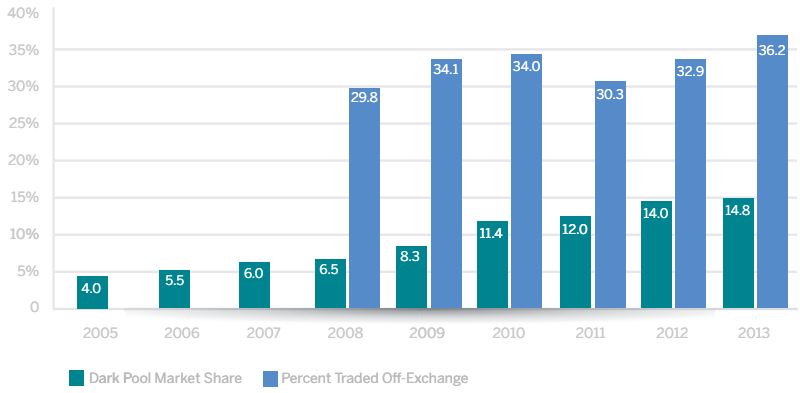
"It's important, for instance, to understand how trading is viewed in the organization," said Voya's Buziak. "You don't want your trading desk reporting to operations; you want to see it fully integrated into the overall portfolio management and investment process."

Indeed, as portfolio alpha is generated from ideas flowing out of portfolio management, it is vital that the portfolio managers, analysts and traders are in synch.

"If we have an investment thesis that we feel will provide an expected return of 20%, with an expected implementation cost of perhaps 100 basis points, or 1%, every basis point we contain in our implementation is alpha that is realized and flows directly back into a client's portfolio," said Buziak. "A critical part of trading is in understanding the PM's order urgency and then containing the information leakage during our implementation." •

## Dark Pool and Off-Exchange Trading Spiked Post-Financial Crisis

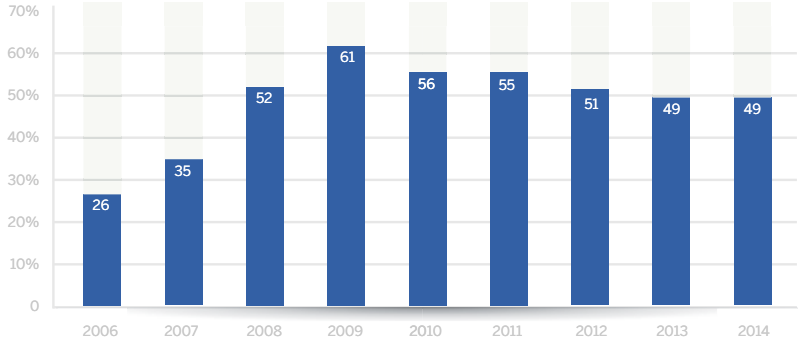
Dark Pool Market Share and Percent Traded Off-Exchange as Percent of Total U.S. Equity Volume




Note: Off-exchange volume data unavailable prior to 2008. Source: Tabb Group

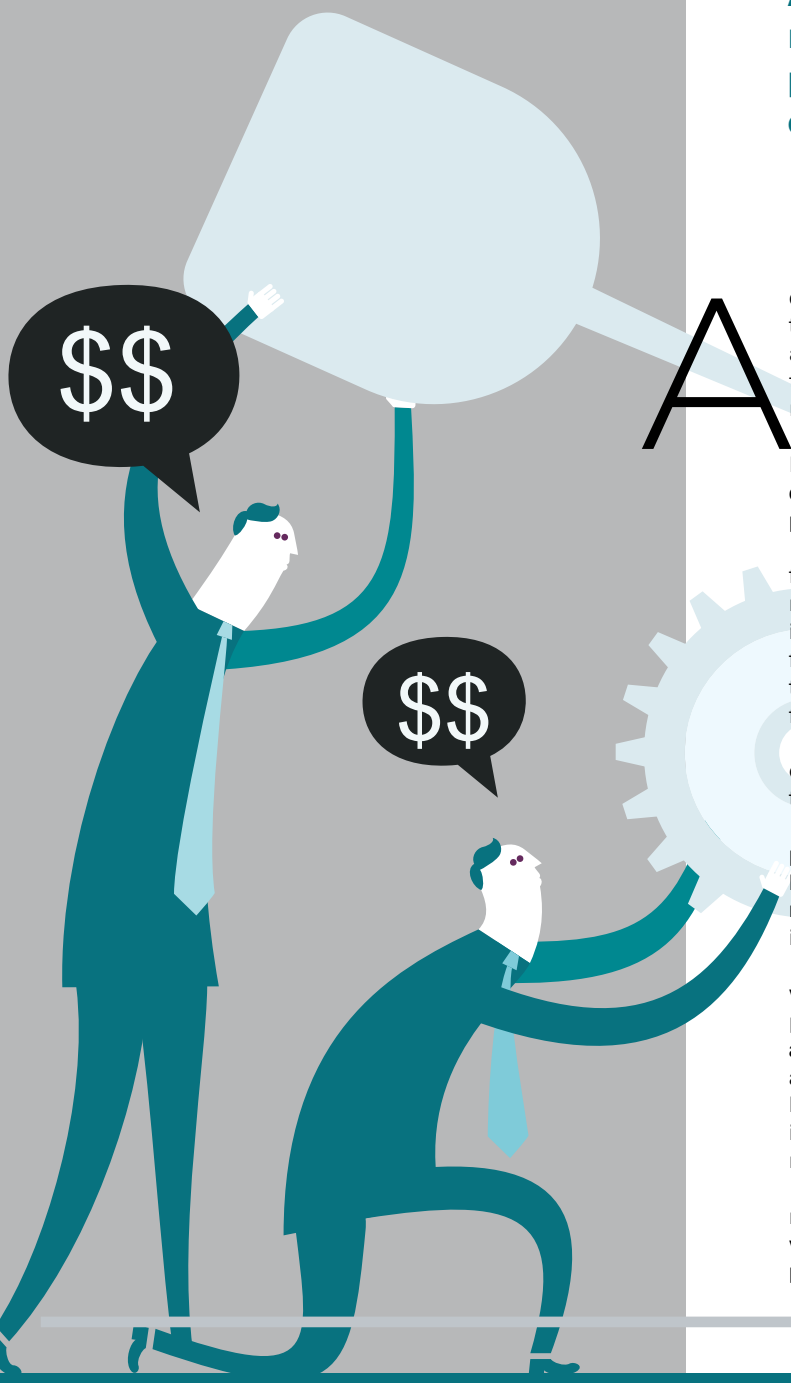
## High Frequency Trading Now Represents Almost Half of U.S. Equity Shares Traded

High-Frequency Trades as a Percent of U.S. Equity Market Volume




Source: Tabb Group

# VALIDATING ACTIVE MANAGEMENT




**Active share provides one measure of differentiated performance but it isn't the only one**

Active management isn't easy to get right. Asset owners know that finding an active equity manager who provides consistent alpha over time is a tough task. Some observers suggest that the task is even harder when, like today, more equity money is managed passively and returns are muted.

Nevertheless, many investors still believe that it is possible — and necessary to meet investment objectives — to acquire alpha above the beta returns that passive investing provides.

One way to identify and quantify that is active share, defined as how different a given strategy looks from the benchmark to which it is compared. The concept was first introduced in 2009 by academics Antti Petajisto and Martijn Cremers, who found that active managers with portfolios that hewed closest to their benchmarks often fail to deliver excess returns net of fees.

Active strategies stand out in active share terms by generating benchmark-beating returns but it's not as simple as that.

"High active share is not a sole predictor of future outperformance" said Vinay Nadkarni, managing director at ClearBridge Investments. "One problem is that active share is a measure at a single point in time. In addition, it has become imbued with a predictive quality that it doesn't possess."

Unsurprisingly, there is no simple measure that allows investors to choose successful active managers. Active share provides insight into some elements of active investing that are important when assessing managers. A strategy with a low active share may be a closet index strategy. A strategy with a high active share is likely to provide a wide return dispersion, indicating a level of volatility of returns that an investor may not find comfortable.

Active share can be useful in helping investors determine whether the fees they are paying for the strategy are value for money. It can also provide insight into sources of portfolio dispersion.

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"A combination of active share and tracking error," said Nadkarni, "can provide a more comprehensive look at how successful the manager is. You need a track record to demonstrate skill, and tracking error provides some indication of return and risk expectations."

High active-share managers can also be called high conviction managers. But while a high conviction strategy may show high active-share, the characteristics of a high conviction manager are broader and will include both qualitative and quantitative elements.

Conviction and skill are complementary for long-term investment success, but the former isn't proof of the latter, said Chris Marx, senior portfolio manager-equities at AB.

Early evidence from an ongoing research study the firm is conducting on high conviction managers and how to identify them has indicated that managers who stay in their high-conviction universe longer tend to post better performance. "There is no substitute for doing deep analysis into each manager's process and outcomes, though," said Marx.

"High conviction means having a strong active perspective, and it also means following a clearly-defined strategy that has both a history of producing returns and a return pattern that investors can follow," he said. "That pattern could mean that a strategy will underperform in certain market conditions, but the investor can be prepared for that."

There's a good reason high conviction strategies often have high active share.

"A high conviction manager has the confidence to construct portfolios that are very different from the benchmark," said Marx. Having an underlying rationale that guides the stock picking ensures that a portfolio manager isn't taking outsized positions arbitrarily.

High conviction strategies come in many shapes and sizes, and can be used to meet a wide variety of goals. Just choosing one strategy can be both difficult and ineffective. No single strategy will outperform year-in and year-out. Market conditions matter.

Managers using value, growth or momentum strategies offer better results in rising markets; those following low beta, high dividend yield or quality strategies offer defensive or downside protection in falling markets. High active share strategies, often invested in a small number of stocks, may be less sensitive to market conditions but produce less consistent returns.

For asset owners, understanding the nature of the strategy is imperative because managers can only be assessed against the metrics established at the outset.

"You should evaluate all managers in relation to what you thought you were buying before they started working for you," said Craig Lazzara, global head of index investment strategy at S&P Dow Jones Indices. That is easiest with passive managers. But even when it comes to a high conviction, high active share manager, "if after three years, the tracking error has 7% underperformance when it was sold as a 3% plus or minus, then something is badly wrong," he said.

Knowing this information about managers and strategies gives investors the tools to construct portfolios that are diversified across a number of managers and strategies to produce a consistent set of returns.

"It's also possible to combine both high conviction active strategies with passive ones to keep costs down, while still meeting the portfolio goals," said AB's Marx. •

"It's also possible to combine both high conviction active strategies with passive ones to keep costs down."

**Chris Marx**
**Senior portfolio manager-equities**
**AB**

# Term Tracker

**The terms below are used when describing active portfolio management, but are not associated with any specific style of management.**

### ACTIVE SHARE

The percentage of stock holdings in a portfolio that differ from its benchmark index. Active share takes into account actual portfolio holdings and their weightings relative to the benchmark and provides a snapshot of stock overlap. An active share of 0 implies that an investment portfolio is identical to its benchmark, while an active share of 100 indicates that a portfolio and its benchmark have no holdings in common.

### HIGH CONVICTION

A broader definition than active share, high conviction equity strategies start with a clear investment philosophy backed by strong research capabilities that allow a manager to capture proprietary insights. The strategy must differ from the benchmark on the basis of the investment philosophy and disciplined process, not simply by taking arbitrary positions.

### TRACKING ERROR

The variability of a portfolio's performance compared to its benchmark index. It calibrates the degree of volatility of a portfolio's monthly returns vs. that of an index. If a portfolio outperforms or underperforms its benchmark by the same amount each month, its tracking error would be 0.

### CLOSET INDEXING

An active strategy that involves mimicking characteristics of an index to create benchmark-like returns. The strategy may hold many of the same securities as the index as well as sector and geography weightings.

### DISPERSION

The range or statistical distribution of returns from the components of an investment strategy compared with the strategy's benchmark.

# Thinking Smart

**Hybrid active-passive strategies — often known as smart beta — provide a middle ground between the two investment approaches**

Active and passive investment management used to be very clearly different. No longer.

Purely active and purely passive today are simply two ends of a spectrum. In between sits a wide range of strategies that go by many names — tilted indexing, factor investing, style investing, alternative indexing — but are most known as smart beta strategies.

Smart beta is often described as a rules-based, transparent strategy that seeks to capture investment factors or market inefficiencies. While often using passive-type implementation strategies, smart beta strategies often seek to achieve above-market returns.

"The one thing that is driving much of the decision-making around passive is cost," said Vinay Nadkarni, managing director at ClearBridge Investments. "Factor-based investing addresses that issue, giving you more active exposure than you get in a purely passive solution, though not as much as in a ClearBridge active portfolio, but nevertheless at a lower cost."

"What factor indexes allow you to do is to deliver, in a passive form, a pattern of returns or access to a factor that years ago you would have had to pay active management

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fees to receive," added Craig Lazzara, global head of index investment strategy at S&P Dow Jones Indices.

Many asset owners migrated to passive investing after the global financial crisis for cost reasons and because they knew what they were getting — market returns. At the same time, many active managers failed to deliver on their promises. But in an era of subdued investment returns, passive is also often a less-than-ideal solution.

Market-capitalization passive strategies organize portfolios around size and therefore past performance, said Chris Marx, senior portfolio manager-equities at AB.

"Smart beta helps investors organize their portfolios around economic or behavioral principles, which we believe can lead to outperformance," he said.

Smart beta's combination of low cost and reliable returns means that many investment managers have been launching products.

"Factor-based investing isn't a fad because there are firms that have been doing it for a long time," said Nadkarni at ClearBridge. "But the number of firms and managers entering the field is a fad. Few firms have a long track record of investing that way with real assets. Everyone has a back-tested model."

S&P's Lazzara added: "Investors need to know that back tests can be manipulated and they need to be wary. But more important, when viewing either a real life track record or a back test, is to know what the market regime was like during the period in question."

For example, if the back test spanned the 1990s and the live period started in January 2000, it wouldn't be surprising to find that the strategy performed one way for the back test 10 years, and the exact opposite for the subsequent 10 years.

Before the advent of smart beta products, an investor who wanted a small-cap value portfolio would have had to find an active manager to deliver it. Then, Lazzara explained, "you would have to hope for three things: that my view and the manager's view of what is small-cap and what is value are the same; that the manager won't change his mind during my holding period because for instance, he sees great opportunities in mid-cap stocks; and finally, that the manager's stock selection capability, if not positive, was at least not so negative that it negated the benefit of the factors."

"Today," said Lazzara, "you can get access to these factors in a passive form."

Although the allocations to smart beta come from both active and passive buckets, it is primarily the active monies that have been transferred into smart beta.

"Because the source of the winner's alpha is the loser's negative alpha," said Lazzara, "the aggregate amount of alpha that a winner can harvest will go down as more investors withdraw from the game by investing passively. So that says that the tendency of money to flow into passive management is almost self-reinforcing." •

"Investors need to know that back tests can be manipulated and they need to be wary. But more important, when viewing either a real life track record or a back test, is to know what the market regime was like during the period in question."

**Craig Lazzara**
**Global head of index investment strategy**
**S&P Dow Jones Indices.**