

Is Hope The Only Active Strategy Left?



There are so many stories going on in the press about the demise of the active management industry that one gets the impression that every portfolio manager must be feeling like a gambler pawning his last possession.

I recently attended a wealth management forum put together by [Marketwatch](#) where the commonly held view among attendees and panelists was that active management is dead and that the whole investment industry has been commoditized.

Certainly when evaluating security selection strategies relative to passively constructed benchmarks the recent record of active management leaves a lot to be desired. Times have been tough for active management shops and investors have been flocking to a myriad of index strategies. Exchange-traded funds (ETF) and multi-asset class strategies such as Target Date Funds have been the primary beneficiaries.

[Barron's magazine](#) recently reported that only 33 percent of active equity managers managed to beat their benchmark last year. Outflows from actively managed strategies surpassed \$288 billion (through November) – worse even than for 2008.

The popular [S&P SPIVA](#) report shows that the situation is not any better if one looks at a longer time period. For example, as of June of 2016, only 8 percent of US large cap strategies managed to beat the S&P 500 index over the trailing five years.

Midcap and small cap managers did not fare any differently. How about REIT managers? Not really - only about 11 percent of active strategies beat their index over the last five years.

International equity managers did fare a bit better than their US counterparts with close to 40 percent beating their index over the last five years. 32 percent of emerging market equity managers likewise beat their benchmark. A bit more hopeful but still nothing to write home about!

What about fixed income active strategies? A bit better in smaller pockets of the markets such as municipals, short and intermediate term investment grade where the majority of funds had higher returns than their corresponding index.

But among longer maturity strategies the situation was as abysmal as for equity managers. For example, only 3.5% of Long Government strategies outperformed over the trailing five years. Even in the emerging market debt category only 8 percent of active strategies outperformed.

Is hope the only strategy left for the active investor? Just like the gambler down to his last pennies it sure feels lonely out there. All active management friends seemed to have slithered out the back door.

If the data cannot be tortured to confess, what about using theory to defend active management? Unfortunately, little help seems to be coming from the halls of academia. Many years ago Bill Sharpe published his famous paper on "[The Arithmetic of Active Management](#)". The basic idea that active managers bear higher costs than passive investors thus creating a wedge in performance between the two has stuck as a reasonable theoretical explanation for the under-performance of active management.

Recently, there has been some debate about some of the logic used by Sharpe (see the recent [Lasse Pedersen](#) paper) but in general while it is clear that index funds are not totally passive (due to new issues, repurchases, and index membership changes) the consensus still seems to be that the basic disadvantage of active management is due to its higher costs.

Another argument working against active management was espoused by another Nobel Prize winner Paul Samuelson even longer ago. Samuelson held that the stock market is micro-efficient, but macro-inefficient.

What this means is that at the level of individual stocks (where active managers ply their trade) it is much harder to beat the overall market but that the market itself may occasionally exhibit economically significant deviations from fundamental value. Research by [Jung and Shiller](#) at Yale corroborates the Samuelson story of micro-efficiency and macro-inefficiency.

Every active manager knows that outperforming benchmarks is tough especially in a consistent manner. A quote by Charlie Ellis of Greenwich Associates has stuck with me over the years. While I can't remember the exact wording it goes something like this – "*outperforming is difficult not because investors are stupid but because they are smart and compete with each other*".

I might have butchered Charlie's quote but the basic idea is that with so many smart people participating in the markets today active management has become at least conceptually a zero sum game with the additional handicap of higher costs.

What this means is that on a capital weighted basis for every winner there must be a loser (assuming a fairly static market portfolio) but both must bear the burden of higher costs. These costs are especially detrimental in an environment of lower capital market returns such as the one currently anticipated by [Global Focus Capital](#).

Given all the evidence against active management what is the investor to do? Load up on ETF's and run away from actively managed strategies? The flow of funds data certainly seems to be confirming this behavior. Active equity and bond managers have seen massive outflows to their strategies while flows to ETF's have grown consistently for over ten years.

But is the investor trading one form of risk (security selection) for another type maybe less understood? Investors flocking away from traditional security selection strategies have had to make a decision regarding which ETF to own.

The proliferation of new ETF offerings in recent years has made this decision more complex. Investors looking for exposure to broad asset classes have the least complex choice as the universe of ETF's can be easily segregated by expense ratio (the lower the better) and fund liquidity characteristics (smallest deviation from index performance). In general, the lowest cost and liquid broad asset class ETF's are dominated by three providers – Blackrock (iShares), Vanguard and State Street (SPDR's).

The decision as to which ETF or index mutual fund to own becomes more complex as the investor delves into smaller pockets of the capital markets. Specifically, the issue applies to what we at Global Focus Capital refer to as sub-asset classes or investment styles.

For example, does the investor want a higher exposure to dividend paying stocks? Is there a preference for a lower risk exposure to the equity market so maybe a “smart” beta ETF is of interest? Is there a desire to shorten the duration of a fixed income investment to minimize the effect of potentially higher interest rates?

Choosing the appropriate vehicle to reflect investor preferences quickly becomes more difficult and in many cases these decisions are disguised forms of active management.

Decisions become more complex as the composition of benchmarks can be very different across providers. Moreover, cost and liquidity differences are usually larger than for the broad based asset classes. Understanding what is “under the hood” requires serious analysis with important portfolio risk and return implications.

Deviating from broad based asset class benchmarks is an active decision. In some cases the implications can be small and inconsequential. In other cases the risk and return implications can be profound.

Let's take a look at a couple of popular strategies. Using the S&P Indices we look at some of the style or “smart” beta strategies frequently used by investors. Table 1 shows the trailing 1, 3 and 5 year returns to a number of popular strategies using the S&P 500 as the starting universe. We also show the 5 year volatility of the strategy.

Let's start with one of the oldest strategies – an equally weighted portfolio composed of all stocks in the S&P 500. The net result of an equal weighting scheme is to introduce a small capitalization tilt to the portfolio. The largest stock by market cap (AAPL) is treated the same as News Corp B the smallest current component of the index by market capitalization. If small caps outperform large cap stocks then investors in the equal weighted S&P 500 should see a higher return. Commensurately, risk would be expected to be higher as smaller cap stocks tend to exhibit significantly higher levels of volatility.

Over the last 5 years differences in weighting have had a small effect overall both to returns as well as portfolio volatility. Investors in the equally weighted S&P 500 have not had a materially different experience from that of core investors.

Table 1

INDEX	1 YR RET	3 YR RET	5 YR RET	5 YR VOL
S&P 500	17.2	10.4	13.3	10.2
S&P 500 EQUAL WEIGHT	17.5	9.6	14.0	10.9
S&P 500 PURE VALUE	19.0	7.1	15.2	14.0
S&P 500 PURE GROWTH	13.8	8.1	13.9	11.8
S&P 500 LOW VOLATILITY	10.4	11.3	13.2	9.3
S&P 500 DIVIDEND ARISTOCRATS	14.4	11.8	14.5	9.9

Note: As of March 31, 2017

What about investors tilting their portfolio in favor of cheaper securities? The S&P 500 Pure Value index has enjoyed a slight edge over the core index but with significantly higher volatility. A value tilt would have had a 1.9% per year advantage over the last 5 years but with 3.8% more volatility. In all likelihood, investors with a value tilt have felt pretty good about this result but history is not always this kind. Anybody remember the late 1990's?

What about investors betting on the fastest growth companies in the S& P 500? In this case, returns are pretty much on top of each other with the growth index exhibiting marginally higher volatility. A layman would call this a draw.

In recent years one of the most sought after "smart" beta strategy has been a tilt toward lower volatility stocks. The strategy has sometimes been sold as providing higher returns than the core index with less volatility. What do the last 5 years show? The S&P 500 low Volatility index slightly lagged the core index with lower levels of return volatility. To the naked eye this appears again as a draw.

Finally, in the never ending search for yield investors have shown a preference for dividend paying stocks. Total annualized returns to a segment of dividend payers called the "aristocrats" have beaten the core S&P 500 index by 1.2% with slightly lower level of volatility. These strategies are highly correlated with valuation approaches. Returns to dividend and value approaches have unsurprisingly not been that different over the last 5 years. Investors with a dividend approach are likely quite happy with their performance but as we mentioned previously history has not always been this kind.

The key point is that by abandoning active stock selection strategies and switching over to, on the surface, more passive vehicles such as ETF's investors are often unknowingly accepting other forms of active management. Most commonly these other forms of disguised active management involve alternative investment styles often packaged as "smart" beta strategies.

In addition to the shift away from active stock selection strategies towards picking ETF's, investors have also been flocking to a variety of multi-asset class approaches such as [Target Date Funds and ETF asset allocation strategies](#). The shift in behavior has altered the source of active risk from (using Samuelson's words) micro-efficient stock selection strategies to macro-inefficient broad capital market asset allocation approaches.

The Investment Company Institute reports that at the end of 2016 assets under management in Target Date Funds were estimated to be \$887 billion. The largest inflows to large mutual fund companies have been earmarked in the last few years for multi-asset class solutions such as Target Date Funds.

Similarly, Morningstar reported covering 881 ETF multi-asset strategies offered by 162 firms. Assets under management totaled \$84.8 billion as of June 2016.

[Do these multi-asset class strategies involve active management even if implemented using broad based index tracking vehicles?](#) The short answer is yes, but the form of active management differs from that practiced by stock selection portfolio managers.

Portfolio managers managing multi-asset class approaches need to make a number of key decisions – which asset classes (and possibly sub-asset classes) to include in the mix, in what proportion and as capital market and lifestyle conditions in Target Date Funds evolve how to shift the asset mix.

[What is the appropriate passive benchmark for these multi-asset class strategies?](#) Is the old standby 60/40 portfolio the right benchmark? What about if the strategy includes real estate as an explicit allocation? Should the equity and bond components include securities domiciled outside of the home market?

Unfortunately, there is very little consensus among practitioners as to the appropriate benchmark for multi-asset class strategies. What is a truly passive allocation?

Finance theory would tell you that the passive benchmark for the average investor is the portfolio composed of all global capital market assets in their market capitalization proportions. Easy in theory, very hard in practice! For example, does one take into account human capital? In what currency does one do the asset class aggregation? Is it even possible to know the real aggregate value of illiquid assets such as venture capital and private equity?

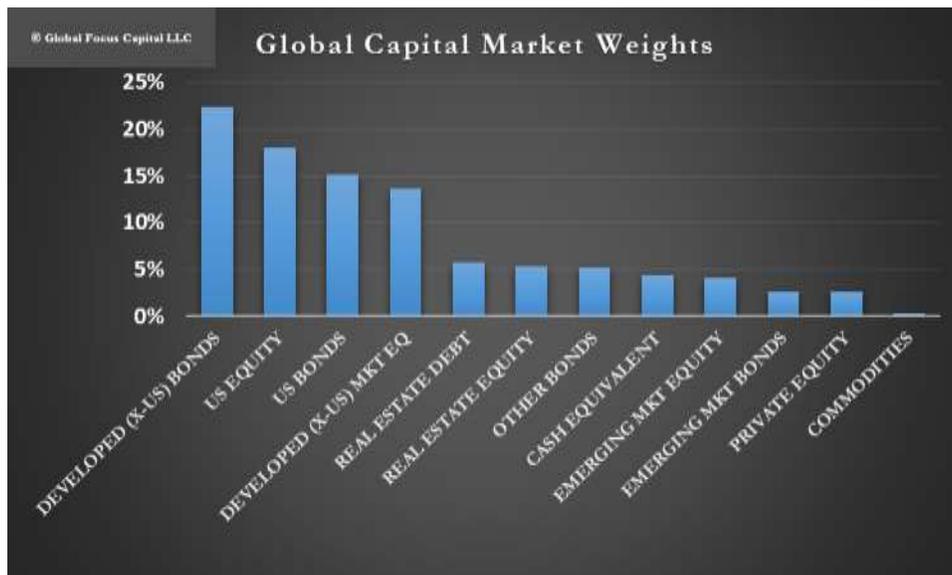
A search in Google on the "Global Capital Market Portfolio" does not yield the usual reams of articles. A bit more digging yields a 2012 paper by [Doeswijk, Lam and Swinkels](#) estimating the composition of the global capital market portfolio. I took the liberty of aggregating some of their asset class buckets for simplicity to arrive at the allocation shown in Figure 1.

What are some of the takeaways?

- Global bond markets represent about 50% of the Global Portfolio
 - Non-US bonds represent the largest stand-alone asset class with a 22% weight
- The overall weight to global equity markets is 36% with the US accounting for half of that

- The next largest bucket, real estate (debt and equity), aggregates up to an 11% weight
- The proportion of capital invested in “everything” else is small (3%)
- The small contribution beyond the big three of stocks, bonds and real estate leads me to question whether the methodology is significantly under-estimating the importance of alternative asset classes such as commodities, private equity, venture capital, etc.
- The inability to properly account for human capital is conceptually troublesome as the greatest contribution to global income comes from wages
- In my opinion, very few investors would blindly accept these asset class weights as their normal or default position

Figure 1



In any case the global capital market weights are significantly at odds with the default option of many individuals in the US – the 60/40 portfolio. The most common expression of this default portfolio is 60% in US equities (primarily large cap) and 40% in a bond portfolio mimicking the Barclays Aggregate. Non-US exposure is often still viewed as risky and not part of the strategic core.

What about the Target Date Funds? Do they look anything like the global capital market portfolio?

There is a wide dispersion in holdings in these funds. Some hold alternative assets such as real estate and commodities in their strategic mix while others are more plain vanilla.

Let’s take a look at a couple of large Vanguard Target Date funds – 2020 and 2050. The first is designed for somebody close to retirement and the second would be more applicable to the Millennium generation.

Table 2

CATEGORIES	VANGUARD TARGET DATE		
	BENCH	2020	2050
DEVELOPED (X-US) BONDS	22.4%	11.9%	2.9%
US EQUITY	18.0%	34.0%	54.0%
US BONDS	15.2%	28.8%	7.2%
DEVELOPED (X-US) MKT EQ	13.7%	22.6%	35.9%
REAL ESTATE DEBT	5.7%	0.0%	0.0%
REAL ESTATE EQUITY	5.4%	0.0%	0.0%
OTHER BONDS	5.2%	2.7%	0.0%
CASH EQUIVALENT	4.4%	0.0%	0.0%
EMERGING MKT EQUITY	4.2%	0.0%	0.0%
EMERGING MKT BONDS	2.7%	0.0%	0.0%
PRIVATE EQUITY	2.7%	0.0%	0.0%
COMMODITIES	0.3%	0.0%	0.0%

The Target Date 2020 fund has 40.7% in bonds – a bit more than the global capital market portfolio. In terms of equity investments the over-weight is a lot more extreme. The fund allocates over 20% more to equities than prescribed by the global capital market portfolio. These two portfolios are quite different in terms of composition.

Moving on to the Target Date 2050 portfolio the differences are even starker. The allocation to equities is a whopping 89.9% with the rest in bonds. Clearly this is a much more aggressive portfolio.

The weighting differences relative to the global capital market portfolio are in the case of target date funds mostly attributable to disagreement as to the relevance of the comparison portfolio.

While some target date funds seek to actively manage asset class exposures, for the most part the allocations are predetermined by the implied glide path. In general the key principles of a glide path are the idea that risk and return are positively related and that the ability of the individual to take risk is a decreasing function of age.

What about the segments of investors that actively seek to adjust their asset class mix to reflect evolving risk and return perspectives? Among these managers are Global Tactical Asset Allocators, ETF Strategists (such as those covered by Morningstar), Global Macro Hedge Funds and many Wealth Managers acting on behalf of their individual clients.

Venerable names in the industry are practitioners of this art – Ray Dalio’s Bridgeport, Jeremy Grantham’s GMO and Rob Arnott’s Research Affiliates/PIMCO among others. It is hard to pinpoint the exact size of this universe of players because it is so heterogeneous in terms of approach, investment structure, and client type. My guesstimate is that the segment of investors making asset mix

adjustments depending on their evolving capital market risk and return views mimics the size of the Target Date Fund industry.

It's hard being a truly passive investor after all. Most portfolios will deviate from global capital market weights due to different investor requirements and attitudes toward risk as well as non-consensus views on the expected outlook of asset classes and strategies.

There is also a lack of consensus as to what the appropriate global capital market portfolio really looks like. For now, the state of the state of the art seems to be more about finding points along a conceptual efficient frontier composed only of easily measurable asset classes such as public equities, market traded debt, liquid real estate and cash equivalents. Maybe not surprisingly most multi-asset class strategies tend to navigate primarily in these identifiable categories.

Samuelson's macro-inefficiencies are the natural habit of multi-asset class strategies but the reality is that exploitable sustainable strategies are still hard to find. Does a momentum approach such as that typically employed by ETF Strategists lead to above average returns? Does the valuation approach employed by many GTAA managers such as GMO and Research Affiliates have the best chance of outperforming some static mix? Is a combination of value and momentum maybe sprinkled with a measure of environmental/macro attractiveness the best choice? Empirically you see as much variation in approaches attempting to exploit macro-inefficiencies as you do on the security selection side.

While good old fashioned security selection (both stocks and bonds) may no longer be in fashion there may come a time when certain approaches gain an edge while keeping expenses in check. We may be entering an era where large asset managers (by AUM) focus more of their efforts at cost reduction and offering index or enhanced index strategies to the masses. Recent strategy moves by Blackrock certainly seem to lean in this direction. The investment industry is becoming more quantitative both in terms of the management of assets as well as in terms of client acquisition and ongoing support.

On the other hand smaller pockets of the markets will always provide fertile ground to security selection efforts. By definition asset managers navigating in these uncharted waters will come from smaller shops less encumbered by large asset bases. The techniques and methods used to identify these opportunities will often still feel like "old school" grass roots research (some might call this "real" fundamental analysis) enhanced in some cases by new concepts rooted in machine and deep learning. My sense is that a lot of these "alpha" opportunities will be fleeting and require a flexible research approach to always be on the hunt for the next big thing.

Similarly, multi-asset class strategies do not require any measurable scale to perform well. Asset class research has always been more amenable to the use of quantitative approaches and the emergence of liquid, low cost index vehicles levels the playing field vis a vie larger asset managers. My expectation is that much of machine and deep learning will gravitate toward multi-asset class applications. Also advances in portfolio construction approaches will continue to be best showcased in this area.

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