ACTIVE OR PASSIVE?

THAT'S THE WRONG QUESTION

by Evan Grace

Evan Grace, CFA, Asset allocation strategist and portfolio manager

The debate over active versus passive investment has been raging for 50 years now – for much of that time, unproductively. To be fair, the debate has at least evolved, starting with the Efficient Market Hypothesis in the 1960s, continuing amid the rise of equity indexing and the behavioural finance counterattack of the 1980s and 1990s, and eventually moving on to current arguments about the use of exchange-traded funds, hedge funds and liquid alternatives. Yet one aspect has remained unchanged: the discussion still centres on which approach is better.

As a multi-asset investor, I believe this debate has been fundamentally misconceived. The choice between approaches should not be binary. Rather, we need a framework for thinking about both active and market sources of return within an investment portfolio. How much exposure to have to each source should depend on the investment problem that needs to be solved. Here, we lay out such a framework and draw three conclusions:

- Both active and passive exposures have a role in any asset allocation.
- There is no such thing as purely passive management, as decisions on implementation can lead to vastly different exposures and investment outcomes.
- The successful generation of alpha largely depends on how active exposures are structured.

THE TRADITIONAL BATTLE LINES

Proponents of passive investing typically deploy two main arguments. First, alpha is a zero-sum game: for every winning investment relative to a universe average, there must be an offsetting loser. Second, fees are clearly lower in passive strategies, creating a challenging hurdle for active managers to overcome.

Active managers generally counter with two main points. The evidence shows that some managers persistently outperform over time, and anyone investing with these managers is likely to experience an above-average result. Moreover, for good managers, the excess return is large enough that returns are still positive net of fees.

FLAWS IN THE DEBATE

I see several grounds for believing that the active versus passive debate has until now been wrongly framed. For one, there is no such thing as genuinely passive investing. Suppose an investor wants to add passive exposure to commodities. Which is the right index[1] to choose? The S&P GSCI has a heavy weighting to energy, whereas the Dow Jones Commodity Index weights energy, metals and agriculture/livestock equally. One investor might favour the Dow Jones index, as it is less skewed to the energy sector than the GSCI. But another could with equal validity prefer the GSCI for basing the index weights on the volume of each commodity that is produced. One index is not inherently better than the other, and an investor seeking passive commodity exposure must choose between these and other options. This choice results in very different exposures.

Similarly, in an equity context, it appears logical to use market-capitalisation-weighted indices, as they simply capture the largest companies without prejudice. Yet it would make just as much sense to have equally weighted indices adjusted for liquidity, because they are less influenced by historical performance and systematically assign all components the same weight. Is one better? That's a subjective question, and the answer represents an active view or at least produces an active exposure.

Changing the language of the debate should help to clarify the issues. Often, so-called passive investments are in practice anything but, and I believe it would be better to talk of "market exposures" than "passive investments". This is not just an empty rebranding exercise; rather, it can lead us past the sterile active versus passive debate and instead focus our attention on the types of exposures and the risks involved. Market risk is what passive investing creates, and we should concentrate our analytical energy on how much market risk to hold and how it should be obtained.

Another rationale for recasting the debate is that the choice of how to invest one's assets is not strictly binary. We regularly construct multi-asset portfolios for clients. Many are bespoke, and nearly all contain both active and market sources of risk and return, for the theoretically and empirically sound reason that return is derived from risk, and active and market risks have different characteristics, which are complementary. We should therefore consider these components separately in order to build portfolios that are appropriate to meet distinct client needs.

A NEW FRAMEWORK

When creating multi-asset investment solutions for clients, we ask three key questions. The answers to these questions go a long way towards determining the relative weights of active and market exposures.

Question 1: What do you believe?

If the investor has a strong philosophical belief in either passive or active management, that will obviously tend to set the course. However, even investors with a clear bias towards passive management will still have to make important active decisions on which market exposures are obtained.

Question 2: How important is cost?

All investors prefer lower fees to higher, but the way fee sensitivity manifests itself is important. If an investor is focused on net-of-fee performance, then active fees should be acceptable as long as the alpha targets are both high enough and realistic. But the analysis will be different if fee constraints are imposed externally at a fixed level (by a board of trustees, say, or by a governmental or regulatory body). In that case, the total allowable fee will be an explicit constraint on the solution and may result in a lower estimated future return net of fees.

Question 3: What is the asset size?

Alpha generally has lower capacity than beta, as it may involve shorting and frequent trading and can be liquidity constrained to different degrees. For very large asset sizes, therefore, market risk needs to be a bigger component of the overall portfolio, simply for capacity reasons.

BUILDING THE EXPOSURES

The answers to these three questions provide an important starting point, but more needs to be done to create an investable solution. As a general principle, returns are associated with risk. So, for both active and market exposures, we should explicitly consider how volatile each exposure is, how much return it can reasonably be expected

to produce and the extent to which different exposures complement one another. In other words, we need to allocate risk, not capital. Increasingly, we see our clients moving from a traditional asset allocation framework, one that allocates capital across traditional market exposures, to one that focuses on risk allocation across a broader set of components, summarised in Figure 1. While there is a vast universe of assets to which we can allocate risk, for our purposes there are three primary components to consider beyond traditional asset classes.

Component 1: Smart-market exposure

We define a smart-market exposure as one that gains exposure to traditional asset classes but targets a better balance across various risk factors, such as country, region, economic sensitivity, liquidity and quality. Traditional index construction tends to emphasise simplicity by choosing weights based on market capitalisation, GDP or other readily available data. Unfortunately, such methods often produce significant concentrations and economic exposures.

Figure 2 illustrates the problem in fixed income. The pie chart on the left side is the Citigroup World Government Bond Index ex US, which bases its weights on market value. This methodology, though reasonable, results in concentrated positions in certain countries. The pie chart on the right shows a smart-market methodology that weights each country based on its volatility, adjusted for liquidity and quality. For an investor who wants to gain broad exposure without expressing a particular view, the latter approach achieves a portfolio with far better balance.

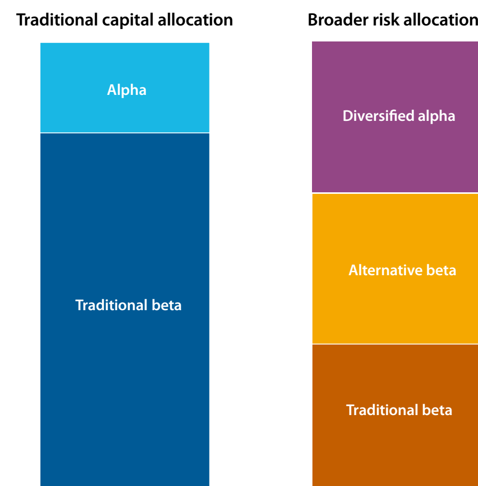
Component 2: Alternative beta

These are similar to traditional asset classes in that they are meant to capture return associated with systematic risks – risks that persist over time and have some theoretical basis, such as the equity risk premium. By contrast, an alternative beta, though often derived from a traditional asset class, produces a return stream that is significantly different. In equities, for example, a classic alternative beta is that associated with momentum. By owning a subset of equities with strong price momentum and diversifying away market, idiosyncratic and other risks, the portfolio is left with the momentum factor, whose returns look quite different from those of the equity market. This is powerful, as it creates an additional market risk that can offer significant diversification from a portfolio's existing holdings.

Component 3: Diversified alpha

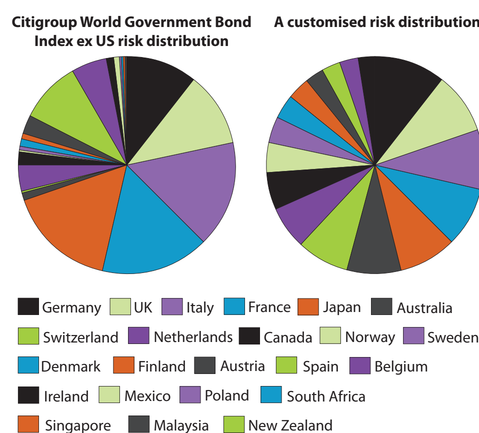
We define alpha as a source of return that is not systematically associated with a specific risk factor or economic environment. In theory, alpha represents true investment skill, as it is a return in excess of any risk premium available in financial markets. The challenges here are clear. Alpha is scarce, tends to be expensive relative to market exposures, changes over time with the economic environment and is a zero-sum game (alpha in aggregate must net out to zero within a given market). Yet the potential reward is substantial: an investment that is highly diversifying, as alphas tend to have low correlations to not only traditional asset classes but also alternative betas and other alphas.

Figure 1: Separate alpha and beta



Source: Wellington Management

Figure 2: Better-balanced market exposures



Based on December 2013 weights of Citigroup World Government Bond Index ex US (WGBI ex US) and an adjusted covariance matrix incorporating daily data from January 2010 to December 2013 for all constituent allocations. Customised risk distribution is for illustrative purposes only.
Sources: Citigroup, Wellington Management

To maximise the probability of avoiding the zero-sum problem, we seek alphas in different asset classes, with different time horizons and from different investment processes. When alpha is created from very different processes, the likelihood of achieving its benefits is significantly increased. Each investment process that purports to produce alpha should be carefully evaluated, as only a strong, repeatable process with a particular investment edge is likely to produce alpha consistently over time.

WHAT'S THE RIGHT BALANCE?

Our new framework is deliberately not prescriptive, as there is no one right answer to the question of how much active or market exposure an investor should hold. Similarly, how much of a portfolio's exposure should come from traditional asset classes or alternative betas will vary depending on an investor's objectives, constraints and preferences.

To illustrate the concept, consider an investor who is seeking absolute returns, relatively low volatility and diversification from traditional asset classes such as equities and bonds. Such a portfolio should emphasise alpha and alternative beta exposures, and risk allocation over capital allocation. It should also have embedded drawdown controls to mitigate downside risks. We manage a variety of multi-asset portfolios for our clients. Some are focused on pure absolute return, as the clients want to diversify their market exposures and therefore are more heavily weighted to the alpha component. Others look to emphasise exposures that do particularly well in a given economic environment and are therefore more skewed towards traditional asset classes. Still others seek a balance across all of these factors via a blend of exposures. Which combination is "right" for a given investor depends on exactly what investment problem needs to be solved.

CONCLUSION

Remember that market risk is never truly passive: every exposure in a portfolio is the result of an active choice. By focusing on how alphas and market exposures are produced, and how they can be combined most effectively, we have attempted to move beyond a stale, unproductive debate and instead propose a new framework that we believe offers a higher probability of investment success.

FOOTNOTE
1 Indices are not managed and cannot be invested in directly.

For information contact: Camilla Hall
+44 (0)20 7126 6215
CMHall@wellington.com

Past results are not necessarily indicative of future results and an investment can lose value.
This material and/or its contents are current at the time of writing and may not be reproduced or distributed in whole or in part, for any purpose, without the express written consent of Wellington Management. This material is not intended to constitute investment advice or an offer to sell, or the solicitation of an offer to purchase shares or other securities. Investors should always obtain and read an up-to-date investment services description or prospectus before deciding whether to appoint an investment manager or to invest in a fund. Any views expressed herein are those of the author, are based on available information, and are subject to change without notice. Individual portfolio management teams may hold different views and may make different investment decisions for different clients. Associated risk includes: Alternatives risks – Alternative investments tend to use leverage, which can serve to magnify potential losses. Additionally, they can be subject to increased illiquidity, volatility and counterparty risks, among other risks.

WELLINGTON MANAGEMENT®
www.wellington.com