Viewpoint

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ASSET MANAGEMENT

Framing the Active vs. Passive Management Choice

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Executive Summary

The relative costs and likely benefits of active versus passive investment management have been debated for years in the pages of academic journals and by investment practitioners. At the end of the day, institutional investors must decide for themselves which approach makes more sense. In the following discussion, ISSG's Ralph Goldsticker provides a framework for thinking about whether to use active or passive investment approaches. He argues that the decision depends on investment objectives, information advantages, risk appetite, investment philosophies and organizational cultures. He also looks at the new alternatives to capitalization-weighted benchmarks in passive investing and suggests how to assess their relative benefits.

Academicians and practitioners have been debating market efficiency and investment manager skill for decades. Study after study has been published evaluating the track records of active managers. Many find little evidence of value added, net of fees and expenses, but others have documented manager skill. Institutional investors are divided as well. While many organizations invest solely in passive strategies, there is evidence that a majority of institutional investors believe that active management can add value.[2]

We use active management to refer to strategies aimed at outperforming a given benchmark. The added value is derived from manager skill and proprietary investment views. Passive strategies have the sole objective of closely tracking a given benchmark. Thus, decisions are rule-based and not premised on subjective views. The benchmark, as we discuss later, may or may not be capitalization-weighted.

In our view, if there is a reasonable probability of investment success, the case for active management is compelling. The higher returns from successful active management would allow pension plan sponsors, for example, to reduce plan contributions or raise benefits. In addition, for most plans, the contribution of active management to total plan volatility is generally relatively small. That said, active management success is not

1 ISSG is part of The Bank of New York Mellon, a principal banking subsidiary of BNY Mellon.

2 According to a 2010 poll, approximately 70% of U.S. pension plans either agreed or strongly agreed that active equity strategies will deliver alpha in the foreseeable future. The comparable figures were 76% of plans in the U.K., 77% in Scandinavia and 88% in Canada. Pyramis Global Pension Pulse Poll, January 14, 2010.

assured, even if there is an opportunity to add value due to market inefficiency. While we believe that skillful managers can add value, we do not believe that all investors should rely solely on active strategies. To help investors decide whether an active or passive approach is appropriate, we provide the following checklist of key questions to consider. If investors can answer each point in the affirmative, then active management might be something to consider. Otherwise, we believe choosing a passive approach may be more appropriate, and discuss some of the new "smart beta" alternatives to traditional benchmarks.

The pattern of institutional investors hiring managers at performance cycle peaks and terminating them at the trough is well recognized.

Does your investment philosophy and culture support active management?

Either explicitly or implicitly, every organization has views on the market efficiency debate. Clearly, organizations that believe that it is very difficult for active managers to add value may prefer to choose passive management. Many organizations choose active management because they believe that the opportunities presented by the market are sufficiently large, and they are confident in their ability to identify superior managers. Other organizations may take a different view. They believe significant opportunities to add value might exist, but choose passive management due to the organization's aversion to potential underperformance or other organizational characteristics.

The offsets to active management's potential to add value are the financial and organizational risks of underperformance. Before adopting active management, we believe all parts of the organization need to embrace the commitment as well as the implications of that commitment. There needs to be a consistent philosophy in order to make appropriate trade-offs between the potential value added from active management and the risk of underperformance. That philosophy should reflect the expected likelihood and benefit of success, as well as the potential consequences of underperformance and higher volatility. It would be unrealistic to assume that the active versus passive debate is only about the economics of the decision. Often an organization's culture and history have significant influence on the decision.

Can you stick with an active manager through periods of underperformance?

The pattern of institutional investors hiring managers at performance cycle peaks and terminating them at the trough is well recognized.[3] In addition to identifying and hiring skillful managers, active management requires sufficient organizational fortitude to weather periods of underperformance. The organization must be confident that it will not let short-term results or unfavorable market environments color its view of manager skill. It must be prepared to give its managers enough time for their process to deliver the expected results. Manager turnover is expensive in two ways. The most important is the opportunity cost of missing the turn in the manager's performance. But the transactions costs entailed from transitioning the assets to a new manager matter as well.

It would be nice if all skillful active managers consistently added value quarter after quarter. Our experience, however, is that on a quarterly basis, the odds of even the best managers outperforming their benchmarks are not much better than 50/50. In addition, due to their investment processes, managers' results often go through cycles. Insights and opportunities vary through time, and managers' investment processes are likely to be more successful in some market environments than in others. The

3 See, for example, Amit Goyal and Sunil Wahal, "The Selection and Termination of Investment Managers by Plan Sponsors," *Journal of Finance*, August 2008.

reality is that, depending on their approach, even skillful managers may experience underperformance that lasts for several years. While the investment professionals that selected the manager usually understand this, others in the organization might have unrealistic expectations. As a result, if the expectations of the entire hiring organization are inconsistent with the manager's process, there is a significant risk that they will terminate that manager at the bottom of a performance cycle. Turnover at the staff and/or board level can exacerbate the problem, as can performance problems and pressure from external constituencies.

Besides higher management fees, active management also incurs other costs. Successfully identifying and monitoring active managers as well as maintaining a robust due diligence and risk control environment require additional staff and infrastructure.

Are you willing to pay more for active management?

In the current environment, many investors are looking to reduce expenses, and management fees are coming under close scrutiny. If sponsors are able to negotiate lower fees on the strategies they currently use, they can improve their net-of-fee performance. However, if they limit their search to managers charging low fees, they are likely to omit a number of skillful managers. Active management skill is a scarce commodity, so anything that reduces the opportunity set is likely to reduce the odds of success.

Besides higher management fees, active management also incurs other costs. Successfully identifying and monitoring active managers as well as maintaining a robust due diligence and risk control environment require additional staff and infrastructure. If cost constraints reduce that capability, the likelihood of active management success will also shrink.

If an organization is unwilling to pay the expenses required to employ skillful managers across all asset classes, it could instead deploy limited resources to actively managing asset classes that are less efficient, but also have larger allocations. The organization could then opt for passive management elsewhere.

Is the target market inefficient enough to justify active management, and is skill required or can the opportunity be captured by a systematic strategy?

The question of market efficiency is an important subject, but beyond the scope of this framework. Nevertheless, we do think investors need to consider the criteria that create the opportunity for successful active management and how they apply to each market segment. Active management is more likely to be successful when there is a wider dispersion of returns within an asset class. That creates opportunities for managers that have an informational advantage or are more skilled at identifying mispriced assets. The informational advantage may be because the asset class is less intensively researched, there is less publicly available information, or there are clientele effects or market segmentation that allows prices to move away from their fair levels. Also, it is more difficult to consistently add value when a market is driven by transitory events or exogenous shocks, which tend to reduce portfolio breadth and are less predictable.

Traditional asset classes such as large cap domestic equity and core bonds tend to constitute the largest allocations, and therefore any incremental returns from active management have the greatest impact on performance. But those asset classes are also perceived to be more efficient. Satellite and specialty asset classes such as emerging markets and high yield bonds tend to be less efficient, but they are more complex to monitor, and their smaller allocations may make it difficult to justify the additional resources active management requires.

It might be that not all markets are zero-sum games. In some, the actions of a subset of participants may allow the rest to outperform the index on average. Investor preference for "glamour" stocks, which can lead to growth stocks underperforming value stocks, is one example. We contend that such situations call for an alternative benchmark that systematically uses a set of rules to capture that inefficiency. Skillful active management should be able to add value above the alternative benchmark. If not, using a passive strategy designed to track the "smart index" might be the preferred approach.

Investors should also not overlook the transactions costs that result when assets are transitioned from one manager to another. Regardless how robust the manager selection process is, it is likely that eventually a sponsor will decide that a manager in the roster no longer fits. At that point, the assets will need to be transitioned to another manager, which will incur transactions costs. The expected gain from active management must cover these costs as well.

A manager selection process either performed internally or outsourced can be successful. What matters is instituting a process that is likely to succeed.

Do you have the skills to identify more successful managers and sufficient resources to monitor them?

The decision to use active management requires a high likelihood of selecting successful managers on a prospective basis. Regardless of the asset class, identifying managers is difficult. It would be easy if identifying skillful managers ex-ante was a science with a well documented set of formulas, but it is not. Investors who choose active management must be confident that they have access to the skill, judgment and resources needed to identify skillful managers as well as to monitor them on an ongoing basis. The monitoring can be quite time-consuming. You must be confident that each manager is following the expected investment process and guidelines. You must also evaluate the managers' results to be sure that the added value and risk are consistent with your expectations. We should also point out that portfolio construction and risk control become more complicated when active management is involved.

A manager selection process either performed internally or outsourced can be successful. What matters is instituting a process that is likely to succeed. Also, when estimating the likely benefit from active management, it is important to include the additional organizational costs necessitated by active management. That analysis should be performed by market segment, and the results may not be intuitive. The same percentage of added value in asset classes with large allocations such as core bonds will have a larger impact on the overall portfolio compared with specialty asset classes such as emerging markets, which tend to have smaller commitments. However, emerging markets may be less efficient, and hence provide a greater opportunity to add value. That said, selecting and monitoring emerging market managers may require more resources than needed for core bond managers.

If institutional investors choose to rely on their own staff for manager selection, they must be confident that they have the necessary experience, skill and judgment. The team must be large enough to monitor all of the asset classes and managers involved. As the complexity of the strategies increases, the amount of time and specialized skills required to monitor them will increase as well. In addition to sufficient staff, teams must have the necessary tools, training, and budget to choose and monitor managers successfully. Lastly, competition for analysts is high. You must be sure you can identify and attract skillful ones, and it is important to have policies in place to retain them.

Using an asset consulting firm is an alternative to internal manager selection, but the same issues arise, albeit in a different form. Organizations must now be able to identify consultants with the experience, skill, judgment and resources to select skillful managers on their behalf. Even when an asset consultant is used, relative to passive management, active management will require additional staff. Not all of the manager selection and monitoring processes can be delegated, and portfolio construction and risk control functions will remain with the institutional investor.

Is the size of your desired allocation consistent with the strategy's capacity?

Every active investment process can reach a size at which the transactions costs from its trades begin to consume a significant portion of the potential added value. Often, managers recognize this, and limit the assets invested in a strategy. Of course, the problem is more acute in less liquid asset classes and for strategies that require low transactions costs to succeed. This creates a constraint for larger investors. The aggregate capacity of the managers they have identified as superior may be insufficient to accommodate all of the assets the investor wants to allocate to that asset class. Recognizing that active management is a zero sum game, adding more managers is not an optimal solution. The second tranche of managers is unlikely to be as skillful as the first, and the investor could be faced with managers who are not skillful enough to cover their fees and transactions costs.

One solution is a hybrid approach. Some assets are managed actively, and others are managed passively. However, this may be less than ideal, since the fixed costs of maintaining an active management infrastructure may be spread across too few assets. If the portion of actively managed assets becomes too small, it may make sense to divert the resources from traditional active management, and focus them where they will have a larger impact.

The economics of successful active management can be compelling, but the decision in favor of active management should be taken judiciously. Even if investors believe there are opportunities to add value with active management, success is not guaranteed. Without the proper organizational philosophy, staffing and governance, active management may not be the best choice, even if markets are not efficient.

The active versus passive decision should be based on whether active managers have sufficient skill to add value (versus the appropriate benchmark), and whether the organization can identify more successful managers and capture their added value at an acceptable level of risk.

Options Within Passive Management

We think the above questions should help investors frame whether active management is a suitable option for them. If they decide that passive investing is more appropriate, we believe there are further questions to guide investor choices.

While passive management is often assumed to refer only to tracking capitalization-weighted benchmarks,[4] we believe that the active versus passive decision should be made independently of the capitalization-weighted versus alternative benchmark decision.[5] The active versus passive decision should be based on whether active managers have sufficient skill to add value (versus the appropriate benchmark), and whether the organization can identify skillful managers and capture their added value at an acceptable level of risk. The capitalization weighted versus alternative

4 The capitalization-weighted index weight = f (shares outstanding x price per share).

5 Alternative weighting schemes are also rules-based, but use other rules. For example, with fundamental indexing, the fundamental indexing index weight = f (shares outstanding x fundamental value per share). Minimum variance portfolio weights are determined by an optimizer.

index decision should be based on their relative expected returns and risks. The two decisions can be blended. For example, you may want to use a fundamental index as the benchmark for an active manager with a value style.

Why choose a capitalization-weighted index?

The argument for capitalization (cap) weighting started with the Capital Asset Pricing Model (CAPM).[6] It suggests that all investors should own a combination of the market portfolio (the capitalization-weighted portfolio of *all* assets) and cash. While the empirical tests reject the CAPM, studies of portfolio manager performance demonstrate that capitalization-weighted benchmarks are difficult to outperform. The practical argument for cap weighting goes as follows: the capitalization-weighted portfolio represents the aggregate portfolio of all investors, and active management is a zero sum game; therefore net of expenses, the average manager will underperform the capitalization weighted index.

Most alternative benchmarks are rules-based investment strategies designed to systematically tilt the portfolio in a way to capture an anomaly.

Why choose a non-capitalization-weighted index?

However, in addition to all of the studies of manager performance, there is also a long history of academic literature documenting "anomalies" — patterns in returns that cannot be explained using classic investment theory and "rational" investor behavior. Most of the alternative strategies such as fundamental indexing and minimum volatility strategies trace their roots to the anomaly literature. The anomalies are explained by suggesting that investors make cognitive errors or have behavioral biases that create systematic opportunities relative to the capitalization-weighted indexes. Most alternative benchmarks are rules-based investment strategies designed to systematically tilt the portfolio in a way to capture an anomaly. For example, fundamental indexes are designed to systematically overweight value stocks and underweight growth stocks relative to the capitalization-weighted index. If the value anomaly persists, fundamental indexing should outperform.

What is the source of the relative performance and will it persist in the future?

An organization's choice between capitalization-weighted or non-capitalization-weighted benchmarks should reflect its views about investor behavior and market segmentation, as suggested below.

Alternative Index	Rationale	Source of Return	Typical Tilts
Fundamental Indexing	Value stocks have higher expected returns than growth stocks	Investors pay too much for growth stocks	Low Price/Earnings, Price/Book, Price/Sales, etc.
Minimum Volatility	Low risk stocks have the same or higher expected returns than high risk stocks	Investors pay too much for stocks with high idiosyncratic volatility	Low Volatility Low Beta

6 William F. Sharpe, "Capital Asset Prices: A Theory of Market Equilibrium Under Conditions of Risk," *The Journal of Finance*, September 1964.

Are the higher returns large enough to offset the higher turnover?

But even if investors believe that the historical anomalies will persist into the future, they may still want to use capitalization-weighted benchmarks. Besides its theoretical justification, capitalization weighting has a practical justification in the form of its very low turnover. The alternative indexes will have higher turnover, with higher transactions costs, which may be larger than the expected benefit from their tilts. The turnover will depend on the design of the index.

What is the capacity of the strategy and how much can be invested before the anomaly disappears (or reverses)?

Capitalization-weighted portfolios are not "capacity constrained." Investing in a capitalization-weighted benchmark does not put disproportionate pressure on any individual stock or market segment, which is not true for the alternative benchmarks. The aggregate holdings from combining all investors' portfolios will reflect capitalization weights. As a result, when investors move from capitalization weights to an alternative set of weights, the rest of the market will have to provide the offsetting trade. The impact may be small at the margin, but not at the extreme. For example, if *all* investors adopted price-earnings-based fundamental indexing, all stocks would trade at the same price-earnings ratio. In that case, growth stocks would be cheap, and you would want to tilt towards them. If you adopt an alternative to capitalization weighting, you should monitor the markets to ensure the reason you used to justify the shift still exists.

If you adopt an alternative to capitalization weighting, you should monitor the markets to ensure the reason you used to justify the shift still exists.

Can the organization tolerate extended periods of underperformance?

Lastly, even if the anomaly persists, and the alternative strategy outperforms the capitalization-weighted alternative over the longer term, there may be extended periods of underperformance. If you adopt an alternative benchmark, be certain your organization will be able to tolerate such underperformance. Otherwise, you might lose confidence and discard the strategy at the bottom of its performance cycle.

In sum, the non-capitalization-weighted benchmarks and other rules-based strategies offered as alternatives to capitalization weighting are designed to capture anomalies or other systematic opportunities. We believe investors should use them only if they believe the anomaly will persist and the expected gain is likely to be larger than the costs of higher turnover. At the same time, they should keep in mind that such strategies can have extended periods of underperformance and their capacity is limited.

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