Three Myths of the Active/Passive Debate

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VIEW FOR THE C-SUITE

Myth #1: Markets Are Too Efficient

Myth #2: Indexing is Killing Active Management

Myth #3: Passive's Knock-Out Punch

Summary

Myth #1: Markets are too efficient

"Market efficiency" is poorly defined and constantly changing

- Market efficiency explains the "average performance", but not the outliers
- The skill of active managers: The journey from idiot to genius (and back)

If not market efficiency vs. manager skill, what really causes the fortunes of active managers to rise and fall?

Active performance factors

- The sum of all active managers ≠ the index
- There are ***systematic differences*** between a universe of active managers and their index
- These differences (i.e., factors) largely explain the fortune/misfortune of active managers from period to period

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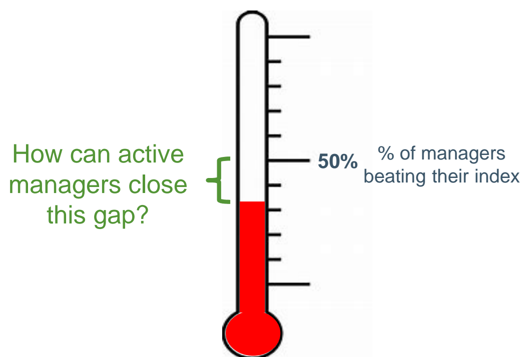
What are some of those factors?

Factor Examples	Explanation	Bias: Helps/Hurts Active
Market Direction	Cash drag of active portfolios (indexes are fully invested)	Bull market hurts Bear market helps
Capitalization Skew	Most active managers have smaller cap portfolios than their cap-weighted indexes	Mega-cap strength hurts Mega-cap weakness helps
Benchmark Density	Lower density = higher active share	High density (S&P 500®) = Harder to beat Lower density (Russell 2000) = easier to beat
Yield & Credit Exposure	Active bond managers are systematically overweight credit (i.e., higher yield)	Credit underperforms = Hurts active Credit outperforms = Helps active

Source: Natixis Investment Strategies Group

During periods when active managers perform particularly well or poorly, it's usually math, not magic.

Myth #2: Indexing is killing active management



It is not the strongest of the species that survives, nor the most intelligent that survives. It is the one that is most *adaptable to change*.

– Charles Darwin (misquoted)

Portfolio Darwinism: The competitive pressures of passive indexing will make active strategies more competitive in the long run

"How Passive Indexing Will Save Active Management"

Portfolio Darwinism

Fee Compression

- Lower active fees, share class migration & liquidation, waning use of soft dollars, improved trade execution; Indexing reaches the zero bound on fees?

The Ruthless Pursuit of Alpha

- AI, machine learning, big data/smart screening, liquidity management, equitization of cash

Death of the Closet Indexers: Highly differentiated portfolios

- Separation of alpha (active) from beta (passive); ***higher active share*** and greater capital efficiency

Misallocation of Capital

- Growing importance of cap-weighted and issuance weighted indexes => Increased mispricing? Increased opportunity? Are investors willing to ignore valuation, fundamentals, and corporate governance?

Defensive Optionality: What about the downside?

- Investors have benefitted from full market beta over the longest bull market in history
- Investors will have a greater appreciation for ***the ability to manage downside risk*** in the next bear market*

Indexing is not going to kill active management.

It is likely to kill ***bad*** active management.

*There is no guarantee that an active manager can position portfolios defensively to manage downside risk.
No investment strategy or risk management technique can eliminate risk in all market environments.

Summary of Effects: No Panacea

Active Pressure	Potential Implications	Reliant on Security Selection
Lower Fees	Lowers the performance hurdle	NO
Ruthless Pursuit of Alpha	Squeeze out biases & costs	YES/NO
High Active Share	More efficient allocation	YES
Misallocation of Capital	Greater market mispricing	YES
Downside Risk	The option of being defensive	YES

Source: Natixis Investment Strategies Group

Active managers still have to get the stock selection right!

Manager selection still matters.

Myth #3: Passive's Knock-out Punch

The Passive "Proof"

A) All managers, active plus passive, make up "the market"

B) Therefore, the average active manager will have a return equal to the market before fees & expenses (Note: There is little empirical evidence that this is true)

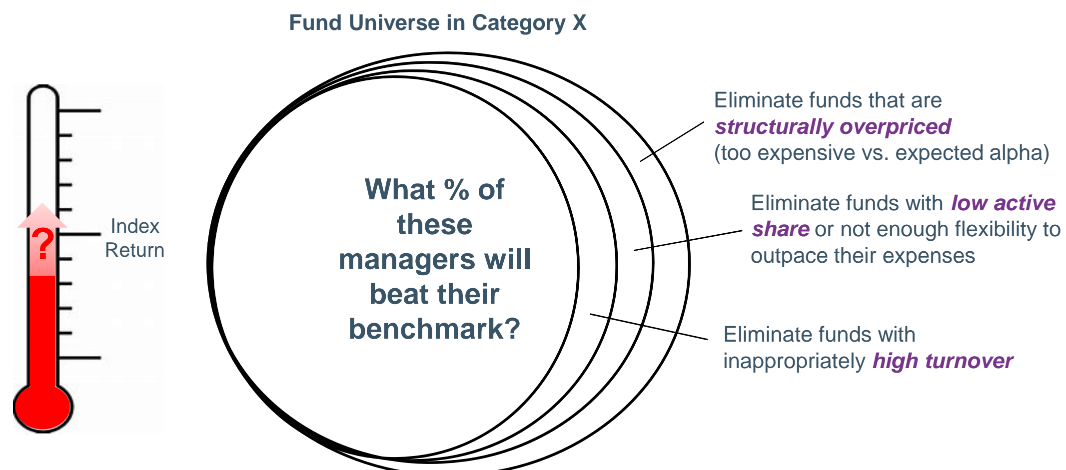
C) Active managers charge fees, therefore, the average active manager has to underperform the market net of fees & expenses.

Even if this were true, is it relevant?

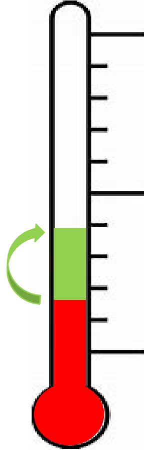
Are advisors and investors seeking the returns of *an average active manager*?

This logic assumes there is no way to identify above average managers...

Improving Your Odds



What might this look like?



Morningstar US Large Cap Blend
January 2008 – December 2017
Statistics = 10 year medians

94 of 563 active funds outperform over 10 years = 16.7%

- Eliminate funds < 80% active share
- Eliminate funds with above average expenses (1.09%)
- Eliminate funds > 50% turnover

16 of 41 active funds outperform = 39.0%

"Winning the Loser's Game"
Simple screening on factors that *eliminate structural laggards* can significantly improve your odds of selecting a manager who may outperform

Source: Morningstar, Natixis Investment Strategies Group
Performance data shown represents past performance and is no guarantee of, and not necessarily indicative of, future results.

Summary

Point #1
If you understand how active portfolios are different (on average) than indexes, you'll understand when & why active portfolios outperform or underperform

Point #2
Portfolio Darwinism – The competitive pressures of indexing are forcing active managers to up their game (lower fees, higher active share, etc.)

Point #3
Investors aren't doomed to buy "the average active manager" if they focus their manager selection on the right factors

Thank You

Disclosure

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High active share is not a guarantee of outperformance or positive performance.

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Scott Gonsoulin

Investment Manager: External Public Markets

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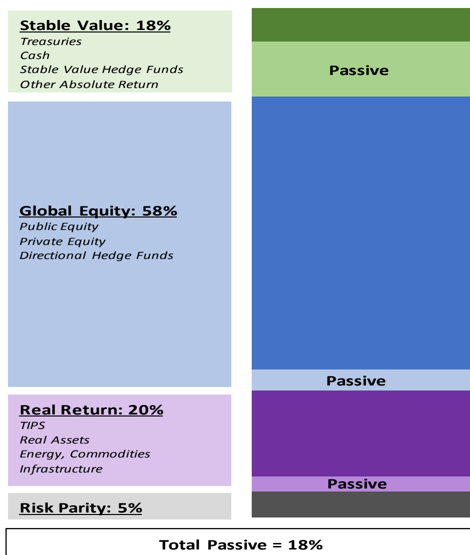
Teacher Retirement System of Texas



$152 Billion

1.6 Million Texas Educators

160 Investment Staff

82% Actively Managed

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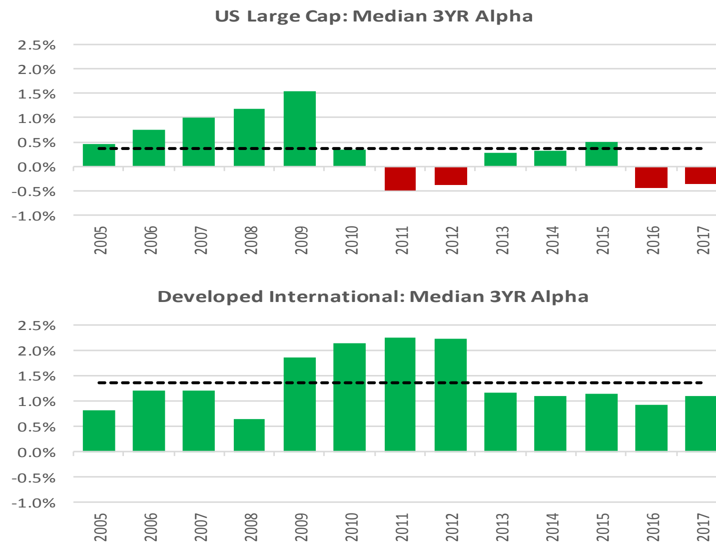
Belief #1: Active management works, but...

...it works better in some places than others...



Source: eVestment

Belief #1: Active management works, but...

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TRS Public Equity 5YR Annualized Alpha

5YR as of Jun-17	Annualized Alpha (bp)			Information Ratio			Monthly Hit Rate		
	USA	EAFE	EM	USA	EAFE	EM	USA	EAFE	EM
External Managers	-162	220	99	-0.82	0.77	0.6	38%	57%	50%
Internal Fundamental	-133	56	261	-1.26	0.32	1.28	35%	55%	53%
Internal Quantitative	183	169	195	0.84	0.73	0.56	58%	65%	60%

Source: TRS

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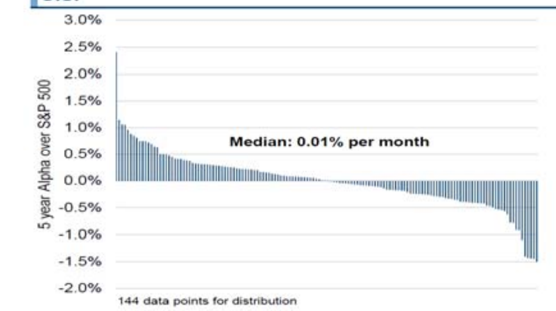
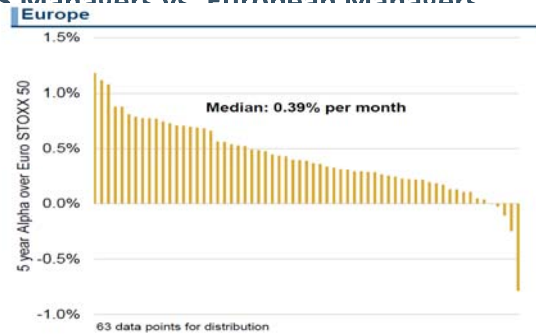
...it works better in some places than others...

Long/Short Equity Median Monthly Alpha: US Managers vs. European Managers





Source: Man Group; FRM

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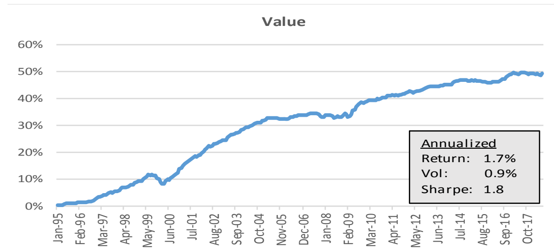
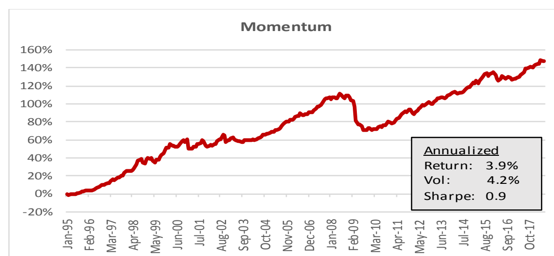
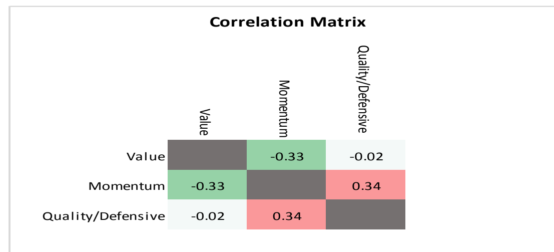
Belief #2: Some risk factors generate excess returns...

...and our portfolios should tilt toward those risk factors







Correlation Matrix

	Value	Momentum	Quality/Defensive
Value		-0.33	-0.02
Momentum	-0.33		0.34
Quality/Defensive	-0.02	0.34	

Source: Barra

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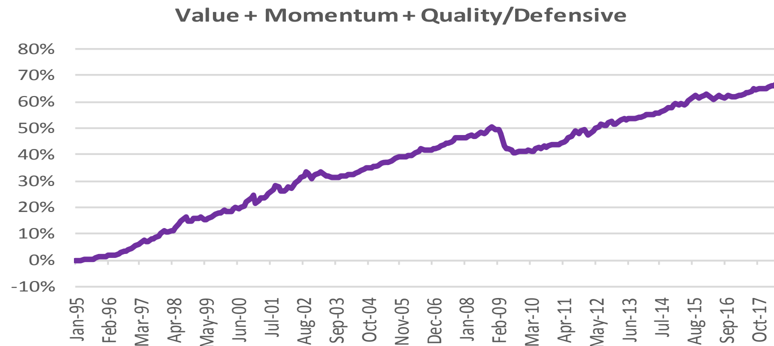
Belief #2: Some risk factors generate excess returns...

...and our portfolios should tilt toward those risk factors

Value + Momentum + Quality/Defensive



	Since 1995	*Last 5YR*
Annualized Return	*2.2%*	*1.6%*
Annualized Vol	*1.7%*	*1.0%*
Sharpe Ratio	*1.3*	*1.7*

Source: Barra

Belief #2: Some risk factors generate excess returns...

...and our portfolios should tilt toward those risk factors

Quant strategies are *typically* the most efficient expression of factor tilts

Internal quant strategies can deliver factor exposure at a low cost (semi-passive, smart beta)

Quant Strategy Factor Exposure

Strategy	Value	Momentum	Quality/Defensive
Internal US			
External US			
Internal EAFE			
External EAFE			
Internal EM			
External EM			
Global			
Total Average			

Fundamental Strategy Factor Exposure

Strategy	Value	Momentum	Quality/Defensive
External US			
Internal EAFE			
External EAFE			
Internal EM			
External EM			
Global			
Total Average			

Source: Barra, TRS

Action #1
Stop Digging (US Active Management)

Reduced fundamental active management in the US by over $12B

Completely eliminated internal fundamental US

Significantly scaled back external fundamental US

Re-allocated to successful internal quantitative strategies

Action #2
Stop Swimming Upstream (Factor Exposure)

Value, Momentum, and Quality/Defensive should be tailwinds, not headwinds

Portfolio is required to be positively exposed to these factors

Primarily use internal quant to achieve this exposure

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Action #3

Don’t Hire a Clown to Fix a Leak in the Roof (External Management)

TRS terminated “active managers” who were only delivering factor exposure

External Managers must deliver alpha in excess of generic factor exposure

TRS is focusing external management allocations on specialized or differentiated sources of alpha – stuff TRS cannot do in-house

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Conclusion

TRS believes in active management

Some markets are better suited for active management than others

Internally-managed quant and smart beta strategies are growing at TRS

External managers must provide differentiated sources of alpha and outperform generic factor exposure

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