Fiduciary Insights

CLIMBING TO THE TOP:

Approaches and Outlook for Active Management in Institutional Portfolios

Outperforming the stock market has always been challenging and is likely to continue to face structural headwinds. However, in our role as an asset allocator, we have seen time and again that careful manager selection has the potential to generate meaningful alpha. Our approach is based on investment experience across market cycles, identification of multiple sources of alpha, relationships with leading investment managers, and focus on portfolio construction and risk management. In this edition of our Fiduciary Insights Series, we analyze the structural challenges faced by active managers and describe how we seek to overcome them.

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Key Takeaways

- Active management in equity markets is challenging, and the headwinds to sustained outperformance are substantial As a result, only a small proportion of active managers succeed in delivering alpha, and even fewer can sustain their success. Net of fees, this becomes a negative-sum game with more losers than winners.
- Many investors fail to recognize that passive investments have inherent risks. We use passive strategies in certain geographies and market environments to complement active strategies.
- As an asset allocator, we focus on identifying a group of exceptionally skilled and differentiated managers across a wide range of asset classes and then sizing them appropriately to each client portfolio. This effort requires a combination of people and tools to provide robust analytical rigor as well as disciplined investment judgement earned through experience.
- Delivering alpha by accessing successful active management can make all the difference in meeting funding objectives and cushioning the portfolio against market downturns.
- We believe the current environment, with wide valuation dispersion within and across equity sectors, looks unusually attractive for our approach to active management.

Introduction

Beating the public equity market index through active stock selection is challenging. Most equity managers fail to outperform after fees. Those that do outperform frequently fail to repeat that outperformance in subsequent periods. However, in our experience, a well-constructed portfolio of differentiated and skilled active managers, while difficult to implement, is a valuable tool for generating excess return to meet critical organizational objectives.

The first step of the process is identifying skilled active managers that are differentiated from one another. The critical next step is building a portfolio by allocating to active managers in a way that diversifies the alpha streams to enhance portfolio resilience, so that the portfolio is not dependent on any one strategy, style, or factor. This second aspect of active management is often overlooked.

Alpha in the portfolio should be independent of what the underlying market is doing. Investors need every possible basis point of investment return to fulfill their organizational missions. As a result, innovative approaches to active management should be a core characteristic of institutional public equity portfolios.

The paper is structured as follows:

1. We first discuss why active management generally fails to outperform and why changing market characteristics will make outperformance harder for active managers going forward.
2. We complement this discussion by highlighting the fallacy that passive management is risk free.
3. We then explain what sets Strategic's approach apart from that of other active allocators.
4. Finally, we analyze the types of market environments that are particularly favorable for active management and explain why we think Strategic's approach is particularly well-positioned right now.

Why is Active Management So Hard?

Active management in public equities is hard because equity markets are generally efficient. In a liquid, well-functioning market, company stock prices are quick to integrate new information, aggregate consensus views into a single observable value, and offer high financial rewards to early investors who successfully seek out and act on new information. Competition is intense. Moreover, active management is a negative-sum game. Above-benchmark returns achieved by one investor come at the expense of another, and fees and costs eat into the returns of both.

Active management is, therefore, inherently a negative sum game in aggregate: value added by skilled active investors must come at the expense of value lost by unskilled active investors.

Structural Challenges to Active Management

The brutally simple logic of macro consistency underscores the challenge of active management. If passive and active investors together own the entire market, and passive investors replicate the market by holding all securities in proportion to their market capitalization, it must follow that active managers in aggregate also hold all securities in proportion to their market capitalization. Since both active and passive investors hold the market, their respective returns prior to fees and costs must be equal to the market's returns. After fees and costs, passive investors will lag the market slightly, while active investors in aggregate will lag more significantly. Active management is, therefore, inherently a negative sum game in aggregate: value added by skilled active investors must come at the expense of value lost by unskilled active investors.

As a result, adding value through active management is a difficult feat to achieve consistently. Indeed, over the 20 years through 2022, most public equity managers across styles and geographies underperformed. This unenviable record extends across large and small cap managers, those specializing in growth and value stocks, as well as both fundamental and quantitative strategies. Among mutual funds, the share of underperforming active U.S. equity managers is strikingly high, with 91% of large-cap managers, 81% of mid-cap managers, and 89% of small-cap managers lagging their respective benchmarks over the trailing 10 years. The picture is similarly bleak, though somewhat less pronounced, in non-US markets as well.

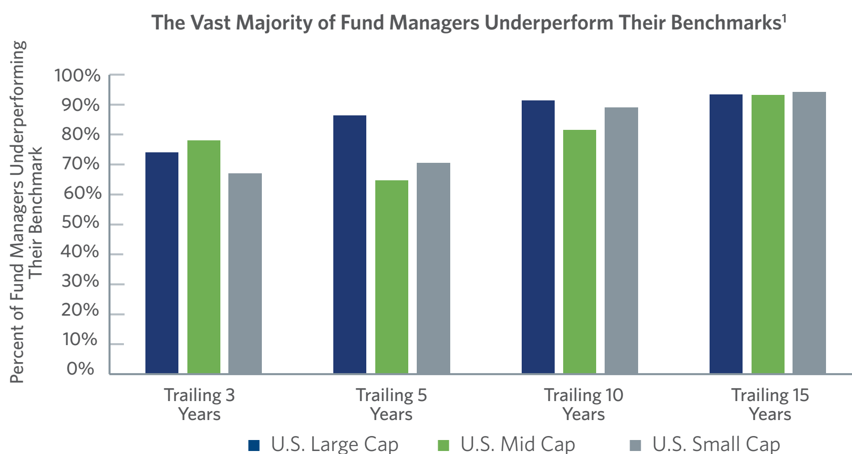
New Challenges to Active Management

In addition to the traditional (and well-documented) challenges to active management discussed above, there are new challenges that have made it even harder to outperform in today's markets.

- Large capital flows into passive strategies have increased the co-movement of securities in dominant indexes. The influence of the security-specific factors that active managers focus on can be overwhelmed, at least temporarily, in the wash of large passive flows in and out of sectors and geographies.
- As passive investments increase, they have dominated the ownership of most company shares. The scale of passive investors (who generally support management in shareholder votes or for Board nominations) takes the pressure off firms to respond to active investors that seek to add value by advocating for improvements in a business or in management's capital allocation decisions. The growth of passively managed assets has reduced the effectiveness of one tool used by active managers to add value.

EXHIBIT 1:

Source: SPIVA U.S. Scorecard – 2022.



[1] SPIVA U.S. Scorecard – 2022. While mutual funds have unique challenges outperforming (too many assets, too high fees, lack of performance-based incentives, etc.), our experience and research shows that large proportions of other active managers also struggle to consistently outperform net of fees.

- During the pandemic, the explosion of retail trading and the ability of social media to incite frenzies of speculation detached the share prices of certain "meme" stocks from their fundamental value, complicating the task of active managers. Many active managers were literally caught short by a spike in prices driven by speculative retail flows. While speculative retail flows are a small share of the overall market, they remain capable of long-term price distortions for targeted stocks.
- Periods of high market concentration also compound the inherent challenges of active management. When market breadth is narrow, the failure to hold the current small group of market darlings can have an outsized impact on relative performance. Narrow breadth and market concentration is especially problematic to active managers when the prices of the shooting stars of the moment are far removed from their fundamental valuation.

The Fallacy that Passive Investing is Risk-Free

Many investors assume that passive investing holds the antidote to the headwinds facing active managers. We disagree. We believe that the current market environment creates headwinds for passive approaches that are not well understood by many investors.

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Passive Investing Buys Yesterday's Winners

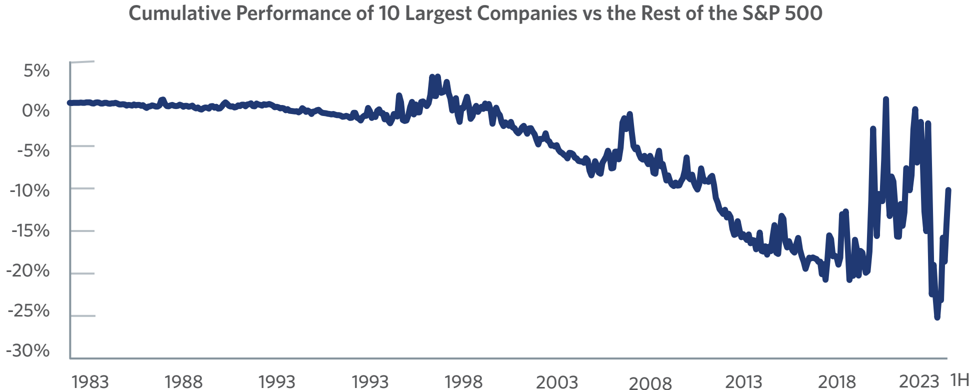
Most passive indices used by investors are weighted by market capitalization. The largest companies get the largest weighting in the index, and vice versa. As a result, the largest stocks within passive indices are often the stocks that have performed best in the past. While those firms may have been great investments years (or often decades) ago when they were much smaller, nimbler, and growing rapidly, their share prices may no longer reflect their go-forward opportunities. Indiscriminately buying an index biased toward past winners exposes investors to loss if the market environment changes. The fall from grace is likely to be particularly steep if the share price of those firms has been pushed well above fair value.

Many of today's largest firms had their spectacular recent stock returns in the era of low interest rates, low inflation, geopolitical stability, and globalized supply chains. By contrast, the current environment is characterized by higher interest rates, higher inflation, geopolitical instability, and regionalizing (or onshoring) of supply chains.

However, the most common US passive indices are even more concentrated than when the dot.com bubble burst. Outside the US, passive indices are also more concentrated than average by historical

EXHIBIT 2: THE LARGEST STOCKS GENERALLY UNDERPERFORM, EXCEPT FOR RECENTLY

Source: S&P Global, Inc.



An active strategy that focuses on exploiting large divergences in market price from fundamental value, in contrast, will invest in those companies only if the future upside, not past performance, is attractive.

standards. A current investor in passive markets gets much more of these mega-cap stocks than at any time in decades just when the market environment that had favored them is changing dramatically.

Lower Exposure to Proven Sources of Return

The academic literature and the experience of the investing community suggests that over the long term, certain types of stocks tend to outperform others. In general, smaller stocks, cheaper stocks, and low beta stocks have better performance through a full market cycle than mega-cap, more expensive, and higher beta stocks.[2] Passive investing has a structural bias to larger, higher-valued companies and will maintain that bias even when the stocks do not reflect the company fundamentals. An active strategy that focuses on exploiting large divergences in market price from fundamental value, in contrast, will invest in those companies only if the future upside, not past performance, is attractive.

How Strategic Approaches Active Management

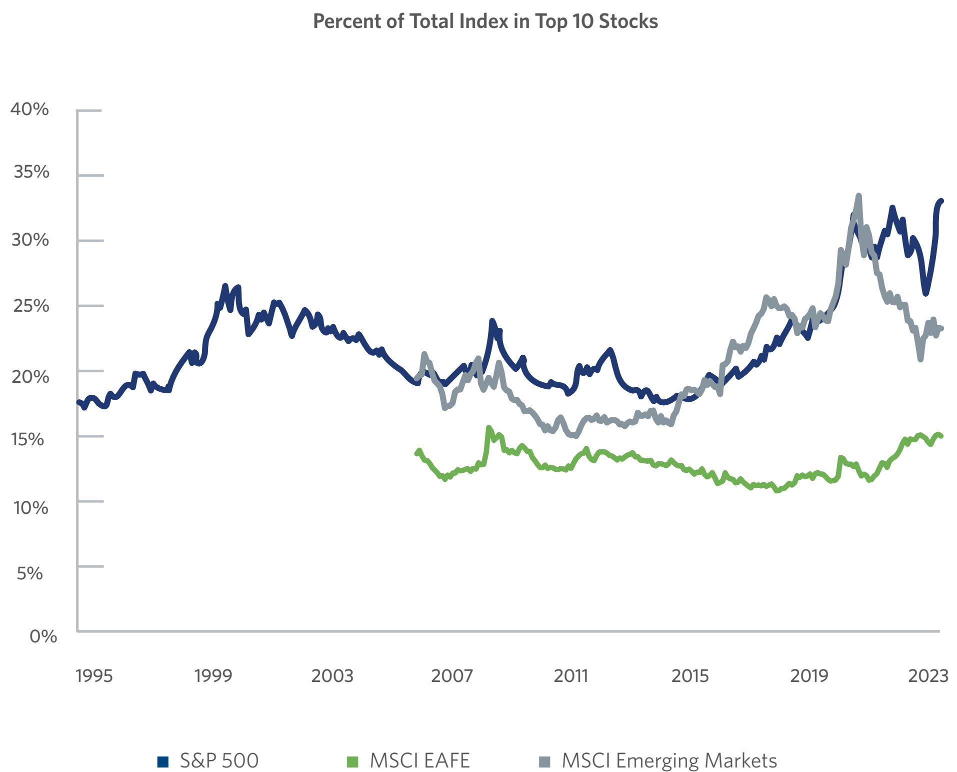
While we recognize that active management is a very hard game, at Strategic, we have intentionally built our business and investment process around a set of principles and techniques that are based on the benefits of active management while attempting to minimize the drawbacks.

We believe the keys to long-term outperformance include:

1. An investment philosophy and process that emphasize a range of manager characteristics and styles rather than a single manager profile.

EXHIBIT 3: RIGHT NOW, EQUITY MARKETS ARE HIGHLY CONCENTRATED IN A FEW STOCKS

Source: S&P Global Inc., MSCI, Inc.



[2] Eugene F. Fama, Kenneth R. French, A five-factor asset pricing model, *Journal of Financial Economics,* Volume 116, Issue 1, 2015, Pages 1-22.

2. A deeply resourced and experienced team that focuses on identifying the investment managers we believe to be the best in the world. Our goal is to find managers that have a disciplined stock selection investment process that not only has worked in the past but, we believe, will work in the future.

3. Analytical tools to support the team in deciphering an individual active manager's luck from skill as well as in constructing and maintaining portfolios of active managers that diversify risk while preserving alpha.

When successful, active outperformance can have a transformative effect on the size of a portfolio over the long run. Investors that have significant spending requirements need every possible basis point of additional return to fulfill their organizational missions. Therefore, we believe that adding value in every asset class through active management is more important than ever in creating increased spending power in client portfolios.

Identification of Multiple Types of Alpha-Producing Investment Managers

At Strategic, we seek out and identify unique managers that are differentiated from one another, ensuring different potential sources of alpha are present in client equity portfolios.

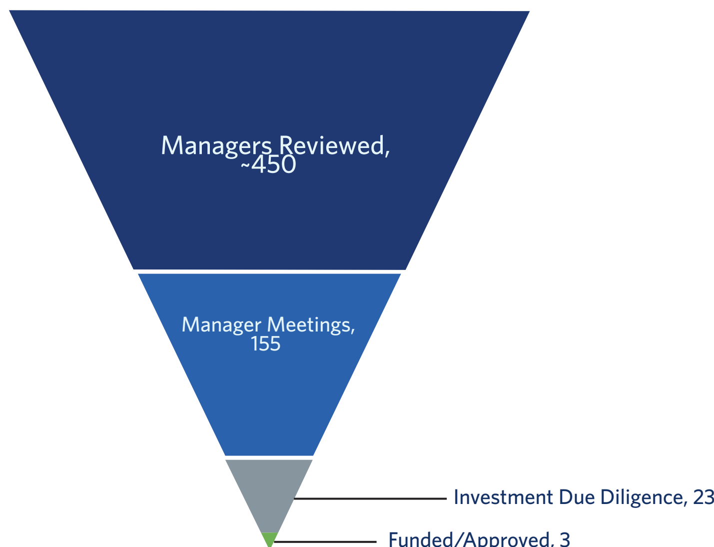
We believe that alpha comes in many forms. We do not rule out (or seek out) managers based on their size, location, investment style, number of names in the portfolio, or fund structure. We constantly source candidate managers using many channels: our extensive networks, conferences, research publications, cap intro and placement agents, and proprietary databases.

Looking For Managers Through Multiple Channels

Allocators that fail to diversify their sources of new manager ideas will inevitably fail to diversify their portfolios, resulting in correlated managers concentrating in similar

Identification of Multiple Types of Alpha-Producing Investment Managers

EXHIBIT 6:
Source: Strategic.



positions and themes. Many allocators rely too heavily on their professional networks for manager referrals. This can lead to a closed network loop of "hot" or in-demand managers, that increases risk instead of return. This can lead allocators to miss up-and-coming diverse managers or a novel investment approach that doesn't fit within existing strategies. These managers can be some of the most uncorrelated and differentiating to the existing portfolio.

In a similar vein, relying only on public databases or conferences could lead to missing managers with undeveloped marketing or investor relations departments.

While we pass on most of the managers we talk to, frequent manager meetings inform our team about current market dynamics, help us refine our understanding of new techniques and strategies, and maintain our professional networks. Regular meetings are also important to building relationships and maximizing access to unique managers and strategies for clients.

Thinking Differently to Find Alpha

Alpha is hard to find because public equity markets are generally quite efficient. In the most efficient segments of the equity market (like U.S. large cap), rather than simply forfeiting excess returns by using exclusively passive investments (like many allocators) or introducing large top-down portfolio risks by avoiding the market segment entirely (like some other allocators), we find innovative ways to capture alpha that are targeted to the nature of the market segment itself.

For example, in highly efficient U.S. large caps, we employ long-short extension strategies that can capitalize on both undervalued and overvalued companies.[3] Extension strategies expand the opportunity set for skilled

Customizing Investment Vehicles for Efficient Execution

We create our own vehicles (at no incremental cost to clients) to take advantage of off-the-beaten-path alpha opportunities that we observe but that may be difficult for individual institutions to access.

For example, Frontier Markets are a fertile ground for alpha but are generally difficult for foreign investors to access due to low capacity, opaque market structures, and severe liquidity constraints. Strategic has a custom pooled vehicle that gives our clients convenient access to a variety of specialist frontier markets managers at no extra cost.

[3] These strategies combine long and short positions to enhance opportunities to add value while maintaining a net exposure of 100% to equity markets.

managers, allowing them to benefit from their insights into securities likely to underperform the market. Moreover, the ability to take short positions enables managers to hedge concentrated exposures to particular industries or market segments that are the unintended by-product of their active long positions. In our experience skilled managers that prefer the richer long-short opportunity set have demonstrated consistent alpha in the efficient large cap segment of the market. As another example, we have identified systematic equity strategies that take advantage of the scale and accuracy of available data in U.S. large cap stocks and we believe are also well-positioned to outperform.

We seek to capture every basis point of potential return for our clients no matter where it might be found and in what form it comes.

Long-Term Relationships with Well-Respected and Capacity-Constrained Managers

Investment managers consider Strategic a preferred partner because of the sophisticated clients we serve, our experience and knowledge as a team, and our strong reputation for thoughtful engagement. These relationships allow us to invest with capacity-constrained managers, effectively negotiate fee and term concessions that benefit our clients, and speak directly to the top investment decision-makers within firms.

As a few recent examples:

- We used our long relationship with a manager (though we had not yet invested) to engage with them in sharing our thoughtful analysis of their top performing positions, feedback on their fees relative to peers, and ideas on alternative fund structures. The manager launched a new, more concentrated fund with Strategic as a seed investor.
  Result: Our clients get access to an experienced investing team through a vehicle that isolates the most attractive elements of their investment strategy at a fraction of the fees.
- Due to the quality of our due diligence analysis, our collaborative approach to discussion of key risks, and our reputation as a trusted partner, a manager granted us increased transparency into individual portfolio positions.
  Result: We use that transparency to prudently monitor risks in the portfolio, allowing us to allocate more capital to the manager in our portfolios.
- We used our long-term relationship and ability to move quickly with a closed and highly-attractive manager to take advantage when another investor redeemed their investment. The manager reached out to Strategic to offer us the limited additional capacity. This opportunity was not marketed or announced publicly.
  Result: Our clients got exclusive access to a capacity-constrained manager that was otherwise closed to new investment.
- We have explicitly chosen not to manage internal direct active equity strategies. Many managers rightly see internal direct strategies as their "competition" and are loath to partner or engage with firms that might poach their stock ideas for their internal portfolios.
  Result: By allocating exclusively to third-party equity managers, we eliminate conflicts of interest and get unparalleled transparency and manager access.

A Deeply Resourced and Experienced Team

At Strategic, we make active management work for our clients through our deep and experienced investment team. Each of our asset class specialists has decades (and collectively, centuries) of experience evaluating active managers and allocating capital to them. These senior investors, with both long tenure at Strategic and with extensive experience from other investment organizations, are actively involved in researching, selecting, and monitoring investment managers. This experience is critical to avoiding the pitfalls that entrap other active allocators and continuing to improve our successful investment implementation.

Common Pitfall: Distinguishing Luck and Skill

Many active allocators do not adequately consider the magnitude and duration of the impact that luck can have on a manager's performance. Such luck can derive from a

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single high-performing stock, or an overweight to an in-demand market segment or investment style. In many cases, the true drivers of return were not the main focus of the manager's strategy, but merely the result of stocks selected in isolation and combined without regard to different risk factors, industries, styles, or market segments. Value added through these inadvertent exposures are the result of luck rather than skill and are not consistently repeatable. Many allocators routinely fail to accurately assess the sources of a manager's return to determine whether those decisions were a deliberate decision or an accidental outcome.

Our manager selection and monitoring process combines qualitative and quantitative insights to evaluate the sources of manager added value and determine whether they derive from the skillful implementation of a deliberate strategy.

We have found these manager characteristics to be indicative of skill:

- Strategies that rely on skilled bottom-up stock selection – *We believe that returns derived from repeated skilled security selection are likely to persist. We therefore seek out managers whose returns are largely derived from security selection. Strategies based on security selection typically open up a larger opportunity set to skilled managers. In contrast, added value derived from macro decisions such as industry, size or regional "bets" are based on fewer active decisions and are thus less likely to be repeatable over time. We don't believe that guessing the right industry, the right country, or the right interest-rate regime is a reliable or consistent approach to generating outperformance.*
- Managers that have generated performance from many good decisions – *We believe that getting many decisions right is a better indicator of skill than getting a few decisions right. History is littered with managers that got a single "big" thing right, attracted huge capital inflows, and failed to continue that performance.*
- Managers with multiple (and ideally uncorrelated) "ways to win" – *We believe that the future is uncertain, and managers relying on a single future path of events for*

Case Study: Two Managers - Who Has Repeatable Skill?

We examined the following two managers (Manager A and Manager B), both of which have demonstrated strong, long-term performance. Although their outperformance is similar, we determined that Manager A's track record had been driven by structural exposures to industries and factors that were in favor, while Manager B outperformed because of strong bottom-up stock selection.

Only a few decisions explain Manager A's performance over this period (a few industries, a single style factor). Manager B's outperformance was the result of over 100 stock decisions. We believe Manager B's performance is more likely to be the result of skill and to persist into the future. It is also likely to be the basis of a more resilient portfolio.

EXHIBIT 6:

Source: Strategic.[4]

[4] **Past performance is not a guarantee of future results.** This analysis is provided for illustrative purposes only, is not intended as investment advice, does not represent actual portfolios and is subject to change at the sole discretion of Strategic. Actual portfolios and their risks and returns may differ significantly from those shown above.

success are less reliable sources of performance than those with multiple paths. For example, a manager relying solely on a reversion in valuation multiples (as is the case with many value managers) is less attractive than one that also looks for earnings growth across multiple industries and potential corporate actions to unlock value.

- Managers whose approach is based on consistently sound principles that are applied across market cycles – *Some managers drift into new strategies as the market mood shifts. In our view such shifts are an indication of market timing or "fad investing," strategies with extraordinarily low breadth that rarely deliver sustained excess returns. We prefer managers that stick to their competitive advantages and are disciplined about shifting strategies to follow trends.*
- Managers who "stick to their knitting" - *As a variant of the above, some managers fall into strategy proliferation, developing a never-ending string of different strategies. We prefer managers that adhere to the core attributes and philosophy that drove their success.*

Common Pitfall: Relying on Past Performance to Hire and Fire Managers

One of the most common pitfalls of manager replacement is a misplaced faith in timing ability, a form of hubris often confounded by unexpected manager or market behavior. Asset allocators tend to be impatient, overreacting to short-term underperformance and thus falling prey to a pattern of return chasing. They are especially prone to impatience if they feel that the herd is leaving them behind.

Many active allocators base decisions on trailing 3-year (or 5-year) performance. However, market cycles frequently last longer than these windows and the more important factor to consider is why a manager is under- or over-performing, not *whether*.

To demonstrate this, we grouped the top 10% of active equity managers each year based on their trailing 5-year actual returns. Below, we show the subsequent 1-year performance of those "top-tier" managers.

Many investors who chase these previously strong returns ("top 10% over a trailing 5-year period!") experienced significant disappointment without having benefitted from the prior strong results.

Instead of relying on past performance for hiring and firing decisions, we focus on building long, in-depth relationships with our managers (including junior and mid-level staff), quantitatively understanding the underlying drivers of performance on a stock-by-stock and decision-by-decision level, conducting reference calls, and surveying the landscape for up-and-coming new talent.

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EXHIBIT 7: THE AVERAGE TOP-DECILE MANAGER IN 2020 SUBSEQUENTLY UNDERPERFORMED BY 6% AND 7% IN 2021 AND 2022[5]

Source: Evestment Inc.

[5] Evestment, Inc. Each year the top 10% of U.S. active equity managers (ranked by trailing 5-year excess return) are grouped into a cohort. The blue bar for each year shows the performance of the previous year's cohort in the given year.

Special Note: Working with a Consultant

Manager hiring and firing decisions are particularly challenging when working with an investment consultant for two reasons:

1. The temptation is for the consultant to only recommend managers with strong recent performance. Committee time is limited, and time spent explaining the sources of recent underperformance and why the consultant believes they will reverse is time that could be better spent elsewhere.
2. Even when a consultant does recommend managers with recent underperformance, no matter how in-depth the analysis, experience and studies show that investment committees tend to pick managers with better recent performance. Knowing this, consultants tend not to recommend managers they think are likely to be rejected.

An OCIO with deep relationships, an experienced team, and the ability to perform nuanced quantitative analysis with proprietary tools is better equipped to identify and invest with managers poised to outperform going forward rather than a consultant screening an "approved" list for managers likely to be accepted by their client based on short-term performance.

When it comes to firing a manager, the decision is rarely about short-term performance. Given the depth of our knowledge and understanding of the manager's strategy, we are more likely to react to poor short-term performance by increasing our investment, a practice that helps build our relationship with the manager and can pave the way for fee and term improvements for our clients. When we do terminate a manager, most often we have simply found a manager with better prospects to generate stronger risk-adjusted alpha going forward. Occasionally, team turnover leads us to reduce our conviction, or organizational changes indicate a loss of focus on future investment returns. Drifting into different investment styles and approaches can also raise concerns. Performance alone is rarely the rationale for moving on from a manager.

Common Pitfall: Focusing on Net (vs. Gross) Performance

Another common mistake made by active allocators is to analyze only net returns and to ignore gross returns. Even if performance analysis is only a portion of the due diligence process, it is common practice (and seems like common sense) to focus on the final net-of-fee performance delivered to the investor as the standard from which to begin. We disagree.

Only reviewing net performance is misleading because:

1. It conflates the investment process (*i.e.*, how good a manager is at picking stocks) with the investment structure (*i.e.*, fees and terms). Investment process and investment structure are different elements of an investment opportunity that should be analyzed separately. They require different tools and different analytical methods. We focus our performance analysis (which is only a portion of the total evaluation) on gross performance to develop an opinion of the manager's actual skill at adding alpha over the market. Then we focus our structural analysis (again, only a portion of the total) on how much of that alpha, and in what market environments, gets delivered to the client. Starting with net returns forces those two steps into one, muddying the waters for both.
2. It assumes that fees and terms are immovable by treating them as an input into the investment-analysis process (via net performance numbers) rather than as an output of the relationship-building process. After determining that a manager has the ability to add differentiated alpha to our portfolio, we engage with the manager to create a fee and term structure that aligns interests and delivers additional value to our clients. We don't take the status quo fees as given.

Focus on Portfolio Construction and Risk Management

Prudent portfolio construction is the cornerstone of our active management strategy. Even highly skilled managers can underperform for multiple years. After spending the time finding those which we believe to be the best managers, our team utilizes both qualitative and quantitative tools to build an optimal portfolio for a client.

By contrast, portfolios populated with only "name brand" or "hot" managers often result in investment returns dominated by common factors shared by those managers – including individual country, sector, and style factors. While that approach can look attractive in the short-term, investors often find themselves surprised during a market pivot that all their "hot" managers were actually outperforming for the same reasons, leading to painful underperformance when those drivers evaporate. In those cases, the alpha generated by the managers is swamped by the aggregate style exposures in the portfolio.

Case Study: Name-Brand Managers Don't Always Measure Up

Through one of our clients, we were introduced to a very highly regarded Asian equity manager. This manager had existing relationships with some of the top endowment and foundation investment offices in the U.S., and we enthusiastically began our due diligence process.

While the headline outperformance was impressive, our analysis showed that much of the return was generated from a few Chinese equities during a Chinese bull market. However, we prefer native on-the-ground local managers when investing in markets like China. The PM for this manager was located in the U.S. (and was not native Chinese). Moreover, many of the specific positions responsible for generating that outperformance were already held by existing managers in our portfolio.

We determined that investing with this manager would duplicate existing positions in our portfolio (at a higher cost) and could struggle in a fast-changing Chinese market.

Like a chef who expertly uses high-quality ingredients combined in a thoughtful and precise manner to make a memorable dish, we carefully size different managers to build a durable portfolio we believe will deliver consistent performance and absorb the inevitable shocks of market downturns. We understand that simply throwing together a group of the rarest, most in-demand "ingredients" does not yield a portfolio with desirable characteristics.

We dynamically adjust our portfolios to balance managers with the goal of delivering an additional source of return and to manage risk. The additional potential performance comes from:

- Tactical changes to manager allocations to take advantage of favorable market dynamics.
- Disciplined counter-cyclical rebalancing.
- Using diverse sources of alpha to reduce drawdowns, especially during times of market stress, leading to stronger compounding over time.

The risk management benefits of thoughtful portfolio construction are just as important as any performance benefits. We use our proprietary analytical tools and unparalleled transparency to understand which managers are likely to have similar performance patterns. More than just simple correlations or principal component analysis on investment returns, we estimate:

- Which managers are likely to outperform in which macroeconomic scenarios.
- Which managers are driven by common performance drivers and by how much.
- Which managers are likely to have alpha simultaneously.
- Which managers have similar holdings or exposures that could lead to over-concentrated or duplicated positions in our client portfolios.
- Which prospective managers, when added to the existing portfolio, are most differentiating as a unique source of alpha.

These analyses also inform our approach to disciplined risk-taking. Understanding our active risk positioning at the total portfolio level helps us scale up risk when we are being over-compensated by the market and reduce risks that are being under-compensated.

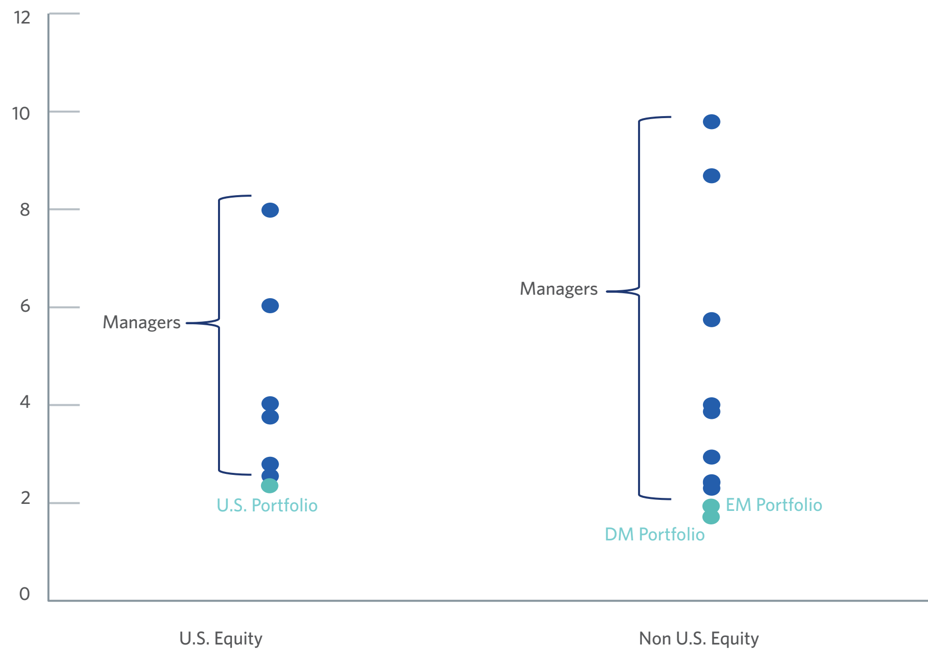
EXHIBIT 8: PORTFOLIO CONSTRUCTION AND RISK MANAGEMENT TOOLBOX[6]

Forecast Correlations of Excess Returns

	Manager 1	Manager 2	Manager 3	Manager 4	Manager 5	Manager 6	Manager 7	Manager 8	Manager 9	Total
Manager 1		0.2	0.2	0.1	0.2	0.2	0.0	0.1	-0.0	0.6
Manager 2	0.2		0.2	0.2	0.3	0.1	-0.1	-0.1	0.3	0.5
Manager 3	0.0	-0.0		0.7	-0.0	0.4	-0.2	0.0	-0.1	0.1
Manager 4	0.1	-0.0	0.2		-0.1	0.4	-0.3	0.1	0.1	0.1
Manager 5	0.1	0.1	-0.0	-0.0		0.3	-0.0	-0.2	-0.1	0.5
Manager 6	0.0	-0.1	0.1	0.0	-0.0		-0.2	-0.1	-0.2	0.1
Manager 7	-0.0	-0.0	-0.0	-0.0	-0.0	0.0		0.1	-0.1	0.1
Manager 8	0.0	-0.0	0.0	0.2	-0.1	-0.0	0.0		0.1	0.3
Manager 9	0.1	0.2	-0.0	0.1	0.1	-0.1	-0.0	-0.1		0.4
Total	0.7	0.4	0.2	0.4	0.3	-0.1	0.2	0.3	0.4	

Upper diagonal presents active correlation from all sources; lower diagonal presents active correlation arising only from common security specific risk.

Active Risk



Our approach to portfolio construction helps the diverse alpha sources from underlying managers consistently flow through to client portfolios.

[6] *This analysis is provided for illustrative purposes only, is not intended as investment advice, does not represent actual portfolios and is subject to change at the sole discretion of Strategic. Actual portfolios and their risks and returns may differ significantly from those shown above.*

Current Market Environment is Especially Favorable to Our Approach to Alpha Generation

We believe that our approach to active management is particularly well-suited to the current market environment.

Generating Alpha is More Important Than Ever

With record-high inflation pressuring the budgets of many institutions, the incremental returns available from skilled active management are more important than ever. The alpha needed to meet organizational spending goals is most often accessed in alternatives, including both hedge funds and private investments. Access to quality, limited capacity alternative investments is a key determinant of the total alpha that an investor will experience. However, an entire portfolio constructed of alternative strategies with low market beta will not generate the growth needed (or have the necessary liquidity) to meet funding targets over time.

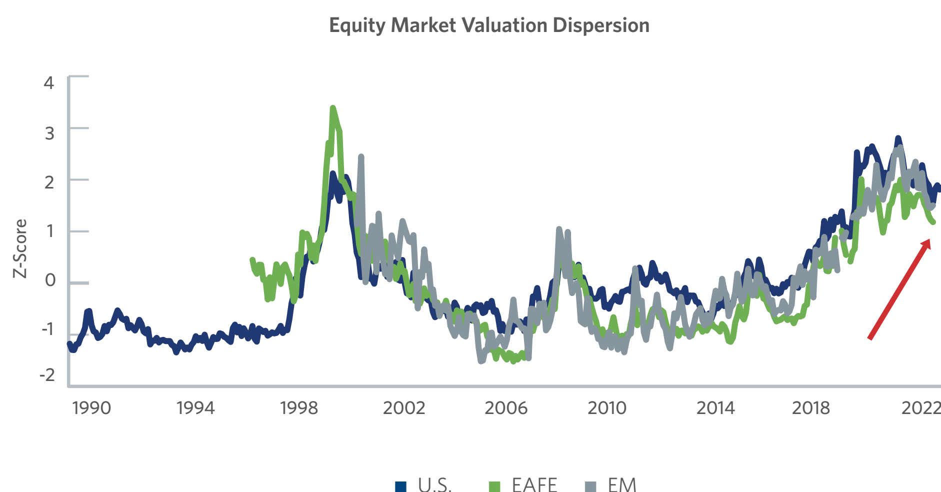
Because of its long history and continued prospects as a key engine of portfolio growth, public equity remains the largest allocation in most institutional portfolios. Given the size of the allocation, the importance of achieving asset growth, and its large contribution to portfolio volatility, it is essential to find ways to generate alpha in active equity investments and construct equity portfolios that strike a desirable balance between risk and return. In this current environment, maximizing risk-adjusted returns of the public equity allocation can make the critical difference towards achieving spending objectives or funding targets.

High Valuation Dispersion

Wide dispersion between the valuations that markets are awarding to certain perceived "winners" and perceived "losers" creates a fertile opportunity set for skilled active managers.

High valuation dispersion across sectors and geographies makes identifying companies misunderstood by the market more potentially lucrative for active managers than in the past. Our experience shows that as this dispersion reverts, our actively-managed client portfolios tend to outperform.

EXHIBIT 9: THE CURRENT PERIOD IS CHARACTERIZED BY HIGH EQUITY VALUATION DISPERSION[7]



[7] Valuation dispersion for the US market is measured based on the forward p/e of the median stock relative to its industry average. For EAFE and EM, dispersion is measured based on the forward p/e relative to the sector and regional average. Data from MSCI, Inc.

Importance of Portfolio Construction

Our focus on identifying managers with stock selection skill reduces the risk of performance reversals due to heightened factor volatility. Concentration in a particular risk factor or investment style is not a recipe for persistent outperformance. Understanding what we own in a client portfolio (down to the individual stock level) and understanding how we expect the portfolio to behave is a key piece of our investment process.

Many institutions now realize that their managers (or unfortunately, their entire portfolios) were more exposed to certain drivers of performance, especially the growth factor, than they expected. In conversations across the industry, we are repeatedly struck by how many institutions are surprised at the underperformance of their "value" managers and how their expected diversification has failed to materialize.

Our focus on portfolio construction and risk management help reduce the risks of over-reliance on a single source of value-add. We strive to create balanced, prudent portfolios that access multiple sources of alpha for our clients.

We invested with a manager that called itself "value" but was actually a core / growth manager. We understood their approach and underwrote the investment accordingly, trimming our allocation as it strongly outperformed alongside other growth managers through mid-2021. Other allocators thought they had found a golden goose, an outperforming "value" manager during a growth rally, and increased their investment at the worst possible time.

Unfortunately, during the market correction of late 2021 and 2022, this manager underperformed like many growth managers. In our portfolio, our true value managers performed very well. Allocators without those true value managers in their portfolio, or who thought this manager was their value manager, experienced heavy losses.

Detailed due diligence, careful portfolio construction, and experienced risk management prevented our client portfolios from being over-exposed.

Conclusion

Outperformance through active management in public equity markets is a challenging proposition. Managers that do outperform frequently fail to repeat that performance in subsequent periods. Recognizing these facts, many investors have decreased (or eliminated) their allocations to active management in public equity, especially in the largest, most efficient areas of the market, in favor of passive options.

We believe that passive strategies are important and use them selectively in our portfolios, but we also know that outperformance through successful active management can have a transformative effect on the size of a client portfolio over the long run. Investors that have significant spending requirements need every possible basis point of additional return to fulfill their organizational missions. As a result, innovative approaches to active management, implemented alongside an investment partner with enduring competitive advantages and a proven track record, should be a core characteristic of institutional public equity portfolios.

We have the skills and resources to find many diverse forms of alpha, but access to quality managers alone does not guarantee success. In addition, we construct portfolios with the goal of preserving that alpha while reducing the uncompensated risk that often comes with poor portfolio construction. We do this using our aligned business model, a deeply resourced and experienced team, an investment process that is not biased to manager characteristics or style, and robust proprietary tools.

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Strategic Investment Group

Strategic, a pioneer in dedicated Outsourced CIO (OCIO) solutions since 1987, offers a comprehensive service platform for managing customized portfolios for institutional and private investors. Our proprietary process combines active portfolio management, rigorous risk management, and open architecture manager selection.

Strategic functions as our clients' investment partner and co-fiduciary, effectively becoming an extension of their resources. Clients are then free to focus on their core businesses, while we focus on providing the highly specialized portfolio management expertise that clients need to meet their investment goals. Depending on a client's needs and preferences, Strategic can orchestrate the management of an entire portfolio comprising multiple asset classes, focus on specific asset classes, such as alternatives (e.g., venture capital/private equity, real estate, and/or hedge funds) or international investments, or manage strategies with high potential for adding value. Customized liability-driven investing (LDI) solutions, whether through an integrated total portfolio approach or a targeted long-duration strategy, are also available, as are solutions that address mission-related investment objectives.

We strive to build enduring partnerships with our clients by strengthening their investment programs through a dynamic, value-enhancing investment process, sound governance framework, and world class client service. Our mission is to empower investors through experience, innovation, and excellence.

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