THE PROSPECTS FOR ACTIVE MANAGEMENT

Strategic Investment Group®

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Fiduciary Insights

PERSISTENT FLOWS FROM ACTIVE TO PASSIVE MANAGEMENT HAVE ALTERED THE VERY STRUCTURE OF U.S. FINANCIAL MARKETS AND RAISED A NUMBER OF ESSENTIAL QUESTIONS, INCLUDING: What is driving these flows? Do they make active management easier or harder? What are the implications for portfolio management? By analyzing a proprietary database of securities holdings in the U.S. equity market, we address these questions in this edition of our Fiduciary Insights series.

Learn More

To learn more about us and download our **Fiduciary Insights** series, which is dedicated to issues relevant to fiduciary best practices and responsibilities, please go to strategicgroup.com/our-thinking/research and publications. Topics include, "***What is the Role of the IC When Hiring an OCIO***", "***The Art and Science of Manager Termination***", "***Developing a Culture of Good Governance: A Committee Self-Evaluation***", "**Common Symptoms of Poor Governance**", "***Understanding Fees***", and "***Does Outsourcing Mean I Lose Control?***".

Introduction

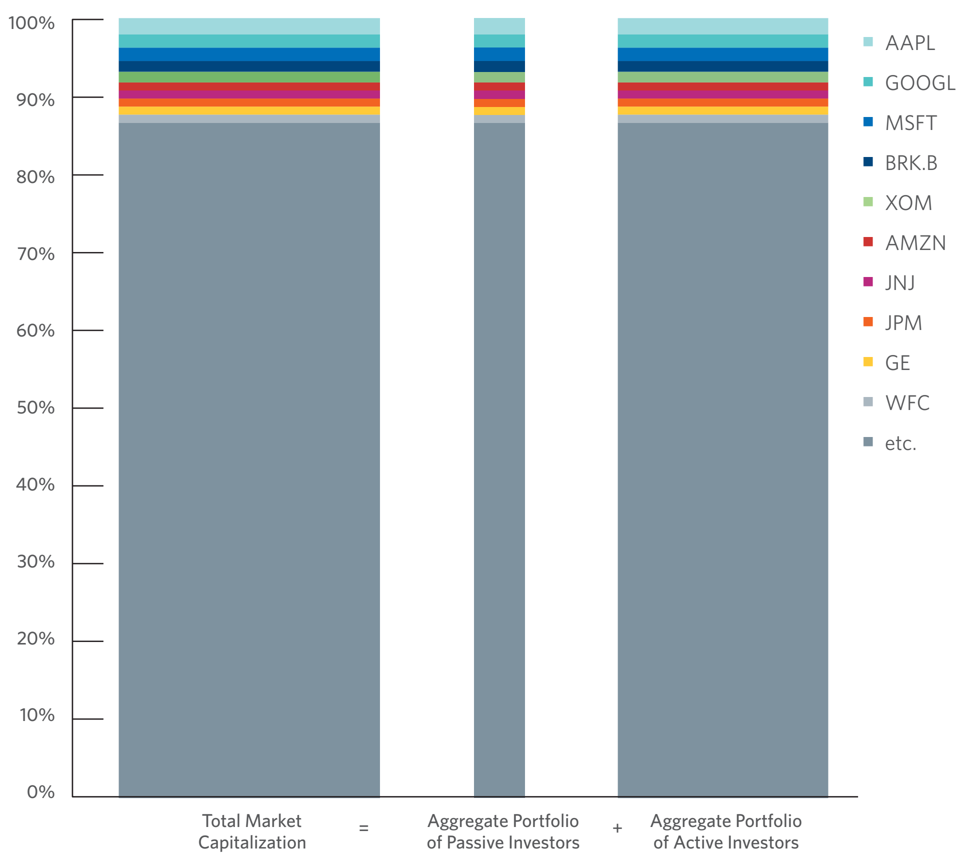
This edition of our Fiduciary Insights series focuses on the outlook for active management. This is a topic of critical importance for investors because constructing a diversified portfolio of skilled active managers, while difficult, remains the most effective way for investors to generate risk-adjusted value added. It is also a hot topic. Active management has been in the limelight of late owing to the poor performance of most active managers and the large flows into passive strategies. We begin by highlighting the implacable market dynamics that make active management so challenging. Next, we analyze recent flows into passive strategies and consider their implications for market structure. We conclude with an assessment of the prospects for active management.

Why is Active Management So Hard?

Harsh Logic of Macro Consistency

The brutally simple logic of macro consistency, best articulated by Nobel laureate Bill Sharpe, 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 (Figure 1).

FIGURE 1:
Mathematics of Macro Consistency
Source: Strategic.



Active management is inherently a negative sum game in aggregate. Value added by skilled active managers must come at the expense of value lost by unskilled active investors. The presence of fees and costs guarantees that the average investor will uderperform.

In the best of times, adding value through active management is a difficult feat achieved consistently by very few highly skilled managers.

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, arithmetic dictates that passive investors will lag the market slightly, while active investors in aggregate will lag 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. Moreover, the presence of fees and costs guarantees that the average active investor will underperform. In order to add value, an active manager must outmaneuver others by an amount that exceeds fees and frictions.

Trials and Tribulations of Active Management

In the best of times, adding value through active management is a difficult feat achieved consistently by very few highly skilled managers. As we have just seen, the harsh logic of macro consistency guarantees that active managers in aggregate will underperform. Indeed, over the 15 years through end-2017, a large proportion of active U.S. equity managers 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 92% of large cap managers, 95% of mid-cap managers, and 96% of small cap managers lagging their respective benchmarks in the 15 years through end-2017[1]. A similar, though somewhat less pronounced, record of broad- based underperformance is apparent across non-U.S. equity managers, U.S. fixed income strategies, and hedge funds.

Ecology of the U.S. Equity Market

We developed a proprietary database to help us analyze the source of recent flows from active to passive investments, and the implications of these flows for market structure and the prospects for active management. Using these data, we were able to explore how the U.S. equity market structure has evolved and which active managers tend to win and which tend to lose.

We focused our analysis on the U.S. equity market for a number of reasons. First, there is no dearth of underperforming active investors in the U.S. equity market. Second, regulatory disclosure requirements make it possible to piece together an ownership profile for each stock in the market. Indeed, the U.S. equity market is unique in that the holdings of almost all institutional investors are publicly available, making it possible to create a taxonomy of U.S. equity market investors.

Using the historical reported holdings in SEC filings, we analyzed the ownership of the U.S. equity market as proxied by the Russell 3000[2]. Owners in the database were assigned to broad investor categories based on their characteristics (e.g. filer type, investment strategy, active/passive orientation). Figure 2 provides a taxonomy of the owners of the U.S. equity market.

Using this database, we followed the evolution of ownership over time to gain an insight into the changing structure of the U.S. equity market. The flows into passive strategies revealed by this analysis are striking. During the past decade, over $2 trillion has migrated to passive strategies (Figure 3). Active institutional managers have been experiencing outflows for nearly a decade. In light of the timing and magnitude of these flows, we believe that the transition from defined benefit (DB) to defined contribution (DC) pension plans is the primary driver of this phenomenon. Because we expect the steady migration to DC to continue, understanding the implications of these flows is critical.

1 SPIVA U.S. Year-End 2017 Scorecard.

2 Additional information on database construction available upon request.

FIGURE 2:
Evolution of Russell 3000 Ownership [3]
Source: Strategic.

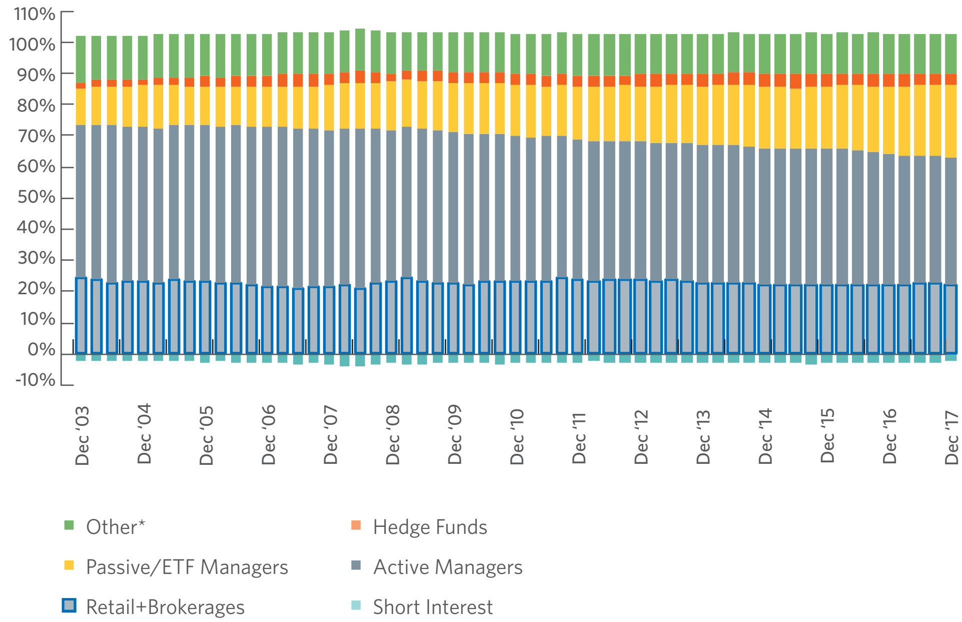
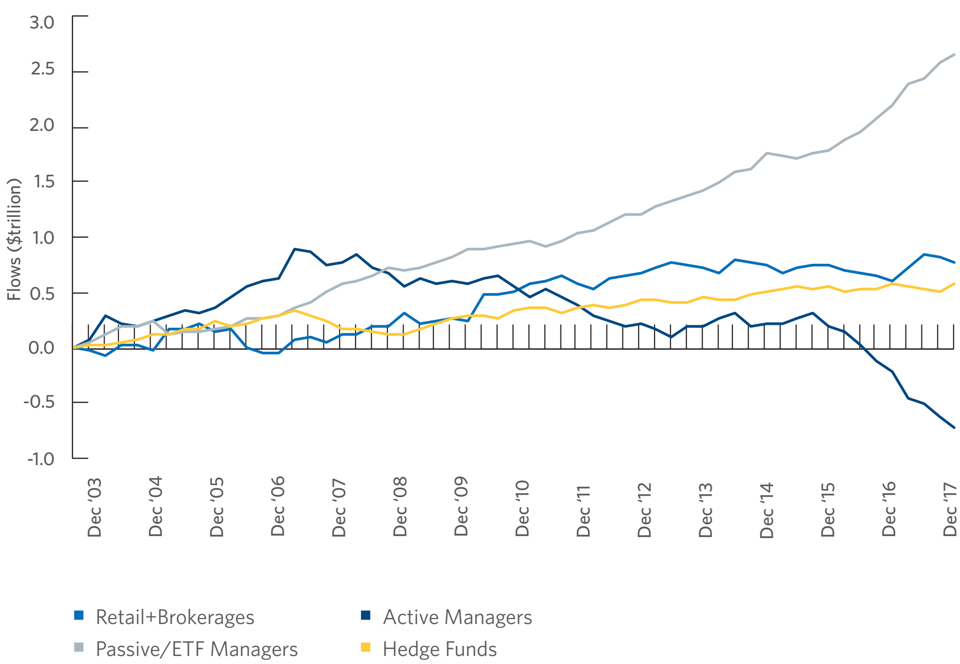


FIGURE 3:
Flows from Active to Passive Managers [4,5]
Source: Strategic.



3 "Other" represents the direct holdings of strategic owners (e.g. corporations, insiders, private equity) and other direct asset owners (e.g. pensions, sovereign wealth funds).

4 "Hedge Funds" represent the combined effects of hedge fund long ownership and reported short interest.

5 Total flows to the Russell 3000 universe, which capture the direction of net issuance/repurchases, have been positive over the majority of the period analyzed.

Implications of Flows into Passive Strategies

Market Structure

In the ecosystem of U.S. equities, the negative alpha pool created historically by retail and brokerage investors has been captured by hedge funds and other institutional active managers.

Some of the implications of the flow into passive strategies are clear. Because passive investors trade less frequently than active, the increased share of passive strategies in the market is likely to result in lower trading volumes, liquidity, and market maker commissions. Moreover, the shift to passive strategies is likely to increase the competition among active managers vying for a dwindling asset base, thus reducing the pricing power of active managers. As a result of reduced trading costs and lower fees, we would expect average net returns to investors to increase.

Perhaps less positive from the perspective of investors, we would also expect increased co-movement of securities in dominant indexes because of the greater impact of passive flows on constituents of these indices. In this case, the influence of security-specific factors on its price could be diluted, at least temporarily, in the wash of passive flows. We address in the next section the more difficult question of the implications of the shift to passive strategies for the ability of active managers to add value.

As we believe that retail investors tend to be less informed and to trade more emotionally, this finding comports with our intuition and our expectation for future market behavior.

Active Management

Knowing only that investors are shifting from active to passive is not enough to form an opinion on the future opportunity set for active managers. To answer that question, we need to know which active managers are losing assets: skilled or unskilled managers?

The law of macro consistency, which dictates that active management is a negative sum game in which skilled managers extract value at the expense of unskilled managers, provides a template for analyzing three possible outcomes.

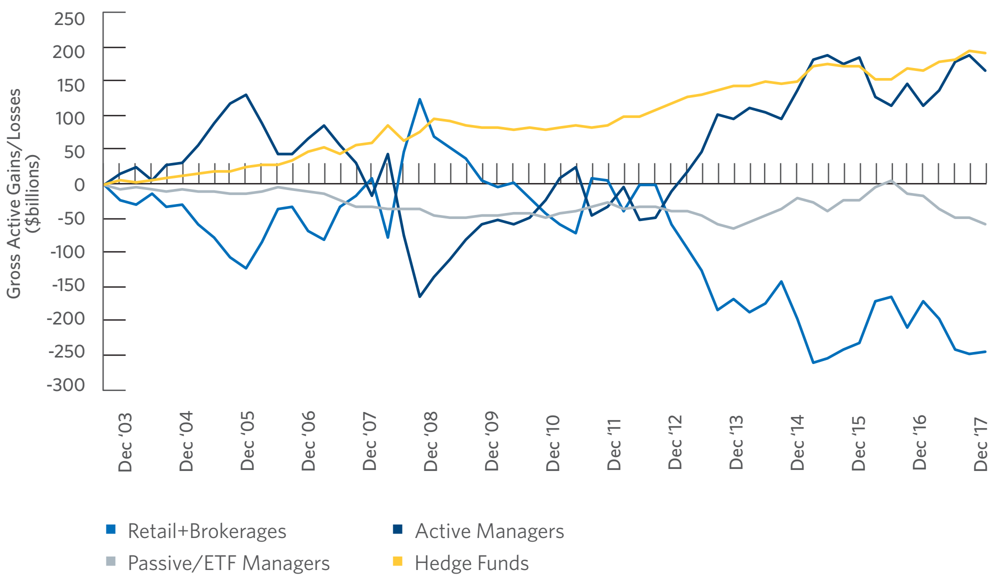
- If the flows into passive strategies have left the split between skilled and unskilled active managers unchanged, they have no impact on the ability of skilled active managers to add value.
- If, however, the share of skilled managers in total active managers declines, the remaining skilled managers have an easier time extracting value from the proportionately larger group of unskilled active managers. Such an outcome would suggest improved prospects for active management.
- In the third case, the flows reduce the prospect for alpha, as skilled managers face tougher competition from other skilled managers who represent an increased share of the total active pool.

We next analyzed our database to distinguish between skilled and unskilled managers and determine the change of the share of skilled and unskilled managers in the remaining pool of active managers. We calculated the performance of each aggregate investor pool and assessed this performance relative to the market portfolio, just as we would to evaluate any active equity manager. We found that, in general, active institutional managers are on the other side of retail investors' trades and positions and have tended to extract value from them (Figure 4). In the ecosystem of U.S. equities, the negative alpha pool historically created by retail and brokerage investors has been captured by hedge funds and other institutional active managers. As we believe that retail investors tend to be less informed and to trade more emotionally than active institutional investors, this finding comports with both our intuition and our expectation for future market behavior.

FIGURE 4:

Gross Cumulative Value Added by Investory Type [6]

Source: Strategic.



Our analysis further revealed that, among active investors, those that have traditionally demonstrated skill are becoming a smaller share of the remaining pool. With the share of retail and brokerage ownership steady or rising, the assets flowing from active strategies to passive strategies appear to be coming disproportionately from skilled active managers. This finding is also consistent with our observation of the steady retreat of defined benefit plans from active equity management as they increasingly transition to fixed income portfolios to mitigate funding risk, and as their assets steadily erode due to benefit payments, lump sum offers, and risk transfer programs. We expect this dynamic to continue to reduce the competition for added value as the remaining active managers will have a proportionately larger share of unskilled investors from which to extract value.

Conclusion

The implacable logic of macro consistency makes active management a negative sum game. After costs and fees, active managers as a group will destroy value. In order to succeed, skilled active managers must consistently extract value from the unskilled, and the amount of added value extracted must exceed their costs and fees. Even passive strategies will lag the market by the amount of their costs and fees, but the latter are significantly lower than those of active managers. Unless you are confident in your ability to identify skilled active managers, passive remains the preferred option.

The secular shift to passive strategies and the logic of macro consistency make it imperative to avoid average active managers. While the current environment increases business risk for active managers and will likely prompt industry consolidation, we believe that the opportunity set for truly skilled active managers is likely improving as passive flows create a less efficient market landscape. The flows into passive strategies have increased the share of retail investors in the pool of active participants, expanding the opportunity for skilled managers to extract value from the unskilled. In addition, flows among the growing pool of passive vehicles are likely to create more market distortions, increasing the opportunities for active investors to benefit from tactical positions in individual securities and broad market segments. Finally, the improved ability to negotiate lower fees is a welcome development for investors. The future of adding value through active management appears bright.

The flows into passive strategies have increased the share of retail investors in the pool of active partcipants, expanding the opportunity for skilled managers to extract value from the unskilled.

[6] "Hedge Funds" represent the combined effects of hedge fund long ownership and reported short interest.

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 investors. Our proprietary process combines active portfolio management, rigorous risk management, and open architecture manager selection.

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For more information, please email us at inquiries@strategicgroup.com.

Strategic Investment Group®

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1001 Nineteenth Street North
16th Floor
Arlington, VA 22209 USA

+1 703.243.4433 TEL
+1 703.243.2266 FAX

strategicgroup.com