Investment Selection: A Framework for Combining Active and Passive Investments

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September, 2014

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Overview

Advisors historically invested exclusively in either active strategies or passive strategies, rarely using the two strategies together. The authors of this research piece, however, are proponents of blending the two strategies, believing that combining active and passive strategies provides a superior risk/return profile than exclusively using one or the other.

More advisors are seeing the virtues of blending active and passive investments, recognizing the benefits of integrating high value-added active strategies with low-cost and tax efficient passive strategies. However, we see advisors in many cases using a subjective process to combine active and passive strategies, and think it worthwhile to share our framework for the active/passive decision as well as for selection of the underlying active and passive investments. This framework is used in the portfolio management process employed by Advisor Partners, and provided background support to conclusions shared in Tim McCarthy's book, *The Safe Investor*.

In this paper, we'll discuss research that drives decision-making about when to employ active or passive strategies while sharing our findings across asset classes. We'll also discuss the decision-making framework used to select underlying investments, providing examples to illustrate the investment process from start to finish.

Active vs. Passive Management

Deciding whether to invest in active or passive strategies is based largely upon a review of historical data for the asset classes under consideration. We respect active managers, but recognize that the bar is set pretty high for active to beat passive, given transaction costs and taxes. Because of the inherent cost and tax advantages of passive funds, in essence active funds have to "prove" themselves to be superior in order to prevail in our selection process.

The major factors considered include:

- *Active return potential*: An important question to answer is the degree to which picking "winners" will help the portfolio. We've observed advisors going to extreme efforts to try to identify the "best" manager in a given asset class. To us, that effort only makes sense if there will be a reasonable expectation that the effort will be rewarded. We evaluate active return potential by reviewing the spread between "success" and "failure", as defined by the return differential between the top quartile (25th percentile) and the bottom quartile (75th percentile). We also examine the return differential between the top quartile and the index return, as in certain asset classes the top performers barely beat the index! This criterion helps identify whether the potential payoff from active management justifies the cost, risk and effort – the larger the return differential relative to the returns delivered by a passive investment, the higher the potential payoff from active management. (See Figure 1)

Figure 1: Performance Spread in Some Fund Categories is Tighter Than in Others				
Morningstar Category	**Foreign Large Blend Equity [%]**	**Intermediate-Term Bond [%]**	**Emerging Markets Equity [%]**	**Emerging Markets Debt [%]**
Twenty-fifth Percentile	9.71	6.26	9.07	10.13
Median	8.98	5.35	7.27	9.30
Seventy-fifth Percentile	7.94	4.48	5.84	6.18
25th minus 75th	**1.77**	**1.78**	**3.23**	**3.95**
Index	9.40	4.47	7.34	9.79
25th minus Index	**0.31**	**1.79**	**1.73**	**0.34**

Source: Morningstar data, Advisor Partners analysis. Indexes used for the four categories are, from left to right, MSCI EAFE, Barclays US Aggregate, MSCI EM and JPM EMBI Global. Five years ending 7/31/2014.

- *Repeatability of outperformance*: It's an unfortunate fact of life in the investment industry that many of today's top performing funds are tomorrow's bottom performers. The more random that performance success appears to be, the lower the likelihood of being able to pick a manager that thrives through time. We evaluate the persistence of success by examining the percentage of top quartile managers in one market cycle who stay in the top quartile for the subsequent market cycle. (See Figure 2)

Figure 2: Percentage of Top Quartile Funds in 2007 That Were Still Top Quartile in 2012	
Morningstar Fund Category	**%**
Intermediate-Term Bond	38%
Foreign Large Blend Equity	34%
U. S. Large Blend Equity	20%
U. S. Small Blend Equity	20%
Emerging Markets Equity	15%

Source Morningstar data, Advisor Partner analysis. Based on five year returns for periods ending 12/31/2007 and 12/31/2012.

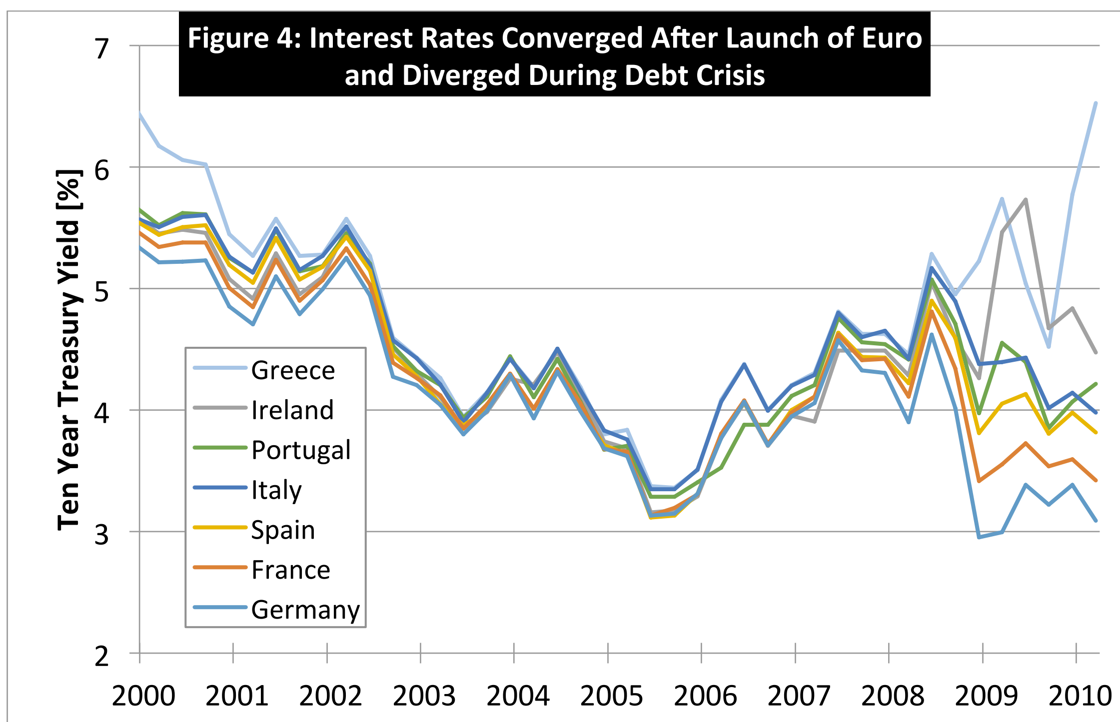
- *Batting average relative to the index*: We evaluate the ease at which managers can beat the index by examining the percentage of funds that beat the index. The batting average follows our thinking about repeatability. Findings indicating that few managers beat the index and that a small number of the outperformers sustain their outperformance favor index approaches for that asset class. (See Figure 3)

Figure 3: Percentage of Funds That Were Beaten By Their Category Benchmark			
Fund Category	**Comparison Index**	**Three Years (%)**	**Five Years (%)**
U. S. Large-Cap Equity	S&P 500	79.95	72.72
U.S. Small-Cap Equity	S&P SmallCap 600	87.32	66.77
International Equity	S&P 700	59.54	70.97
International Small-Cap Equity	S&P Developed Ex-U.S. SmallCap	43.64	45.00
Emerging Markets Equity	S&P/IFCI Composite	60.87	80.00
Government Intermediate Bonds	Barclays Intermediate Government	72.50	46.51
Investment-Grade Interm. Bonds	Barclays Intermediate Gov./Credit	37.19	36.96
High-Yield Bonds	Barclays High Yield	87.08	91.33
Emerging Markets Bonds	Barclays Emerging Markets	94.29	64.29

Source: "S&P Indices Versus Active Funds (SPIVA®) U.S. Scorecard", Standard and Poor's. Periods ending Dec. 31, 2013.

Although empirical data is of primary importance in our investment process, we think it prudent to augment the data with forward-looking judgment about each asset class. The primary factors we assess are:

- *Changes in expectations*: The market is a remarkably adaptive organism! Over our investment careers we've experienced dramatic changes. Once-sleepy sectors such as financial services became among the most diverse and volatile of sectors during the financial crisis. Country dynamics also changed radically, as European equity and bond markets converged for a period of time following European Monetary Union, then diverged dramatically during the sovereign debt crisis. (See Figure 4) Relying blindly on past patterns of performance and risk can be a trap. We review changes in market expectations for each asset class, assessing catalysts that will make the asset class more or less "efficient", and determining whether there are observed or projected changes in return potential, correlation or volatility.



Source: Bloomberg data

- *Index shortcomings and changes*: Indexes may or may not be good proxies for the asset classes we intend to invest in. We are wary of many fixed income indexes, as the indexes may be concentrated in the biggest borrowers rather than the most creditworthy borrowers. The well-covered shortcomings of bond rating agencies is a factor in our skepticism about commonly-used bond indexes. (See Figure 5) Indexes also evolve over time, and may be more or less representative of the asset class for investment. We review changes that may influence index performance and portfolio fit, such as privatization, growth or decline in number of constituents, and changes in index concentration.

Figure 5: Concentration of Troubled Borrowers in the Barclays Global Treasury Ex-US Index , 2009

Country	Index Weight
Italy	12%
Spain	5%
Greece	5%
Total	**22%**

Source: Barclays Capital

- *Portfolio role*: Often lost in the investment process is the role that an investment is supposed to play in the portfolio. A portfolio is like a sports team or an orchestra – if well designed a portfolio can be greater than the sum of its parts. If poorly designed, disaster can ensue! We pay careful attention to the role that the investment is designed to play in the broader portfolio; and how well the index is aligned with the desired capitalization profile, style profile, country exposure or credit exposure.

Current Positioning
The positioning of Advisor Partners asset allocation models follows reasonably closely to the conclusions derived from our empirical research. (See Figure 6)

Empirical factors favor index funds in the large capitalization equity category, as actively managed large capitalization funds in both the U.S. and in developed international markets have a tough time beating indices, and when they do "win", the payoff is rarely worth the incremental risk, cost and tax impact. In addition, today's winners aren't necessarily tomorrow's winners. Less intuitively, we observe much of the same phenomena with small capitalization U.S. stocks and emerging markets stocks. Most funds fail to beat the index, and winners have a tough time repeating their success. We, however, think that small cap value strategies can offer some risk enhancement to a portfolio, providing some downside protection and margin of safety in certain market environment. Consequently, we use active funds to supplement our core position in a small cap index ETF. We recently came to the same conclusion, albeit for different reasons, in our positioning for emerging markets stocks. The major emerging markets indexes are unbalanced, featuring significant concentration in commodity and financial stocks. Looking forward, we see the greatest opportunities in smaller companies in less mature sectors within emerging economies. Consequently, we use a mix of active and passive investments.

International small capitalization stocks are a very different story, as most managers beat the index; the payoff from beating the index and peers is high; and there is a relatively higher degree of repeatability among the "winners". We favor active managers for international small cap, while being painfully aware that the best of managers often reach investment capacity and choose to limit availability of the product.

Fixed Income presents a different set of challenges, some of which may be transitory in nature as we exit a 30 year bull market for bonds. Certain fixed income categories favor active managers, with "winner's" justifying their fees and demonstrating some ability to repeat their winning strategies. In other categories, such as high yield, historical data favors index strategies; but shortcomings in index construction make actively managed strategies arguably superior from a risk management perspective.

Figure 6: Current Positioning
Active versus Passive Management
in Asset Classes

Asset Class	Investment Product Style
U.S. Equity	
U. S. Large Cap Equity	Passive
U. S. Small Cap Equity	Active and Passive
International Equity	
International Developed Large Cap Equity	Passive
International Developed Small Cap Equity	Active
Emerging Markets Equity	Active and Passive
Real Assets	
Commodities	Passive
Infrastructure	Active
Global Real Estate	Active and Passive

Fixed Income	
U. S. Investment Grade Bonds	Active and Passive
U. S. Below Investment Grade Bonds	Active
International Fixed Income and Currency	Active

Source: Advisor Partners

Passive Product Selection

Selecting passive products is primarily a quantitative exercise, centered on identifying the product that meets portfolio objectives while minimizing the total cost of ownership. Our framework incorporates the following criteria:

- *Portfolio purpose:* What index best meets the objectives for the portfolio; in other words, which index is most likely to be successful at filling the desired role for the portfolio.
- *Product preference*: A wide variety of investment vehicles may be appropriate, and we typically consider ETFs, ETNs and mutual funds. Most of our index investments are through ETFs, but at times an ETN or mutual fund may be a better fit for the portfolio.
- *Tactical or strategic investment purpose*: Some investments are core to a portfolio, designed to be held for years at a time; others are more tactical in nature. Identifying whether the investment is intended to be held for a long or short period of time influences our thinking about which vehicle to use, and which cost factors are most important.
- *Total cost of ownership*: We evaluate factors such as expense ratios, trading spreads, transaction costs, and tax distributions to evaluate the cost of ownership.
- *Liquidity*: Liquidity is a function of the trading volume as well as the liquidity of the underlying holdings of the ETF. An ETF that doesn't trade in high volumes may still be very liquid if its underlying holdings are liquid. We are also aware that liquidity in some ETFs may evaporate during turbulent periods in the market, so we examine patterns in trading volumes.
- *Performance*: We examine how well the product tracks its underlying index, as well as deviations of ETF and ETN markets price from underlying Net Asset Value.
- *Product survivorship*: Following previous published research by Advisor Partners, we assess the risk that the product will close or merge into another product.

Active Product Selection

Selecting actively-managed products is less purely quantitative, and we view our process as being a combination of art and science. Ultimately, the due diligence process is designed to answer a specific set of questions about an active manager:

- **What is the manager's "edge"?** In other words, what does the portfolio manager do that provides an advantage relative to other investors and the index?
- **Is the manager's edge sustainable?** Too many investors are captivated by past performance success, and fail to take a critical enough look to assess whether past success will continue into the future. Looking forward, we work on evaluating whether the portfolio manager has an edge that is defensible and sustainable. Identifying an advantage that is all in the past does the advisor no good if it won't persist into the future.
- **How will the manager perform in different investment environments?** No product does well in every environment. Understanding patterns of performance is critical to identifying whether the product will fulfill the portfolio role it is assigned.

The framework we use for active strategies incorporates the following criteria:

- *Portfolio purpose*: What role will the investment serve in the portfolio; what are the return and risk expectations that guide the selection process.
- *Universe screening*: Screening of the investment universe based on historic risk and return characteristics, with screening criteria aligned with portfolio purpose.
- *Universe additions*: Additions to the candidate list, guided by past research and industry contacts; potentially identifies products that may have been out of favor in recent periods but would be a fit for this portfolio purpose.
- *Review of "4 P's"*:
  - *Philosophy*: What are the fundamental investment beliefs of the team; how do those beliefs shape the approach to managing money?
  - *People*: Who are the primary decision-makers for the product; how are they supported; what experience do they have managing money and working as a team?
  - *Process*: How does the team make investment decisions; how is information gathered and analyzed; what in the process provides a competitive edge?
  - *Performance*: How has the product performed over time; during what periods has the product underperformed or outperformed; how consistent has performance been; does the performance pattern for the product line up with expectations based on the other three P's?

Investment Example

We conclude by providing an example of our process from end to end, referencing an investment search we completed in the latter part of 2011. The search was for an intermediate-term bond manager to fill a core fixed income role. We decided to seek an active product to fill the role, a decision supported by empirical data including the performance spread between top and bottom performers in the category; the performance spread relative to the index; and the relatively high number of successful funds that were able to sustain their success in subsequent periods.

We were looking for a diversifying fixed income investment, one that would reduce our reliance on Treasury securities. We were enthusiastic about opportunities in corporate bonds, balanced by concerns about economic momentum and the potential for interest rates to increase. Given the potential for disruption in the credit markets, we wanted to select a manager with strong credit research capabilities while also hoping to identify a firm with a framework to understand the risks associated with rising interest rates.

The fund that was ultimately selected offered strong historical performance, boasting top decile performance in 90% of 5 year periods leading up to its selection and meeting our screening criteria from a risk perspective. The fund's value-driven philosophy and investment process was robust and repeatable, and gave us confidence that historical success would be sustained into the future. We were equally impressed from a people perspective, drawing confidence from a lead portfolio manager with several decades of investment experience and more than a decade of experience managing the fund, supported by a deep team of research and credit analysts.

About the Authors

Daniel Kern, CFA, President, Chief Investment Officer, Advisor Partners

Daniel is responsible for establishing and driving the overall company strategy for Advisor Partners, and oversees all aspects of company operations. As CIO, he establishes the investment philosophy and process for Advisor Partners. Prior to joining Advisor Partners, he was Managing Director and Portfolio Manager for Charles Schwab Investment Management. His leadership positions at Schwab, prior to October 2008 included heading product development and serving as CFO of a fund company. Prior to Schwab, he was Managing Director and Principal for Montgomery Asset Management.

Daniel is a graduate of Brandeis University and earned his MBA in Finance from the University of California, Berkeley. He is a CFA Charterholder and a former President of the CFA Society of San Francisco.

Gerard Cronin, CFA, Portfolio Manager, Advisor Partners

Gerard develops asset allocation models and assists in the ongoing oversight of portfolios, including construction, risk management, and cash management. Previously, he was a research analyst at Charles Schwab Investment Advisory, where he performed manager due diligence for separately managed accounts and mutual funds. Prior to his investment career, Gerard worked in the computer hardware and environmental services industries.

Gerard holds a BS in Civil Engineering from Carnegie Mellon University (CMU) and an MBA from CMU's Tepper School of Business. He is a CFA Charterholder and teaches ethics and private wealth management in the CFA Society of San Francisco's exam review program.

Tim McCarthy

Timothy F. McCarthy has dedicated his entire career to the financial services industry. He has worked nearly half of his adult career overseas, giving him a uniquely informed view of the global economy. His notable positions include: Chairman – Nikko Asset Management, President – Charles Schwab and Co. and President – Fidelity Investment Advisor Group. He is the author of *The Safe Investor: How to Make Your Money Grow in a Volatile Global Economy* (Hardcover, 320 pages, Palgrave Macmillan, February 2014). As an executive who formerly led large and successful corporations, McCarthy understands how difficult it can be for employed individuals to speak their minds. At this point, he prides himself on offering candid comments and frank opinions.