EXPERT OPINION

Active vs passive: a false argument

If a strategy meets return expectations, why worry about the category? Emmanuel Bourdeix explains that outperforming the index does not need to mean outsized fees.

Investors are constantly calibrating their weightings to active and passive assets. Are they spending their time on the right question? I would argue that the whole passive versus active argument is potentially flawed and that neither style of investment management is optimal for investors.

A strategy benchmarked against indices that are cap-weighted no longer makes intuitive sense for a growing number of institutional investors. Volatility in equity markets following the 2008 financial crisis convinced many investors of the shortcomings of cap-weighted indices. The problem is they are excessively concentrated on the largest market-cap stocks, so they are not efficiently diversified.

On the other side of the coin, there are actively-managed funds. Stock pickers on average underperform the index while charging higher fees than index trackers do. In any case, conventional stock pickers are often inadvertently (or passively) exposed to risk premia that are the source of stock market returns without knowing the exact levels of their exposures.

I would argue you can capture and measure risk premia and create active portfolios that are an alternative to traditional equity investing, and which outperform the index consistently over time, but at a much lower cost than for traditional active management.

Could you explain what you mean by these "risk premia"? A risk premium is a commonality shared among various stocks that explains a portion of their performance. There are many kinds of risk premia. One of the best known is the equity risk premium, which is the additional return investors can expect over the long term from investing in equities. Another risk premium is volatility. This can be a negative contributor to investment returns as many investors in 2008 and 2011 found out to their cost.

The only strategy that delivered outperformance in those markets was low-volatility investing. With this in mind, Seeyond created a strategy designed to minimise volatility without surrendering long-term outperformance. This "minimum variance" strategy significantly reduces risk over the long term and was our first risk premium strategy.

So is your investment strategy focused mainly on low-volatility stocks? Not only, no. We always believed in the possibility of exploiting various risk premia. After the success of the minimum variance strategy, we carried out further research and discovered that just four – low volatility, value, small-cap and momentum – have explained two-thirds of market variability over the last decade. We decided to develop a unique and innovative strategy around these four risk premia and make it the cornerstone of our business.

Focusing on these four risk premia provides investors with more complete and measurable diversification, which is not usually offered by stock pickers.

The argument for combining the four risk premia in this way is compelling. In back-tested data going back 20 years, we found the combination delivered 2.1% annual outperformance over the MSCI Europe, with an Information Ratio of 0.70. In fact, over 20 years, the strategy has only underperformed the MSCI Europe in four discrete years.

So simply by investing in these risk premia you can outperform the index? Yes, but *how* we invest in them is our competitive edge and the key to outperformance.

Over the last decade, each of these risk premia has delivered strong alpha in certain periods, but has also underperformed at times. So focusing on one or two factors alone can lead to underperformance. For instance, if you were a "value" investor in Europe in 2011, you would have underperformed the market by nearly 23%. But the following year, a "value" investor would have outperformed the market by 14%.

So there is significant volatility in allocating to just one factor. And this is one of the problems with traditional active investors, who often have a bias towards a single approach, or risk premium, such as value or small-cap stocks.

Our multi-factor process diversifies the portfolio and enhances performance by allocating dynamically between the four risk premia. Dynamic allocation is also the preserve of some traditional stock pickers of course, but systematic risk premium investing is a more repeatable, more consistent process, which can deliver steady returns over time and avoid the swings of many active investment strategies.

Did you say systematic? Aren't investors wary of these "black box" strategies? And so they should be, but this is definitely not a black box strategy. It is transparent and also very robust. Our methodology is designed to be easy to understand. We looked at the 200-plus known risk premia and chose the four investable factors that contribute most to performance and which diversify the risk among them. All four are extremely well-defined by academics and index providers, so investors can see exactly what they are exposed to. Our portfolio construction is no mystery either, we can easily explain it without baffling investors with science.

OK, so can you explain how you construct your risk premium portfolio? Our four risk premia are divided into two categories: structural and behavioural. The structural premia – low volatility, value and small-cap – have attractive diversification attributes and outperform over long-term cycles.

The behavourial premium – momentum – catches market trends and themes that have a short-to-medium life span and which are not embodied in the long-term structural risk premia. In other words, the two groups have complementary characteristics.

Momentum is the core investment of the portfolio because it provides most outperformance over the longer term, whether for US or European assets. In Europe, for example, momentum investing has delivered 12% a year over the last 20 years, compared with 7% from the broad market and 13% from value investing.

Of course, momentum investing is potentially exposed to severe drawdowns: over an observation period of 20 years, the maximum potential drawdown in any one year of US equities is -49% compared with -32% for low-volatility US equities. So you need a highly active allocation. This helps the strategy to fulfil its aim of winning by not losing.

What is your maximum weighting to any one risk premium? The core investment is momentum, with up to 70-75% of the portfolio dedicated to a basket of momentum stocks. However, when we don't see value in the momentum risk premium, we may reduce its portfolio allocation to as low as 25%, and shift our portfolio to more structural factors.

Our aim is not to forecast which of the four risk premia will outperform over the short term. But over a three to five-year time horizon, if we allocate mainly to momentum stocks and avoid momentum drawdown by reallocating when necessary to fundamental risk premia, we believe we will consistently outperform the market. During an observation period of 20 years, the probability of the strategy outperforming the broad market in any rolling one-year is more than 78%.

Compare this with conventional stock pickers – their probability of outperforming the market is quite comparable, around 80%, but over a three-year period. The difference is we have true, measurable diversification and we are risk-oriented.

So help me understand where this strategy fits into my portfolio – is this an active or a passive product? Our benchmark is the broad equity market. For UK equity investors, that's the FTSE All-Share. Our aim is to beat the index consistently. So the strategy can be employed as a core equity allocation, replacing traditional passive products. But the actively-managed style and long-term outperformance means it can be used by investors as part of their active allocation.

In short, the risk premium strategy provides sufficient outperformance and an attractive fee level to appeal to passive and active investors alike. And unlike conventional stock-picking funds, the target performance can be tailored to investors' needs, by calibrating the amount of active risk taken.

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All data as of 30 June 2016. Source: Seeyond quantitative research/Factset. Performance of long-only Equity factors as defined by Seeyond quantitative research.

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