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Active Management

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Key Points

There is no debate – you cannot avoid active management

Asset Allocation is key – we all agree on that

Diversification is important

Clients/Members deserve active management

There is no debate – you cannot avoid active management

- As long as you are exposed to asset markets you cannot avoid active investment management.
- If you choose not to be active, your decisions are driven by the active decisions of other participants in the markets.
- It's useful to make that point explicit because some people speak as if active is 'risky' and that other approaches are 'safe'.
- A simple thought experiment with, say, one market, two investors and three securities should illustrate the point.
- We assume that it's only the actions of intentionally active investors that have any market impact.
- It's clear that the buying and selling decisions of active investors determine price discovery in the market place and hence determine the relative weights of the securities in the market.
- If you choose to just replicate the market weights of the securities – rather than actively choosing them yourself - the weights you replicate are totally determined by active management.

There is no debate – you cannot avoid active management

- We can think of price discovery as the process whereby buyers and sellers agree to a specific transaction. The faster the price discovery process is, the more ‘efficient’ a market is deemed to be.
- You will hear the argument that it doesn’t make sense to be active in a market which is ‘efficient’.
- But efficiency/price discovery is also shorthand for active managers incorporating known information into their buying and selling decisions, generally within a short time frame.
- Therefore by not being active you don’t achieve some ‘objective truth’ / safe/riskless position; you’re merely accepting the decisions of a whole host of active managers.
- Also of interest is that there would seem to be a natural mechanism which determines the balance between active and passive investors in any market:
- A predominance of active investors creates greater ‘efficiency’ and theoretically prepares the grounds for people moving away from active management.
- But if this process goes too far then price discovery and efficiency are impaired and this then provides an environment for active managers to thrive.

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- Even the way we phrase the question: 'do you *believe* in active management?' suggests it's a philosophical as much as scientific question.
- We know that not all participants can beat the market. But there are some who can - managers with demonstrable skill over time, both as asset allocators and stock pickers.
- But like the debates between atheists and followers of religion, much of debate about the merits of active management is sterile.
- In reality the relationship is somewhat symbiotic…while active management can function happily if there are only other active investors in the market, other approaches can only survive with the strong presence of active investors.

Asset Allocation is key – we all agree on that

- All of the evidence backs the notion that the returns on your pool of money is driven by what class(es) of asset you are exposed to.
- Certainly security selection can add to returns but it is unlikely to be a key driver of your overall return i.e. asset returns dominate securities' returns.
- Therefore a lot of time and energy is – or at least should be - devoted to constructing the correct asset allocation policy.
- This is regardless of the objective of accumulating assets i.e. whether you are saving for retirement or just for a 'rainy day'.
- Theory and history tells us that we should be patient and not expect instant gratification from investment markets.
- The combination of volatile asset markets and the expectation of a particular 'point in time' return is a recipe for disappointment – potentially an extreme one.
- So your policy mix should not hinge on some 'point in time' return expectation, rather that returns 'over time' would meet your expectation.

Asset Allocation is key – we all agree on that

- If we get outsized gains in a particular period, human nature suggests we may ascribe it to our skill in determining the correct policy mix.
- But in reality our policy mix should allow for the fact that asset returns are volatile with the potential for outsized gains/losses in a particular period.
- We all are aware that this is a 'known known'…they should not come as a surprise, pleasant or otherwise. They should be part of our standard expectations.
- See the example on the following slide.

Asset Allocation is key – we all agree on that

Say we determine that an appropriate policy mix is 60%/40% bonds/equities (the same principle applies if we have ranges rather than 'points')

Over the year, equities rise by 40% and bonds fall by 5%;

This will drive your asset mix to 69%/31%.

The policy mix of 60% /40% should incorporate an expectation of this type of volatility in the returns of the two assets, especially for equities.

Rather than take the move to 69% equities as a signal of our skill, we should take it as evidence of the volatility we expect and react accordingly.

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- In other words it doesn't make sense to let your well thought out policy 'drift' because of the movements of the marketplace.
- If your asset allocation does move because of the relative performance of your assets, this should be actively monitored and managed.
- We should recognise the need to bring your allocations in line with your policy; in other words, active management is vital to ensure your objectives are met and is not a residual task.
- If we think of risk in different terms – think of it as the exposure from being away from your chosen policy mix – then active management should be seen as controlling the risks of your portfolio, not just about managing its return.

Diversification is also important

- Warren Buffet hates diversification because he claims it reduces returns; the theory being that the more securities you own the less you can know about them and the less likely you are to have 'winners'.
- In fact for most investors the lack of diversification would undoubtedly reduce returns as they would concentrate their holdings to the point where they could suffer catastrophic losses from one or two losing securities.
- Arguments about the diversification of securities' holdings aside, from an asset allocation point of view the key benefit from diversification is the management of the volatility of return of your portfolio rather than the return itself.
- Thinking of asset diversification in terms of returns being sacrificed is taking a too narrow view of investment policy; diversification is an essential part of getting the policy right.

Diversification is also important

- In looking for diversification we need to be aware that in stress scenarios – such as we witnessed during the beginning of the financial crisis – some assets that apparently contribute to diversification benefits in ordinary times may not produce it when needed.

- Exposures to such assets also need to be actively managed and their 'negative correlations' – another name for diversification benefits - should not be taken as a given.

Clients/Members deserve active management

- Clearly equities have been the best performing asset over the long term.
- They 'must' continue to be the best over future time periods, so long as have a capitalism-biased system, where the providers of capital will be rewarded sufficiently for putting that capital at risk.
- But that 'long term' timescale we talk about can be just that.
- There have been many 5 and 10 year timescales for which equity returns have been negative.
- That doesn't mean that we avoid equities; on the contrary. We just need to be explicit about the implications of such volatility in returns.
- One of those is that you will get opportunities to both sell equities and to buy them and we should seek to embrace both [see earlier slides].

Clients/Members deserve active management

- Additionally we should not expect this 'best performing' asset to deliver just when we want it, because it won't; history provides plenty of evidence.
- So we need a mechanism that gets the right policy mix from the outset, we need to actively manage to that mix but we also need to ensure that the mix varies with time horizon
- The latter because our attitude to risk varies with time. This means that active de-risking can be just as important as active risk taking.
- Lifestyle strategies – we have employed them in Zurich since we commenced managing monies for pension funds – are a relatively straightforward strategy to achieve this.
- Equally all investors should have maximum visibility of the asset mix of their portfolio, they should be able to see rebalancing impacts and see the mix varying over time as appropriate.
- 'Dashboarding' – such as the type that Zurich pioneered – is both necessary for transparency and will undoubtedly become mandatory over time.

Clients/Members deserve active management

- The purpose of this talk was to focus more on the ‘what’ and some of the ‘how’ of active management, particularly active asset allocation policy.
- The ‘who does what?’ question is a big one in itself.
- As an active manager of assets and an active stock picker, you’d probably expect me to talk about the merits of multi-asset funds or of our strong track record of security selection in distinct portfolios.
- But we can leave that for another day!

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