HighMark®
CAPITAL MANAGEMENT

To Be, Or Not to Be (Active)

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Introduction

Over the last several years, many active managers have struggled to add value compared to their respective benchmarks. This unfortunate reality has generated significant media coverage raising valid questions about the relative merits of paying active management fees.

As with many investment issues these days, superficial coverage and punditry may contribute more confusion than clarity to the topic. The arguments for all-passive portfolio implementations, while generally well-intended, often miss the mark. Avoiding active managers for failing to outperform indexes after fees may be warranted in some circumstances, but not in others. In practice, the debate around this issue is far more nuanced than what typically meets the eye.

Reading between the lines

What sounds like a simple question: "Is an investor better off using active or passive strategies?" becomes more complicated as we dig deeper into the details. Posing the question in binary 'active vs. passive' terms ignores the option of combining the two to create what is often called a "Core-Satellite" approach.

As part of our investment philosophy, we begin with the belief that there is no single solution to portfolio construction that is appropriate for all investors. Moreover, ensuring that the costs and value of potential investment approaches are aligned is among the most important functions of any investment advisory relationship.

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To guide the discussion and to provide information, which can help investors discuss the active/passive question with their financial advisor, we pose three critical questions and offer our responses to each below. The articulation of our logic behind each response is intended to illustrate the foundation of our portfolio construction framework and how we decide between active or passive investment products when implementing a client's asset allocation policy.

1 Can active managers outperform passive benchmarks net of fees?

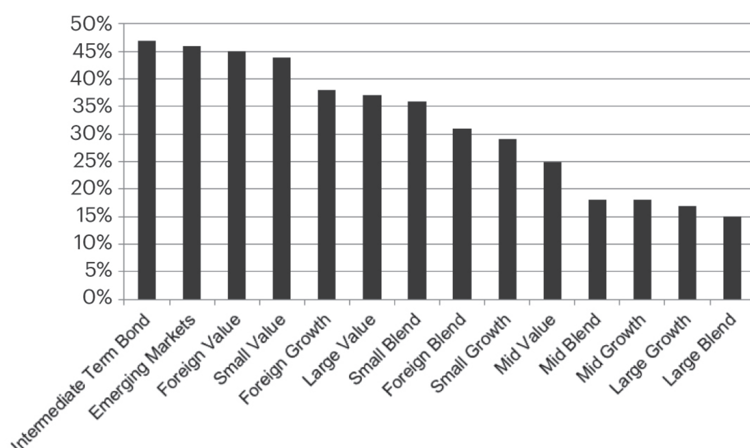
Finding that a majority of managers underperform is not the same as finding that all managers underperform. Recent historical data clearly confirms that some active managers have outperformed net of fees in every asset class. However, their success rate varies greatly across asset classes. In certain areas of the market, the percentage of active managers beating their respective benchmarks is discouragingly low, whereas in others the frequency of success is much higher. This finding should be somewhat intuitive because certain asset classes are more trafficked than others. In other words, the degree of so-called 'market efficiency' will vary by asset class. We can also expect success rates to fluctuate over time as market conditions change (more on this later). Breaking down active manager success by asset class often gets overlooked in the debate, but should be a very relevant consideration in any portfolio construction framework.

As Exhibit 1 indicates, active managers who focus on international equities, small capitalization U.S. stocks, and U.S. bonds have enjoyed a much higher success rate than managers seeking to outperform large capitalization indices. It stands to reason that the lower the odds of active managers outperforming an asset class, the stronger the case for a passive approach to that asset class.

It is also important to note that fees often vary widely across identical versions of the same product. For example, the mutual fund universes used in Exhibit 1 contain multiple share classes of the same fund with varying expense ratios. Our structure and scale allows us to provide access to lower cost share classes of mutual funds and separate accounts that can keep costs down for our clients. Lowering fees for active managers will start to tip the scales back in favor of active management.

Naturally, one might assume that the success rate of active manager outperformance directly translates to the probability of selecting an outperforming manager. While this is an understandable (and common) assumption, it discounts any effort made to research the underlying caliber of the active managers. In fact, we believe that comprehensive qualitative and quantitative due diligence enables us to identify active managers with a sustainable edge relative to the competition. Therefore, by putting time and effort into manager research, the lack of success active managers may have had in a particular asset class should not be the sole determinant to opt for a passive product.

Exhibit 1



Source: Morningstar

Morningstar Category	Index
Emerging Markets	MSCI EM (USD)
Foreign Blend	MSCI EAFE (USD)
Foreign Growth	MSCI EAFE Growth
Foreign Value	MSCI EAFE Value
Intermediate Term Bond	Barclays US Agg
Large Blend	Russell 1k
Large Growth	Russell 1k Growth
Large Value	Russell 1k Value
Mid Blend	Russell Mid Cap
Mid Growth	Russell Mid Growth
Mid Value	Russell Mid Value
Small Blend	Russell 2k
Small Growth	Russell 2k Growth
Small Value	Russell 2k Value

We further stress that selecting managers based only on past outperformance can often be perilous, as luck and skill are indistinguishable by merely looking at past returns. To avoid falling into the trap that strong past performance can often lure us, we must look below the surface and perform rigorous qualitative research in order to identify managers that are truly skillful and therefore likely to generate persistent outperformance going forward.

2 Why has active management underperformed in many areas of the market?

Peeling back the layers on the claim that active management is nearly futile in some areas of the market, we must begin to examine the root cause of the challenges managers faced recently. Exhibit 1 demonstrates the validity of the claim among domestic large and mid-cap equity managers in particular. Over this period in history some rather unique "top-down" macro-economic circumstances dominated financial markets. Many of these circumstances created direct headwinds for managers that most often focused on "bottom-up" company fundamentals. While some are confident that these headwinds will persist, further hampering active manager performance, our view is a bit more nuanced.

The post-crisis expansionary cycle and the interplay of financial markets, economics and governments have been incredibly unique in terms of their impact on investing. The conditions which coalesced over the last decade upended past historical economic and financial relationships and we witnessed governments' (mostly central banks) unprecedented role in markets, not only as a referee but also as a player on the field. Through quantitative easing and other central bank moves, interest rates were driven to zero which, in turn, were supportive of global asset prices and valuations.

Such heavy involvement by central banks distorted natural stock and bond price discovery mechanisms, complicating the investment processes many active managers rely on to add value.

Going forward, however, we believe it is unlikely that the environment of easy money—which encouraged possibly indiscriminate crowding into risk assets—will endure. Therefore, context around past market, economic and financial relationships will once again be relevant to active management. Unwinding all the stimulus activity in the system will likely be turbulent and may require a period of adjustment for markets that have become conditioned to expect low volatility, high correlations, and low performance dispersion across equity asset classes.

Additionally, the growing trend towards passive strategies has created its own self-fulfilling prophecy of sorts. With nearly all new (and significant existing) assets migrating to price-sensitive passive strategies, there is a reduced opportunity for mean reverting forces to enter the picture.

On balance, active management has found more success under regimes consisting of the following conditions:

- rising interest rates
- moderate to high market volatility
- Low correlations among individual stocks, sectors and industries.

Over the last several years, central bank interventions have created the opposite environment, but we believe the tide may be turning to a world where markets are less influenced by government interference and the invisible hand of Adam Smith once more takes hold. We believe that in such an environment, active managers as a group are poised for a healthy comeback.

3 How do we decide when to use active or passive strategies when implementing our clients' asset allocation policy?

We believe that there is no 'one size fits all' investment solution for every client. Portfolio construction decisions, much like asset allocation decisions, should consider multiple client-specific factors and an implementation plan that may be appropriate for one client may not be right for another. Client-specific considerations in a dynamic portfolio construction framework include sensitivity to fees, tax circumstances, and active risk aversion. We discuss these considerations in more detail below:

- **Active manager fees** present the most significant and direct hurdle to market outperformance. As such, fees must be of paramount importance when assessing a manager's likelihood of beating a benchmark. However, one should be cautious about being overly myopic on the fee issue. Because cost and value are often uncorrelated in the investment management industry, this can be a challenging issue to navigate. We believe managers who can justify active fees by delivering excess returns net of fees exist and, with comprehensive due diligence efforts, can be proactively identified.

- For taxable investors, an investment's potential tax implications must always stay at the forefront of the policy implementation decision. In order for most active managers to outperform, portfolio turnover is almost always going to exceed that of a static benchmark index. Since the selling of securities creates a taxable event prior to a withdrawal or liquidation, many active managers are considered to be tax inefficient. Some active managers make tax-efficient trading a key part of their investment process and these strategies may be an appropriate option for taxable investors. ***In any case, an investment advisor must determine if the expected value delivered exceeds the benchmark after fees and taxes are factored in.*** This, in effect, raises the hurdle active management must clear to be justified.
- **Active risk** is the risk of deviating from the stated benchmark. While clients are always pleased when their portfolio outperforms the index, the same cannot be said for deviations to the downside. Even when we believe a manager has a high likelihood of beating his or her benchmark over the long-term, periods of short-term underperformance are not only likely, but virtually guaranteed. A client's tolerance for active risk should be factored into the active/passive decision matrix in much the same way a client's tolerance for overall portfolio volatility is factored into the strategic asset allocation policy decision. All else equal, a client with a high degree of active risk aversion would find a predominately passive portfolio to be most appropriate. On the other hand, a client who can tolerate short-term underperformance in return for the potential to add value over the longer-term may prefer higher allocations to active managers.

Conclusion

The ongoing debate between the merits of active and passive investment strategies often suffers from oversimplification. Our investment approach seeks to avoid ideology and focuses on the evidence, while contextualizing the decision for each client alongside the available universe of active management options. A prudent investment advisor should not feel compelled to make an all-or-nothing decision related to the implementation of a client's portfolio with active or passive investment products. High quality active managers capable of outperforming representative benchmark indices after fees do exist. In some asset classes they are easier to find than others, but there are also other client-specific considerations to be factored into a comprehensive portfolio construction framework. A holistic approach will often, but not always, lead to a custom blend of active and passive managers.

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