BostonPartners

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Active Alpha: Capturing Idiosyncratic Risk

Recent analysis and research reinforces the value of a systematic, bottom-up approach to investment management.

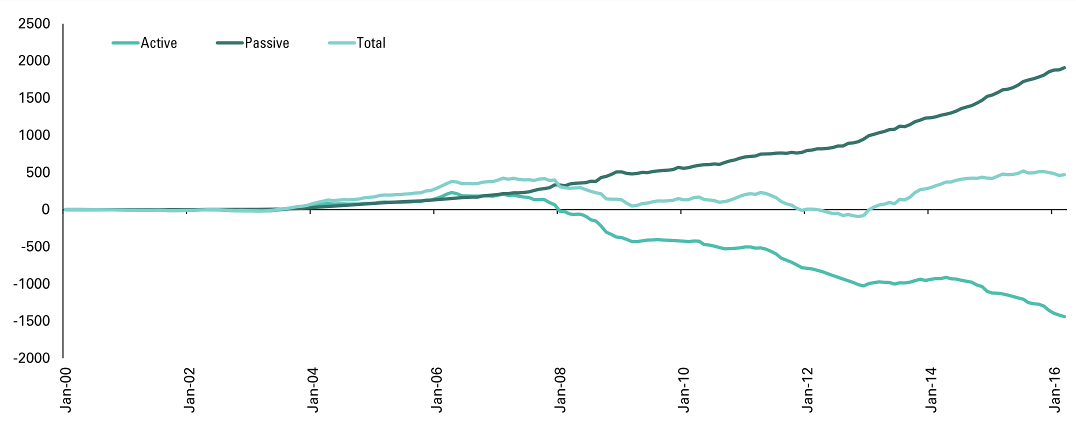
A search on *LexisNexis*, scanning just the past 12 months, will return well over 3,000 news articles, all focused on the active-versus-passive debate that has come to define today's investment landscape. The arguments are all pretty much the same, with proponents of passive strategies keying in on the themes of lower costs and comparable performance, while those defending active strategies will underscore the value of a hands-on approach in a sideways or downward moving market. What very few of the articles care to mention is exactly how sweeping of a generalization it is to lump all active managers into one bucket, or for that matter, all passive strategies, particularly as factor investing and smart beta entries have blurred traditional boundaries.

To be sure, a substantial segment of fundamental investment managers are very likely in denial about the value proposition they're bringing to the market. Many – outside of event-driven managers – may have trouble clearly demonstrating an ability to capture idiosyncratic risk in building portfolios that offer uncorrelated return streams. And among pure quantitative funds, the sting of the 2007 Quant Meltdown still hangs over the segment, as a failure to differentiate – though it may work in ascending markets – can leave those strategies among the most exposed in the transition to a more challenging environment.

While active strategies do often get lumped together, creating an "averaged out" strawman easily set ablaze, the fact is that the active-versus-passive argument isn't nearly as black and white as it may seem from 50,000 feet. To really understand how well one approach fares against the other requires a disaggregation in which the many different variations and categories of active strategies are viewed in isolation and set against multivariate benchmarks to track exactly how well they perform against comparable passive strategies or indexes. This is what Bernstein Research set out to accomplish through a study published this summer, "*In Defense of Active Management*." The analysis concluded that, far from entering into a death spiral, a strong and compelling case can be made for active strategies. The caveat, however, is that for an active strategy to outperform today – in a lower-cost environment and as access to more sophisticated products becomes democratized -- it requires a systematic approach, one supported by robust quant capabilities and paired with a bottom-up focus on value and fundamentals.

Roughly $2 trillion in aggregate has rotated into passive equity funds and ETFs over the past decade, while over the same period $1.5 trillion has streamed out of active strategies. As it stands today, passive managers control a market share of nearly 40% in the U.S. and over 30% in Europe.

Chart 1: Active versus Passive



Source: Emerging Portfolio Fund Research (EPFR) Global, Investment Company Institute (ICI), and Bernstein analysis.

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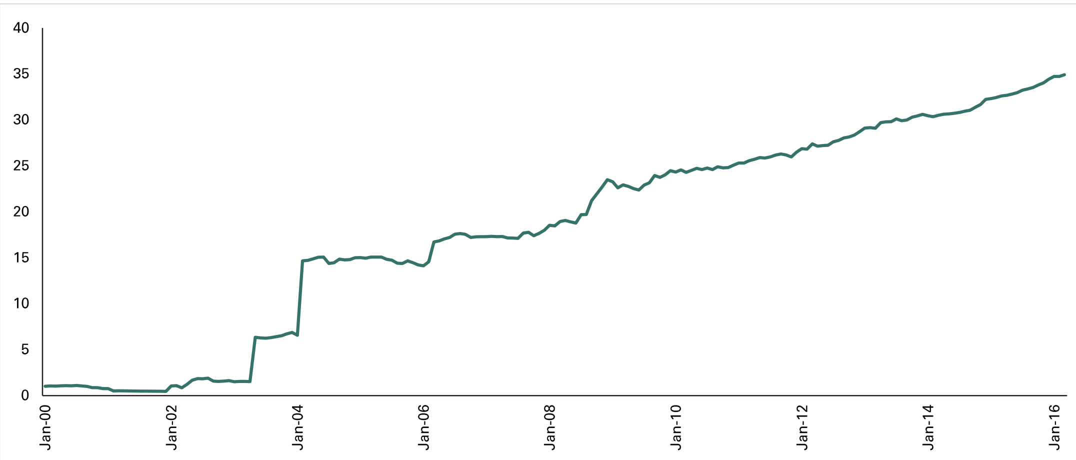
Chart 2: Passive Share



Source: EPFR Global, ICI, and Bernstein analysis.

A recent article in *InvestmentNews* exploring the various drivers of active-strategy outflows quoted one investment advisor, a proponent of passive funds, who surmised: "Clients and investors have absolutely no need to beat the markets; they simply need to capture the returns of the capital markets."

Anecdotally, this is exactly the kind of sentiment that might be expected to materialize at around year eight of an uninterrupted run in the U.S. equity markets. The S&P 500 Index, which hasn't posted a negative return annually in the past seven years, has generated double-digit total returns five times since 2008, while 2009 and 2013 produced total annual returns in excess of 26% and 32%, respectively. Make no mistake, these are the ingredients for complacency.

This sense of aplomb, however, probably couldn't arrive at a worse time, as most signs point to a developing low-growth environment. As Bernstein pointed out in its research, the Shiller PE index implies total returns of 6% per annum over the next 10 years and the current yield on bonds suggests annual returns of 2% over the same period. Many though, including institutional and retail investors alike, have yet to adjust their expectations. Evidence of undue optimism can be found among many sophisticated institutional investors, as state pensions are counting on annual returns of 7.62% on average, according to the National Association of State Retirement Administrators.

Whether it's to meet liabilities in the case of institutional asset owners or to fund the retirement and college-savings plans of retail investors, investors will again become dependent on those fund managers who can produce idiosyncratic alpha. The question thus becomes, from where will that differentiated and uncorrelated return stream emerge?

It may sound obvious, but in a low-return market, the best way to beat the benchmarks is to avoid the groupthink that fuels so many passive strategies.

There is a collection of academic research and literature demonstrating that active fund managers who employ high active-share strategies will outperform in both good and bad markets when adhering to a buy-and-hold approach. Martijn Cremers, of the University of Notre Dame, and Ankur Pareek, of Rutgers Business School, identified in a paper published in 2014 ("*Patient Capital Outperformance: The Investment Skill of High Active Share Managers who Trade Infrequently*"), that mutual fund managers in the top active-share and fund-duration quintiles, on average, beat the market by as much as 2.22 percent. Outperformance was attributable to "picking safe (low beta), value (high book-to-market) and quality (profitable, growing, less uncertainty, higher payout) stocks and holding on to those over relatively long periods."

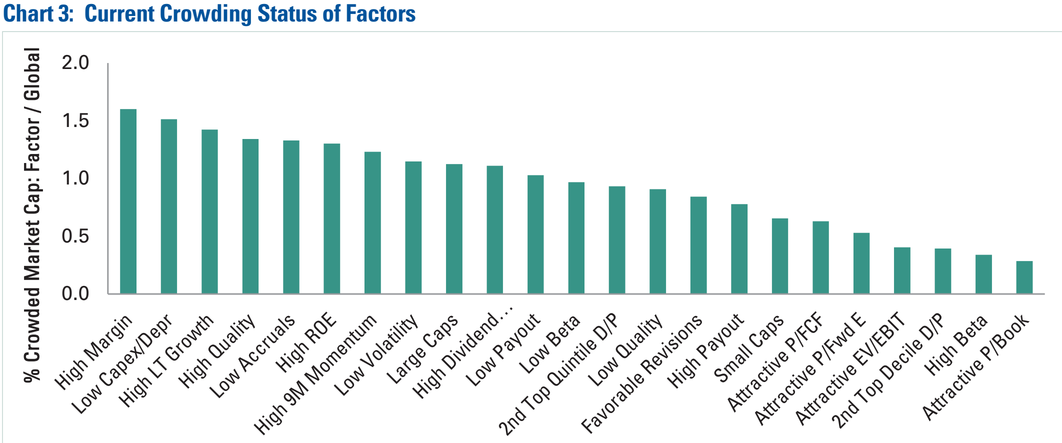
AthenaInvest CEO C. Thomas Howard, in a July interview with CFA Institute's *Enterprising Investor,* noted that in his research, the underperformance of active managers stems from structural decisions at the fund-manager level that translates into "portfolio drag." Howard cites asset bloat, closet indexing and over-diversification as three factors leading to underperformance among active strategies, but he notes that these are all issues that can be flagged by prospective investors and that, contrary to conventional wisdom, the funds most likely to outperform generally charge higher fees. His research also found that nearly 80% of the active funds in his sample displayed management skill large enough to cover the higher fees of an actively managed strategy.

There is an argument, however, that as fund flows pour into passive strategies, correlation across equities will rise as the market structure evolves; share prices, in turn, will start to run independent of their intrinsic values. The Bernstein analysis, using data from Ken French, identified six periods of prolonged underperformance since 1926 in which pure value factors suffered over a business cycle. While growth and momentum may take precedence in certain environments, mean reversion remains one of the more powerful tools investors have at their disposal. Moreover, it's the potential for underperformance that creates the idiosyncratic risk that value investors can take advantage of in the first place.

In a similar vein, Scott Opsal, Director of Research at The Leuthold Group, published an article in July tracking the historical returns of both active and passive strategies, which concluded that relative performance between the two are indeed cyclical. He identified that since 1991 there were four distinct windows across eight periods in which active outperformed passive strategies. His research, *Active vs. Passive: A Three Club Wind*, further supports the findings of French in that active strategies tend to perform better during times when value beats growth, international equities outperform U.S. equities and small cap stocks are more attractive than large caps.

All of this is not to say that the increasing prevalence of index funds and growth of smart beta strategies aren't having an impact. Parallel to the rise of passive management has been the growing tendency for crowding into certain factors. High long-term growth, high margins and high momentum currently sit as the top three crowded factors across regions.

Chart 3: Current Crowding Status of Factors



Source: Bernstein Research.

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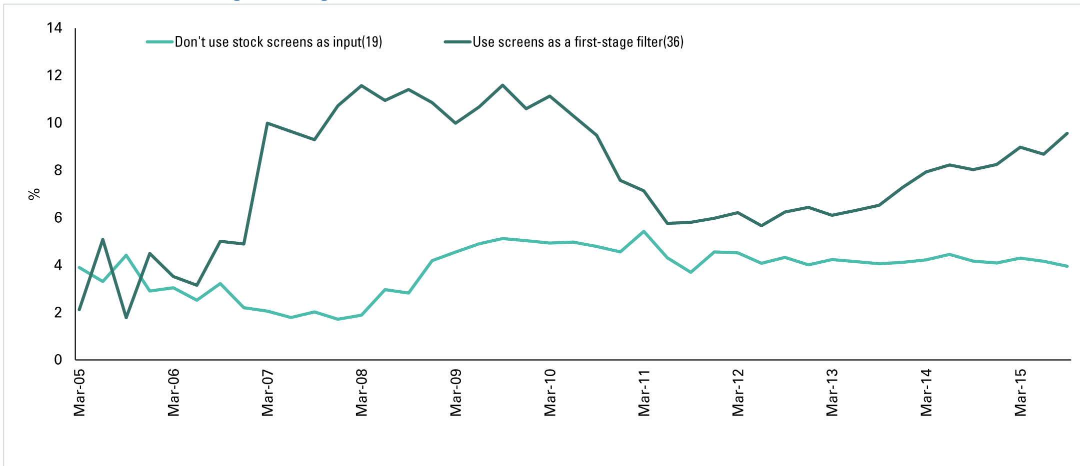
The volatility and potential for losses that can result from this overcrowding will only become more frequent and more severe as quant share escalates. This will likely be driven by the ongoing adoption of smart beta strategies, as costs continue to fall, as well as the growing adoption of white-labeled quant screens by pure fundamental managers seeking to reverse engineer their processes to meet consultant biases.

Chart 4: Stock Screening Growing



Source: eVestment and Bernstein analysis.

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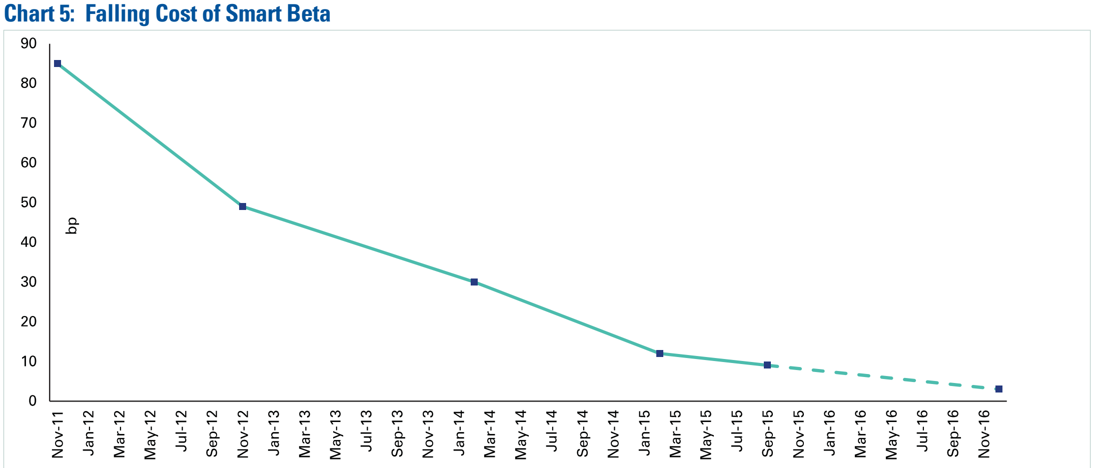
Chart 5: Falling Cost of Smart Beta

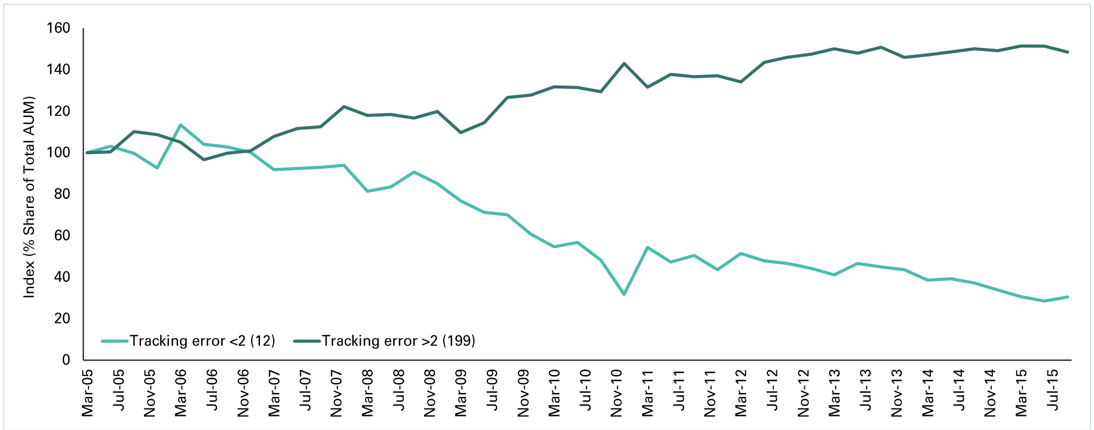


Source: Financial Times, and Bernstein estimates (from November 2015 onwards) and analysis.

Indeed, each of these developments is rapidly changing the investment landscape and the distinction between active and passive management is no longer so black and white.

Most research argues that for fundamental managers, a systematic approach is necessary to capture the full breadth of the investable universe, and deliver the higher active share and higher tracking error that has been attributed to outperformance. Moreover, investors are also increasingly aware today of those managers that could be characterized as "closet indexers," and they have shown little in the way of amnesty for those assessing active-strategy fees and failing to deliver a differentiated return stream.

Chart 6: Closet Indexers



Source: eVestment and Bernstein analysis.

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This scrutiny will only became more pronounced in the wake of the DOL Fiduciary Rules' emphasis on fees, not to mention the lagging performance of products whose portfolios most closely hug their respective benchmarks.

But while the rediscovery of quant capabilities is driving thematic changes across the global investment landscape, in the right hands, a systematic approach can be among the critical differentiators for fundamental managers. There is evidence that consultants consider this a prerequisite for most global mandates and there is growing recognition that screening inputs can drive consistency among active discretionary managers. This foots with previous research and literature showing that performance persistence is positively linked to market breadth.

As the passive-versus-active debate dissolves, investors will likely be more focused on the kind of activity a particular fund manager engages in – be it strategic factor exposure, timing or stock picking. While it can be challenging to articulate the value add of the latter, those who consistently generate the idiosyncratic returns that will continue to be so critical in a low-return, high-quant share environment, will be able to demonstrate the alpha that only active management can deliver.

To provide a sense of what this looks like at Boston Partners, our quantitative-driven, front-end analysis allows us to isolate the tails of the distribution to create a target-rich environment. Our quant team, for instance, has refined our proprietary, 40-plus factor model over 25 years and continually adjusts the factors to reflect market dynamics and new learnings. Our fundamental analysis builds off of this to apply our proven three-circle approach, incorporating lenses through which we assess a company's valuation, fundamentals and momentum. This guides us to the areas of market "underweighted" by those who base and fill out their models on economic forecasts or other macro factors. While the quant screens may help us winnow down our investable universe, we will often pursue alpha-driven trades, completely independent of the composite rankings. It's a systematic and bottom-up process that has stood the test of time, but also features all of the characteristics now in vogue as the market reshuffles amid the evolving financial landscape.

About Boston Partners:

Boston Partners is a premier provider of value equity investment products that are firmly rooted in fundamental research and are based on a disciplined investment philosophy and process. Boston Partners, which currently manages $78.3 billion*, is focused on investing in companies with attractive value characteristics and strong business fundamentals, where there is a catalyst for positive change. The firm, founded in 1995, has a longstanding reputation for superior client service.

** As of June 30, 2016.*

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Mr. Farren is a senior portfolio analyst for Boston Partners. He joined the firm from Alliance Bernstein in New York where he spent over three years in a sales capacity covering Hedge Funds and concentrating on Event Driven Research. Prior to that he was a product engineer for SSGA's Fund of Funds product SSARIS, where he was responsible for client facing interactions with existing investors and potential allocators. Before that he spent four years at Tudor Investment Corporation working on the Raptor Fund as a fundamental analyst where he specialized in the restaurants, food and beverage companies, household products and miscellaneous consumer non-retail sectors of the equity market. He holds a B.A. in history and political science from Tufts University and an M.B.A. from the Kellogg School at Northwestern. He has twenty-two years of industry experience.

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