HEALTH WEALTH CAREER

ACTIVE VERSUS PASSIVE

JULY 2019

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MERCER

> "My dear, here we must run as fast as we can, just to stay in place. And if you wish to go anywhere you must run twice as fast as that."

The Queen of Hearts to Alice in *Alice in Wonderland* by Lewis Carroll

Whether to use active or passive management is one of the most divisive discussions in the world of investments. Money talks, and more of it flows to passively managed assets each day. Some say passive management is freeloading, anti-competitive and that hard work should be what drives results. Others say that one should be humble enough to admit that "alpha," or above-market return driven by the unique insights of the manager, is a mirage. In this paper, we discuss:

- **Beating the index** — is it possible to identify managers who can use their insights to outperform the market?
- **Top tips for finding reliable outperformance**
- **Proper governance and investment beliefs** — the way an investor engages with active management is critical

BEATING THE INDEX

If anything is clear, it is that "beating the market" is hard. Just as in the realm of the Red Queen in *Alice in Wonderland*, active management could involve doing an awful lot of work without getting anywhere. Not only this, but as the world changes, yesterday's wisdom becomes today's cliché. As the Gryphon in Alice remarked, "That's the reason they're called lessons, because they lessen from day to day."

There is, however, reason for optimism: Some active investment approaches have stood the test of time. We suggest that in some occasions, one should use active management, whereas in others, passive approaches make more sense. As an investor, you should ask yourself a number of key questions, and only when your beliefs are clear will it be clear whether active or passive management is the best choice.

BACKGROUND

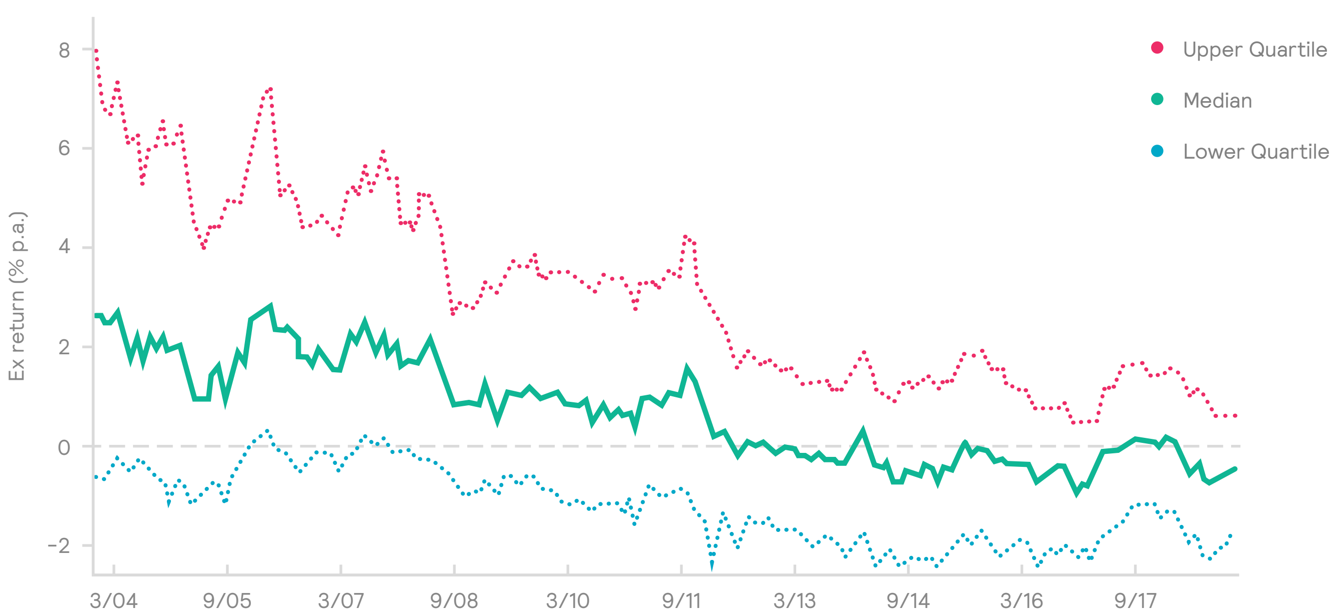
Since the first passive funds came to market in the 70s, we have witnessed an inexorable shift toward passive investment. Since the Global Financial Crisis, the policy-driven environment — where markets have been supported by extraordinary monetary policy measures — has frustrated stock-picking managers, who attempt to make money discerning the good from the bad. Junk rode up on the tide of quantitative easing along with everything else. Figure 1 shows that the median return from active global equity management has been mostly negative on a gross-of-fees basis since the Global Financial Crisis. If you want to grasp what has been a relentless march to passive, consider the following:

- For institutional European clients, the percentage of equity assets managed on a passive basis rose from 43% to 52% within the last five years, with the equivalent rise for fixed income assets from 37% to 51% (Mercer European Asset Allocation Survey).
- The 2018 Investment Company Factbook records a huge rise in assets under management globally for indexed funds, moving from $619 billion in 2008 to $3.4 trillion at year end 2017. Within the fund market (including exchange-traded funds), 35% is now indexed, compared to 15% in 2007.
- Net new cash flows to US indexed funds continue to be strongly positive, rising to $223 billion in 2017 (see Figure 2), with 27% of US equity mutual fund assets now in indexed equity, up from 14% in 2008.[1]

Figure 1: Median Excess Return of the Global Equity Universe

Rolling 3-year excess return vs. MSCI world free in USD (before fees) over 15 years ending December 2018

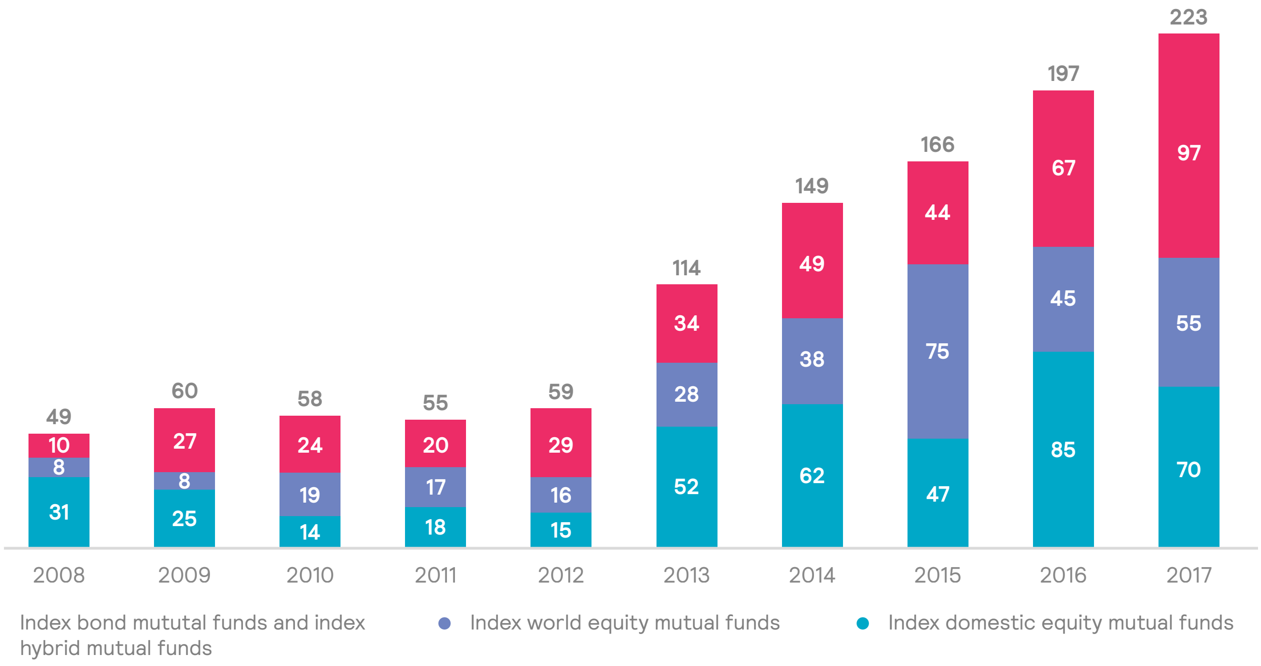
Comparison with the global equity universe



Source: MercerInsight

[1] *Investment Company Fact Book 2018. A Review of Facts and Trends in the Investment Company Industry, 58th edition* (Washington, DC: Investment Company Institute).

Figure 2: Net New Cash Flow to Index Mutual Funds (US$ billions)



Source: *Investment Company Fact Book 2018. A Review of Facts and Trends in the Investment Company Industry, 58th edition* (Washington, DC: Investment Company Institute).

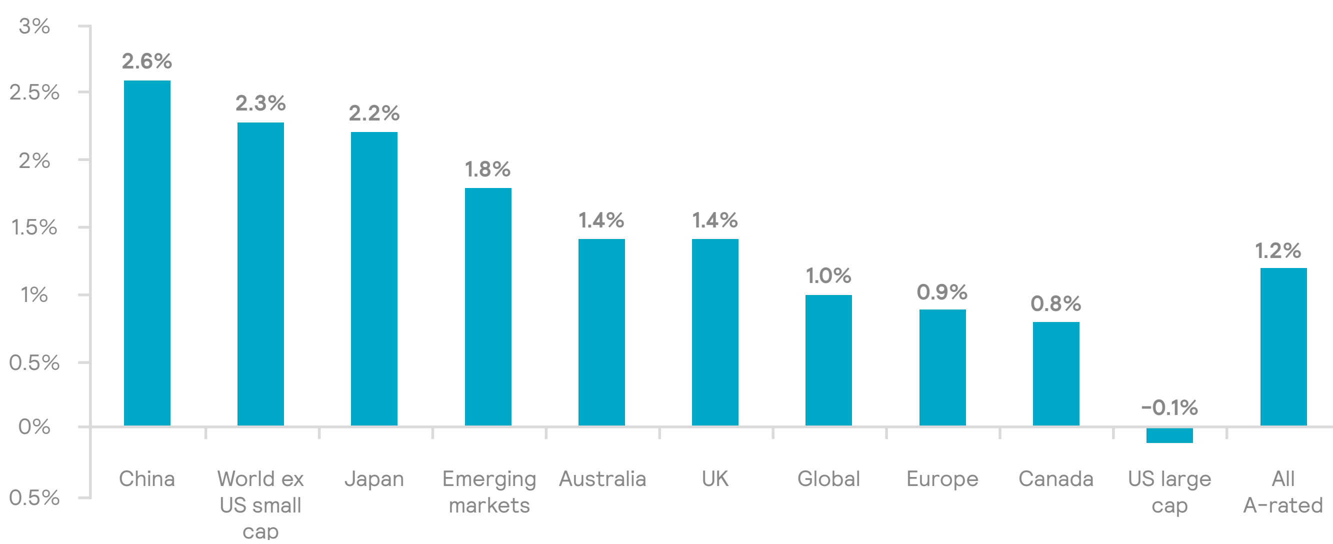
Note: Components may not add to the total because of rounding.

MERCER EXPERIENCE AND RELATIVE MARKET EFFICIENCY

We believe that by effective assessment of asset managers' capabilities and robust governance through the manager selection and monitoring process, it is possible to have a better than average chance of selecting good active managers. The sum of all active returns is the market return, and the average investor return from active management is therefore the market return minus fees. This investment truism can be disheartening but is offset by important caveats. First, non-professional investors take part in the market and are likely to underperform. Second, it is possible to use research to identify the best managers from the universe of professionals.

Our confidence in this is based on our record. We have 162[2] staff directly involved in the research process, many of whom have sat on the other side of the table, looking for teams with insight. In general, we have been able to do this (see statistics on our value added in Figure 3). Our record confirms what many say anecdotally: The US large cap equity market is relatively efficient and difficult to make money in, whereas small cap is a more fertile hunting ground, as many stocks are under-researched, particularly with the regulatory pressure on sell-side analysis. Emerging market stocks also benefit from lower analyst coverage, so proprietary research can add value; in addition, access to countries with high growth rates can lead to better opportunities for equities.

Figure 3: Mercer Value Added — Equity Regions and All A-Rated — Since Inception to December 31, 2018



Source: Mercer calculations, local currency excess returns. Performance is gross of investment management fees and certain other expenses. Past performance does not guarantee future results. Please see Important Notices for further information on value-added methodology.

[2] As of April 1, 2019.

TOP TIPS FOR FINDING RELIABLE OUTPERFORMANCE

ACTIVE SHARE

Even in the relatively efficient US market, a small pocket of investors has managed to deliver meaningful alpha over a long period. The managers in question had a relatively long time horizon and a high active share — active share meaning that they were willing to deviate significantly from the benchmark. This was the result of an academic study looking at mutual funds over a 24-year period to 2015[3] and also of Mercer's own analysis. We categorized managers into five quintiles based on the level of active share, and the results of the return analysis are as follows:

Returns 10 years to June 30, 2018 (% p.a.)	1st Quintile (low active share)	5th Quintile (high active share)
Global equity	7.1	9.0
Emerging markets equity	3.5	4.9
US large cap core equity	10.5	11.1

Source: MercerInsight

ACTIVE OWNERSHIP

Not all "alpha" or return from skill is about making better sense of the world than competitors (going to the same meetings, looking at the same financial statements and seeing something different). Sometimes excess returns can come from elbow grease/value creation — for example, where a real estate manager adds value by real economic activity, such as redeveloping properties, or where distressed debt investors restructure and refinance ailing businesses. Accessing this type of alpha is a relatively sturdy approach, as track records tend to be more reliable. We note that many of these approaches exist in markets where true passive approaches (holding all assets in an index) are not possible. Within more liquid markets — for example, equities — effective stewardship practices (such as voting and company engagement) can improve company and market outcomes.

PLAYING TO YOUR OWN STRENGTHS

Alpha can also be about leveraging your own characteristics as an investor — for example, many institutional investors are well placed to hold investments for longer. If markets are efficient in the short term, a manager with a longer horizon and an aligned investor should be able to beat them with sufficient insight. Longer-term investors with forecastable cash-flow needs can also benefit from premiums available from less liquid investments. Many such investors should ask themselves whether maintaining one month or less liquidity on 100% of their assets is prudent beyond reason.

[3] Cremers M, Pareek A. "Patient Capital Outperformance: The Investment Skill of High Active Share Managers Who Trade Infrequently," *Journal of Financial Economics*, Volume 122, Issue 2 (2016): pp. 288–306.
[4] Mercer analysis over 10 years to 2008 and 10 years to 2018.

PROPER GOVERNANCE AND INVESTMENT BELIEFS

YOUR DISCIPLINE AS AN INVESTOR MATTERS MORE THAN YOU THINK

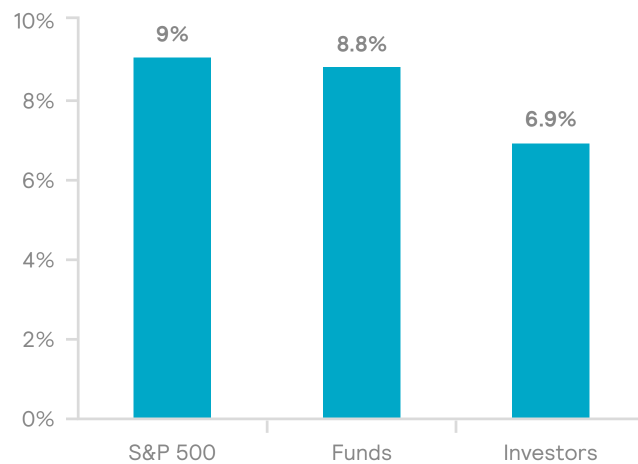
Overconfidence

A survey on self-reported ability once documented that 93% of US drivers felt they were of above-average ability at driving.[5] This is an extreme example of overconfidence bias, but it illustrates a characteristic that active managers can exhibit in their search for alpha, and investors can exhibit in their search for outperforming managers. If, as an investor, you employ active management, you must regularly reassess your own ability in hiring and firing managers and related governance processes. Be prepared to both allocate a substantial proportion of your governance budget to it and make difficult and often counterintuitive decisions (for example, holding onto an underperforming mandate or terminating an outperforming one). If you are governance constrained, consider expanding your resources, using portfolios that require less governance (such as passive ones) or delegating the ongoing mandate monitoring and maintenance.

Performance chasing can be dangerous

How investors engage with active management and how they make decisions can have a meaningful impact on outcomes. This is highlighted in a study of average mutual fund returns in US equity over a 23-year period ending 2015, compared to the average return investors actually got[6] (see Figure 4). In this study, although on average the funds delivered close to benchmark returns, the average investor received a significantly lower return. In essence, investors tend to make pro-cyclical decisions — hiring managers that have outperformed and firing managers that have underperformed. Another way in which the money-weighted return the investor receives can suffer is in the following scenario, where an initial "comfort" investment in a fund gathers good performance and is then ramped up, only for the full weight of an allocation to suffer poor performance.

Figure 4: Investor Return Gap (USD Returns)



Source: Hsu J, Myers B, Whitby R. "Timing Poorly: A Guide to Generating Poor Returns While Investing in Successful Strategies," Journal of Portfolio Management, Winter 2016.

In our paper from February 2019, we noted that over a five-year horizon, "past outperformers and past underperformers both have a close to random (50%) chance of outperforming in the future." This does not mean that there are not investment managers with persistent outperformance; it's more that picking on past outperformance alone is not a reliable method.

One reason for the result could be that portfolios maintain systematic return drivers (factors such as value or quality), which come in and out of favor. There may be reason to believe that non-systematic (or more truly skilful) excess returns are repeatable. When you find evidence of skillful return, you also have to assess whether the conditions for that success will remain — for example, will a successful culture avoid the trap of complacency and remain innovative? The bottom line: It's important to monitor and analyze performance and find where it truly comes from.

[5] Svenson O. "Are We All Less Risky and More Skilful Than Our Fellow Drivers?" *Acta Psychologica*. Volume 47, Issue 2 (1981): pp. 143–148.
[6] Hsu J, Myers B, Whitby R. "Timing Poorly: A Guide to Generating Poor Returns While Investing in Successful Strategies," *Journal of Portfolio Management*, Winter 2016.

MONITOR PERFORMANCE EFFECTIVELY (QUANTITATIVELY AND QUALITATIVELY AGAINST A PRIORI EXPECTATIONS)

Patience is a definite virtue in monitoring investment managers, as is understanding the pattern of performance an investment is likely to have. If you are invested with a deep-value manager in a period where value stocks underperform, you shouldn't be surprised by underperformance of a broader index. You should wait for the thesis to play out. Always keep in mind how the manager said it would perform, including the key risks outlined before you appointed the manager. Monitor the manager against what it said it would do — which will often involve monitoring the manager in several areas, both quantitative and subjective.

A good monitoring process will record the original reasons for investing in a portfolio of assets and retain this information in the live documents/dashboards that form part of the monitoring process. This guards against the situation in which a supervisory group undergoes personnel turnover and the original rationale is lost.

PAY AN APPROPRIATE FEE

Once you've found a strategy that you believe has a good probability of outperforming a relevant index or peer group, you need to assess whether the fees you pay are appropriate. Mercer has developed a framework for assessing value for money from manager fees, based on expected return from active management, aligned share of expected outperformance and relating the fee to a passive equivalent. The expected return from active management should be set realistically and is likely to be lower than a fund's stated performance target.

We have noted in previous sections that an investor should be aware of a portfolio's factor exposures. Factors or systematic return exposures can be attractive sources of excess return; however, due to their systematic nature, exposure can be obtained relatively cheaply. Make sure a manager is adding value in its management of factors and not simply achieving an unsophisticated factor exposure at a higher than necessary price.

Some types of funds can charge a performance fee (in addition to the base fee), where the manager shares more of the gains than the pain, and this may incentivize the wrong type of behavior — taking excessive risk, as the manager is not worried about the pain, or taking less risk than appropriate to "bank" a performance fee. An example of a better way to structure such fees would be to introduce symmetry, such that a manager's fee decreases from the base if underperformance occurs.

CONCLUSION

In the introduction, we highlighted three critical areas in the debate over whether to use active or passive management.

- **Beating the index.** Despite the momentum behind passive investing and some investor fatigue regarding active management, we showed evidence that our manager research has a good record of identifying successful managers.

- **Top tips for finding reliable outperformance.** Although it is true that all active positions sum to the market, and that the average active investor therefore underperforms the index after fees, we believe that professional investors have an advantage over non-professional investors, and that it's possible to identify types of active managers that have a better chance — for example, the average high active share manager does not underperform the index after fees. We also made the case for more activist investment while noting that fewer opportunities for such investment are found in liquid markets, where true passive options exist.

- **Proper governance and investment beliefs.** In terms of return erosion, this is perhaps the most important of the three areas. Behavioral biases can lead investors to experience money-weighted returns that are less than the time-weighted returns of their active managers, and common behaviors — such as performance chasing — impede desired outcomes.

When considering whether to employ active or passive management, we find that:

- **The market matters.** Within equities, the US tends to be the most efficient and therefore least conducive to active management, whereas small cap and emerging markets tend to be less efficient. Also, investments that offer a true ability to add value via active ownership, in terms of both governance and real economic activity, are attractive alpha sources.

- **The manager matters.** Having a robust process for identifying the managers with the best chance of success is critical. An example from a strategy perspective are equity managers that have a longer time horizon and exhibit high active share. Business habits matter: Does a manager co-invest/eat its own cooking (important everywhere, but particularly in private markets)? Does the manager have a well-structured and stable business that incentivizes employees? Does the manager take operational risk seriously?

- **The investor matters.** Discipline and self-awareness are important. Avoiding an over-focus on pure performance numbers and ongoing monitoring of managers against both qualitative and quantitative targets set at inception are both crucial to getting the best from active management. Couple a proper governance and monitoring process and a sufficient time horizon with the ability to make taxing and often behaviorally difficult decisions.

- **Fees matter.** Passive management is a commoditized service and available cheaply; higher fees can be an appreciable drag on returns. Make sure you pay fees that are well structured (fees are not just a number) and have a relationship with the amount and quality of work the manager is doing and the expected return from active management.

Find where active management has worked best, align with your manager, consider the structural problems in benchmark indices and be prepared to roll up your sleeves.

ABOUT MERCER

At Mercer, we make a difference in the lives of more than 115 million people every day by advancing their health, wealth, and careers. We're in the business of creating more secure and rewarding futures for our clients and their employees — whether we're designing affordable health plans, assuring income for retirement or aligning workers with workforce needs. Using analysis and insights as catalysts for change, we anticipate and understand the individual impact of business decisions, now and in the future. We see people's current and future needs through a lens of innovation, and our holistic view, specialized expertise, and deep analytical rigour underpin each and every idea and solution we offer. For more than 70 years, we've turned our insights into actions, enabling people around the globe to live, work, and retire well. At Mercer, we say Make Tomorrow, Today.

HOW MERCER CAN HELP

Wealth and investment require sophisticated solutions. We offer research and advice on how to assess risk and design Wealth and investment require sophisticated solutions. We offer research and advice on how to assess risk and design investment strategies while keeping in mind the need to optimize throughout changing times. Along with more than 140 manager researcher with in-depth knowledge of the complexities and ever-changing factors that impact investment, Mercer's consultants can help you make effective decisions that align with your business needs and ensure more rewarding futures for your employees.

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