Mercer

Budgeting for Active Management

Not a One Size for All Exercise

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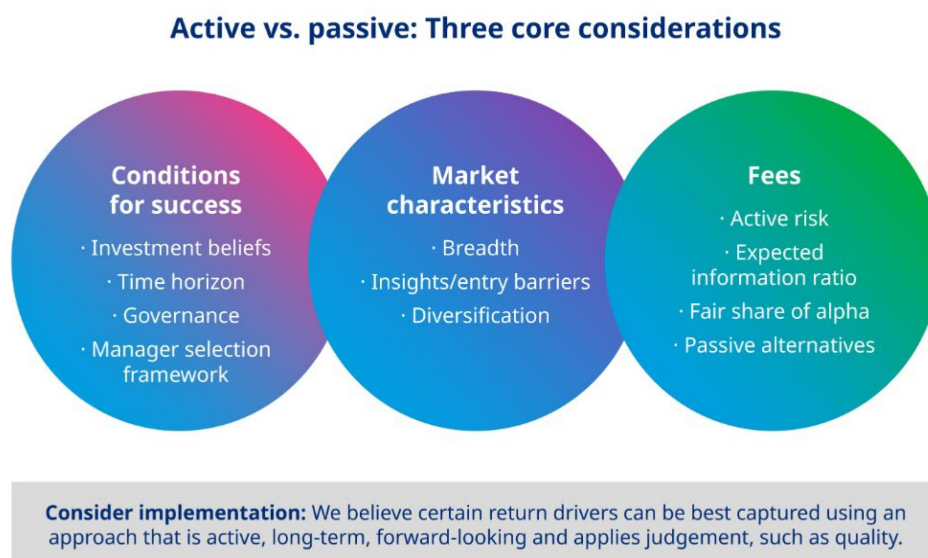
Budgeting for Active Management – Not a one size for all exercise

Much has been written about the relative merits of active and passive management. Numerous studies have documented the alpha opportunity[1] in active management across asset classes, regions and investment styles. However, there has been little discussion of the key factors that we believe help to frame allocation decisions on when and where to include both active and passive management strategies in a portfolio. Mercer's Equity Guiding Principles outline where to invest actively based on some critical considerations: the conditions for success from a governance standpoint, the characteristics of each market, and fees. In this paper, we expand on the conditions for success with a focus on asset-owner capabilities and values, as we frame what we believe are the key considerations in deciding when and how much active or passive management to use in an investment program.

Figure 1. Equity portfolio construction



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[1] Quantitative studies on active/passive
Mercer Active vs Passive, May 2019 - https://www.mercer.com/our-thinking/wealth/active-versus-passive.html
Morningstar's U.S. Active/Passive Barometer, September 2022 - https://www.morningstar.com/lp/active-passive-barometer
S&P Dow Jones Indices, SPIVA® - https://www.spglobal.com/spdji/en/research-insights/spiva/

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Governance

In our experience, the most critical factor that drives successful long-term active management is the asset-owner decision-making group itself (usually the investment committee). This group can add or subtract more value in larger increments than any underlying investment manager. Knowing when to hire and fire managers can often be more important than the actual manager selection. Decisions on where to invest and what types of managers to hire will also have a greater impact on total results than any individual manager. Governance is the broad term we use to capture holistic decision-making at the asset-owner level.

A key first step is understanding the investment committee's governance structure and its implications for portfolio construction. Committee member composition, tenure, knowledge, engagement and investment beliefs all influence decisions. Very large committees and those with limited tenure or engagement are likely to question prior decisions more frequently, which may lead to shorter time horizons and consensus decisions that lack conviction. A strong committee chair can overcome some of these issues, but it will be more challenging than for smaller, more engaged and tenured committees that have more conviction in their managers and prior investment decisions. Additionally, the more fragmented a committee's investment beliefs, the harder it will be to stick with a strategy that is underperforming for a period of time.

It is critical that the committee understand several important elements concerning the managers in their portfolio. These include how a manager builds portfolios and what role that manager plays within the overall portfolio.

Understanding how a manager constructs portfolios illustrates the manager's attitude toward risk management, both relative to benchmarks and in an absolute sense. Managers that take on significant risk, whether sector or security concentration, often perform well when their style is in favor and markets are rising, but may underperform dramatically when their style is out of favor or markets are falling. Other managers, even within the same style, pay more attention to downside risk. These managers are likely to have a performance pattern that differs significantly from those of managers with greater upside capture. These performance patterns speak to the roles that managers serve in a portfolio. Having managers with complementary styles or performance patterns helps minimize the overall volatility of performance from active managers. But this means that, in all likelihood, there will always be some managers that are underperforming. If this is understood and expected, there does not need to be too much time spent reviewing underperforming managers when they have performed in line with expectations.

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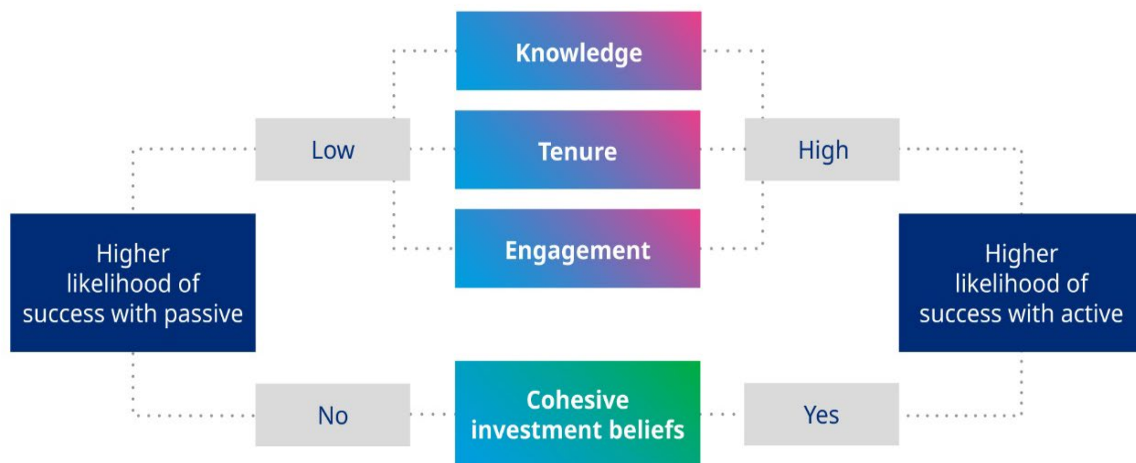
Figure 2. Governance process



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Investment Program Complexity

Investment programs range from relatively straightforward to complex. At one end are simple investment programs that consist mainly of publicly-traded stocks, bonds and cash. At the other end are complex programs that invest heavily in private markets, hedge funds and other alternatives. There are a few key differences among these programs that can help determine the allocation to passive strategies:

1. Complex investment programs tend to have higher return expectations than simple investment programs typically driven by the higher return expectations from private market allocations. Investment programs without private markets or other alternative allocations normally need a greater allocation to growth assets (e.g., equities, high yield) and/or will have to rely more on manager alpha to enhance returns.
2. The use of alternatives significantly increases resource requirements to select and monitor the managers, complete documents, manage capital calls and distributions, and review and vote on amendments. For this reason, investors with significant allocations to alternatives may want to simplify the publicly traded portion of their investment programs through the use of more low-cost index funds, particularly in areas where the value-add potential is small.
3. Fees for private markets, hedge funds and other alternatives are higher than those for publicly traded stock and bond strategies. If there is a desire to reduce fees, it is most easily accomplished within publicly traded strategies through the use of index funds.

Some investment committees may want to generate as much return potential as possible from all areas of the portfolio, embracing complexity throughout the investment program, including the publicly traded portions. There are pros and cons to doing so. Complex public market structures allow for the use of high-conviction specialist managers that have greater alpha potential over the long term. If well-constructed, there is potential to add meaningful alpha while minimizing portfolio volatility. However, the more active decisions that are made, the lower the decision quality may be, which could hurt alpha potential. Whether or not an investment committee can benefit from complex portfolio structures across the public and private portions of their investment program will depend on the governance structure, particularly the resources available to make manager selection and portfolio decisions.

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Time Horizon for Evaluating Investment Managers

The longer the time horizon, the more likely it is that an investment committee will achieve success with active managers. All investment managers go through periods of underperformance. An investment committee that is overly concerned with poor performance during a quarter, one- or three-year period will find it more difficult to stick with underperforming managers and will be more prone to selecting managers based on performance, which is often counterproductive. Even very good managers are likely to underperform over a three- to five-year period, especially if their investment style is out of favor. The key is to understand a manager's approach, when they are likely to outperform or underperform, and ensure that the time horizon for evaluating performance is sufficiently long. There are some rules of thumb on time horizons – often it is three years, but equally often this is not long enough. Every market cycle is different, so understanding the manager's strategy and performance in the context of the market environment is important.

Alpha Goals

Most clients have return goals which vary by client type. These goals could be based on spend rate, an operating budget or an Expected Return on Assets assumption. Often these return goals are in the range of 5.0%-7.5%. While interest rates have risen from historic lows, they remain low relative to return goals. If clients are seeking to match or exceed their return goals, alpha potential from the use of active managers may be critical.

Tracking Error Sensitivity

Tracking error refers to the manager's return less the return of the appropriate benchmark. Within the active manager universe, there are high- and low-tracking-error managers. Index funds have near-zero tracking error. High-tracking-error managers may deliver substantial alpha but tend to underperform their benchmarks by large amounts, sometimes over long periods. Low-tracking-error managers perform closer to the benchmark, whether they underperform or outperform. The use of high- or low-tracking-error managers is dependent on the investor's governance structure and ability to withstand periods of underperformance without changing managers. The greater an investor's sensitivity to tracking error, the more that should be allocated to passive or low-tracking-error strategies.

Fee Sensitivity

Investment manager performance should be evaluated after fees – in other words, the value derived for the fees paid. Fees for separate accounts and commingled accounts are typically on a sliding scale. The larger the allocation to the manager, the lower the fee as a percentage of the assets. The comparison should be made relative to the fees a particular investor pays. Nonetheless, even low-cost active manager fees are more expensive than passive management fees. Some investors are very sensitive to fees regardless of performance or have tight fee budgets. The more sensitive investors are to fees, the more they should allocate to low-cost index funds. However, this requires acknowledging the limitations this places on alpha potential.

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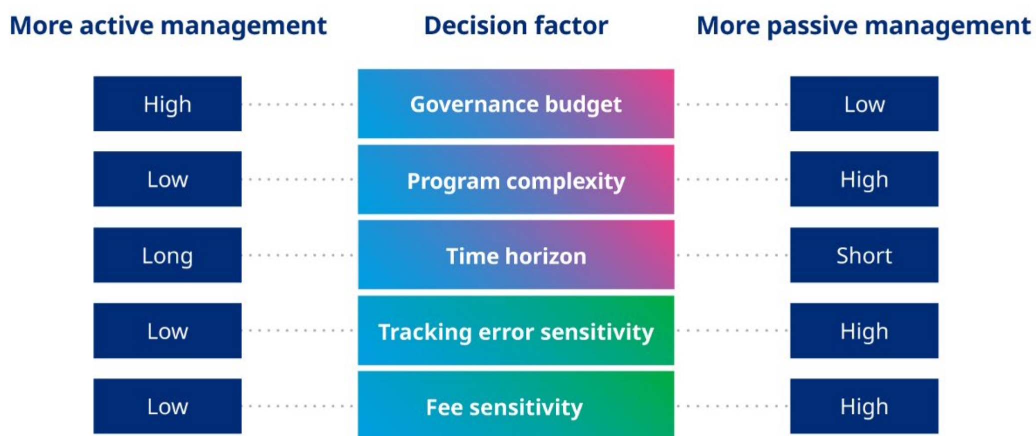
Summary

These key factors are all interrelated. Together with the studies on the alpha potential in different market segments, these factors will decide the optimal allocation balance between active and passive strategies. Considering each factor independently, however, helps to prioritize goals and frame the decision.

One of the major factors we mention as a component of the active management decision is governance resources. This is one thing that can be enhanced through an OCIO relationship, which can provide a very robust governance process based on each client's overall needs and tolerance. It can also lower the fee hurdle and manage complexity.

Figure 3. Decision tree



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Portfolio expectations are forward looking and reflective of Mercer's capital market assumptions, as defined by asset class and incorporating return, standard deviation, and correlations. Our process for setting asset class expected returns begins with developing an estimate of the long term normal level of economic growth and inflation. From these two key assumptions, we develop an estimate for corporate earnings growth and the natural level of interest rates. From these values, we can then determine the expected long term return of the core asset classes, equity and government bonds. We combine current valuations with our expectations for long term normal valuations and incorporate a reversion to normal valuations over a period of up to five years. Volatility and correlation assumptions are based more directly on historical experience except in cases in which the market environment has clearly changed. Manager impact on performance is not incorporated into expectations. The views expressed are provided for discussion purposes and do not provide any assurance or guarantee of future returns.

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