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## We Are All Active Investors Now

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By Larry Hatheway      Thu, May 16, 2019

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*'The biggest mistake investors could make in today's environment is to seek a safe haven in balanced portfolios of stocks and bonds,' writes the chief economist at GAM Holding.*

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Investors have long debated whether their portfolios should be actively managed or passively track a market index. But that discussion is becoming a sideshow. Attention is shifting to what matters most: the active *decisions* about strategic asset allocation that largely determine subsequent investment returns.

To paraphrase Milton Friedman in the 1960s, we are all active now.

True, passive global exchange-traded funds (ETFs) have experienced explosive growth—from just over \$200 billion in assets in 2003 to more than \$4.6 trillion last year—which has enabled them to gain market share from more expensive actively managed funds. And investors should always take the lower-cost option if paying higher fees for an active fund brings little additional value (especially during bull markets, when simply being in the game can yield outsize returns).

Yet the rapid rise of low-cost ETFs has had two other important effects on investment management.

First, active management fees have come under pressure, particularly for weaker-performing funds. For example, the proportion of hedge fund managers charging “two and twenty” fees—a 2% management fee plus 20% of any profits earned—has fallen below one-third. Given mediocre hedge fund performance over the past decade and the emergence of liquid alternatives, it’s surprising that fees haven’t fallen further. Moreover, average fees for active funds across all investment strategies fell from about 1% in 2000 to 0.72% in 2017, a downward trend that shows no signs of abating.

Second, the proliferation of ETFs has blurred the distinction between passive and low-cost investing. Strictly speaking, a passive strategy is one that continuously rebalances a portfolio to track a market-capitalization-weighted index. Yet many ETFs go well beyond this textbook definition by offering investors exposure to particular regions, sectors, factors, or types of credit, as well as a multitude of other “sub-market” criteria. These funds are not passive, but rather instruments for expressing active investment views inexpensively.

But now ETFs themselves face challenges. Several decades ago, the advent of cheaper investment vehicles, including ETFs, boosted investors' net returns. Between 1979 and 1992, for example, the average weighted retail mutual-fund expense ratio was about 1.5% (including sales load fee). But with the average fee on actively managed funds now below 75 basis points, versus about 44 basis points for ETFs, the "excess return" to ETFs is falling.

What's more, the rapid expansion of ETFs coincided with bull markets. Index performance largely dictated security selection, and asset allocation meant little more than piling into stocks, bonds, and credit. But those days are probably over. Further sustained market advances are unlikely, given stretched stock and bond valuations, slowing economic and earnings growth, and heightened political and policy uncertainty. Broad market returns are likely to be lower, with episodes of volatility probably more frequent.

In a world of lower returns and a narrowing fee gap between active and passive investment vehicles, investors must shift their emphasis from cheap market access to proper portfolio construction. After all, the choice of which asset-allocation strategy to pursue determines most of an investment portfolio's return. Other factors, such as tactical asset allocation or the choice of instrument, are of secondary importance and may account for less than 10% of portfolio variance.

The biggest mistake investors could make in today's environment is to seek a safe haven in "balanced" portfolios of stocks and bonds. Both asset classes suffer from unattractive valuations and deteriorating fundamentals. It beggars belief to think that holding a roughly equal proportion of each will deliver satisfactory results.

Instead, investors must recognize that lower risk-adjusted returns—as reflected in falling Sharpe ratios—and shifting market correlations place a premium on genuine diversification and loss avoidance. Diversification requires investors to pay attention to market, factor, and non-directional sources of return, and also to focus on volatility and correlation. Avoiding losses calls for flexible decision-making to cut exposures when necessary.

Some of the instruments that investors need to diversify and avoid losses may well be low-cost. But many of them, including long/short or alternative risk-premium strategies, are unlikely to be found in the ETF universe. A blended approach is therefore likely to provide the greatest diversification benefits.

Rather than worrying about whether their portfolios are actively or passively managed, investors should focus on the crucial decision of strategic asset allocation. The tired active-

passive investment debate has run its course. We truly are all active investors now.

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