CHAPTER 1

The Beauty of Simplicity – The Rise of Passive Investments

In the old days, asset management was a pretty straightforward business: A fund manager, skilled and equipped with the ability to find attractive deals and investments in the financial markets, took care of the investor's money and got in exchange a decent fee and tried to increase profit. The majority of fund providers or portfolio managers in the asset management industry tried to pick attractive stocks, bonds or other securities, to decide when to move into or out of markets or market sectors, and to place leveraged bets on the future direction of securities and markets with options, futures and other derivatives. Their objective over the year was to make a nice profit, and, sometimes by chance, to do better than they would have done if they simply accepted average market returns.

In pursuing their objectives, active managers searched out information they believed to be valuable, employed legions of research analysts in all parts of the world, and often developed complex or proprietary selection and trading systems. Active management encompasses hundreds of different methods, and includes fundamental analysis, technical analysis (interpreting charts) and macroeconomic analysis, and all of these have in common an attempt to determine profitable future investment trends. But don't be too impressed: if one looks behind the curtain, in some cases a "proprietary selection" is often nothing more than a simple play with Bloomberg's equity screening and its back-testing tools or one of replicating the investment strategy of a competitor firm.

OUTPERFORMANCE – A TOUGH CHALLENGE

In the mid-1970s, change came to the active asset management world. Not radical change, but the active world faced some competition for the first time from the pure, minimalistic approach of passive investing, namely the index fund. As described in detail in the next chapters, at this time the first generation of passive investments was born. An index fund provides investors with a return and performance equaling the underlying market. The market is effectively a well-known benchmark index like the S&P 500®, Euro STOXX 50®, FTSE100® or the DAX®. While the idea of consistent, market-beating returns that transform a smaller initial investment into greater wealth was and is still attractive to millions of investors, the reality over the last decade shows clear evidence that outperforming broad markets over longer periods of time has become more and more challenging. A matrix of the best-performing asset classes in each year or the hot stocks of one year will often become poor performers in the following year.

As a result, settling for achieving, rather than exceeding, market return is an increasingly popular option. Rather than trying to guess which investments will outperform in the future, index fund managers try simply to replicate the gains in a particular market, sector or, nowadays, factor. This means that they invest in all or most of the securities in the index – a technique called "indexing". Also, increasingly volatile markets, shifting correlations and the most recent disruptive interventions of many central banks have made it even more challenging for active managers to correctly predict the winning stocks or assets and to outperform the market or a sector. Therefore, many investors who are looking for exposure to broad markets and low costs switch to passive investment products.

INSTITUTIONAL INVESTORS: A SMALL CHANGE IN ALLOCATIONS, A BIG STEP FOR PASSIVE INVESTMENTS

Despite the massive rise of passive investments, active managers will probably not become the dinosaurs of the financial industry as smart investment ideas always stay in fashion. Particularly in some exotic investment spaces like Frontier Markets, Small Caps or Alternative Investments, skilled active managers have good chances to generate extraordinary returns. However, the broader the market, the more rapidly the chances of delivering returns that outpace market returns are diminishing. Also, buy-side investors are more and more sensitive with regard to costs and outperformance over time. Thrifty retail investors, with no sizeable amount of assets that would justify hiring a smart investment advisor, stick more and more to passive products like ETFs for their core investments. Sophisticated institutional clients like pension trusts, endowments and other "big dollar investors" are increasingly reviewing their investment mandates to decide whether their external managers effectively run a truly active managed portfolio – and therefore are justified to charge higher management fees compared with a passive mandate – or merely replicate an ordinary index.

Although the majority of fund assets are still actively managed, there has been some decrease in allocation to active funds over the past three or four years, according to the ETF sell-side. Mostly after the financial turmoil in 2008, the institutional world became more receptive to passive investments – though they did not switch every single one of their assets into ETFs. Of course, that is a story that the ETF industry often tends to tell a bit differently. According to the latest issue of the US Institutional Investor Brandscape® report, one of the most detailed surveys of institutional ETF usage, published by Cogent Research in spring 2016, the vast majority of pension investors, over 95%, still incorporate actively managed strategies in their institutional portfolios. There is a similar picture in Europe. In the 2016 edition of Mercer's European Asset Allocation Survey, which reflects data and feedback from nearly 1,100 institutional investors across 14 countries representing assets of around €930 billion, only 3% of participants in the survey reported any direct exposure to ETFs. This means that €28 billion from these institutional market participants is invested in ETFs already.

NOT ALL "BIG GUYS" LOVE ETFS

A detailed picture of the current state of active vs. passive investment styles can be painted based on the US Institutional Investor Brandscape®[1]: Figures 1.1 to 1.4, which show the results of the 405 investors managing $20 million or more in institutional investable assets, show that the use of active management varies little by asset size, ranging from 93% among pensions managing between $250 million and $1 billion in assets to 100% of the $1 billion-plus pensions. Interestingly, when questioned about their current usage of passively managed strategies, only 68% of the pension plans in 2016 report that they are using them, down from 81% in 2014. Notably, the use of passive investments is lowest among the cohort of smallest pensions, as just 54% of pensions managing less than $100 million in assets invest in passive instruments. Conversely, pension plans managing larger assets are much more likely to allocate at least a portion of their assets into passive products or to devote some portion of their assets to passive strategies (90% of pensions managing between $250 million and $1 billion in assets and 82% of $1 billion-plus pensions). Corporate pensions appear to be driving the decrease in use of passive investments. Some experts assume this might be a reflection of the reliance on liability-driven investment strategies among this cohort of the pension market.

In the non-profit world, where 89% of organizations utilize actively managed strategies, the picture seems similar as regards a decreased usage of passive strategies, and this decrease appears to be driven by the smaller

		$20M–<$100M	$100M–<$250M	$250M–<$1B	$1B+	Corporate DB	Public DB & Taft-Hartley
Active	95%	94%	98%	93%	100%	90%	100%
Passive	68%▼'14	54%	64%	90%	82%	67%▼'14	73%
Other	78%▼'14	73%	73%	83%	91%	75%▼'14	83%

Low High
Key ≤63% 64% to 72% 73% to 82% 83% to 91% ≥92%

▲/▼=Significant change from stated year
△/▽ =Significant change observed in 2014 sustained in 2015
Base: All pensions

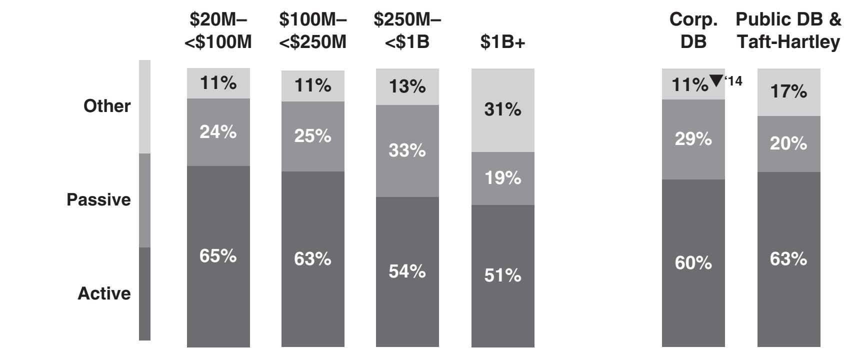
FIGURE 1.1 Usage of Active vs. Passive Strategies – Pension Assets
Source: Market Strategies International, "The Pull of Active Management – Examining the Use of Active vs. Passive Strategies in the Institutional Marketplace", April 2016

		$20M–<$100M	$100M–<$250M	$250M–<$1B	$1B+	Endowment	Foundation	TEO
Active	89%	85%	95%	99%	100%	93%	86%	89%
Passive	59%▼'14	56%▼'14	63%▼'14	66%	67%	63%	75%▲'13	48%
Other	88%▼'14	88%	84%	90%	97%	85%▼'13	95%	85%

Low High
Key ≤58% 59% to 69% 70% to 79% 80% to 90% ≥91%

▲/▼= Significant change from stated year
△/▽ = Significant change observed in 2014 sustained in 2015
Base: All non-profits

FIGURE 1.2 Usage of Active vs. Passive Strategies – Non-Profits
Source: Market Strategies International, "The Pull of Active Management – Examining the Use of Active vs. Passive Strategies in the Institutional Marketplace", April 2016



▲/▼= Significant change from stated year
△/▽ = Significant change observed in 2014 sustained in 2015
Base: All pensions

FIGURE 1.3 Proportion of Active vs. Passive – Pension Assets
Source: Market Strategies International, "The Pull of Active Management – Examining the Use of Active vs. Passive Strategies in the Institutional Marketplace", April 2016

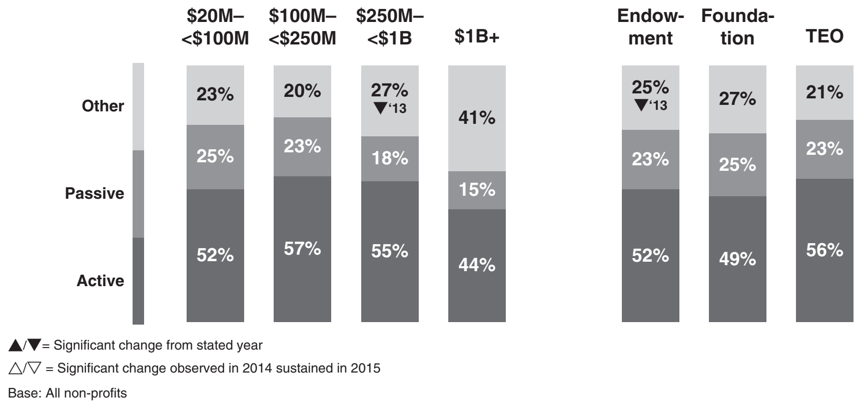


FIGURE 1.4 Proportion of Active vs. Passive – Non-Profits
Source: Market Strategies International, "The Pull of Active Management – Examining the Use of Active vs. Passive Strategies in the Institutional Marketplace", April 2016

institutions which manage less than $250 million in assets. However, there is a growing fan base among the non-profits: foundations report an increase in their use of passive strategies compared with 2013, and are the only segment of the non-profit market to have boosted their use of passive management over the past three years. The use of other asset classes is more prevalent among non-profits (88%) than among pensions (78%) and is noticeably higher among the $1 billion-plus segment. In addition, 95% of foundations incorporate these asset classes in their portfolios – that is higher than any other type of institution.

One aspect that has not changed is what drives asset allocation changes. Institutional investors continue to follow two divergent paths: the focus of pensions is very clearly on de-risking, while non-profits seek higher returns and further diversification. Thus asset managers serving the institutional market need to employ dramatically different strategies, with distinct product offerings to retain and cultivate existing relationships and position themselves effectively for consideration for future mandates.

NOTE

1. Market Strategies International, 2016