



# Combining active and passive managements in a portfolio

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In recent years, established ideas on portfolio construction have been called into question. Investors can now choose from a range of 'smart beta' strategies, offering exposure to market risk premia in a systematic, transparent fashion. Where does the dividing line between active and passive fund management lie today? What is the future role of active managers? As indices evolve, how should standard, capitalisation-weighted benchmarks be used?

In this Expert Opinion, Nicolas Gausse, Chief Investment Officer at Lyxor Asset Management and Arnaud Llinas, Lyxor's Head of ETFs and Indexing, share their views on these important questions.

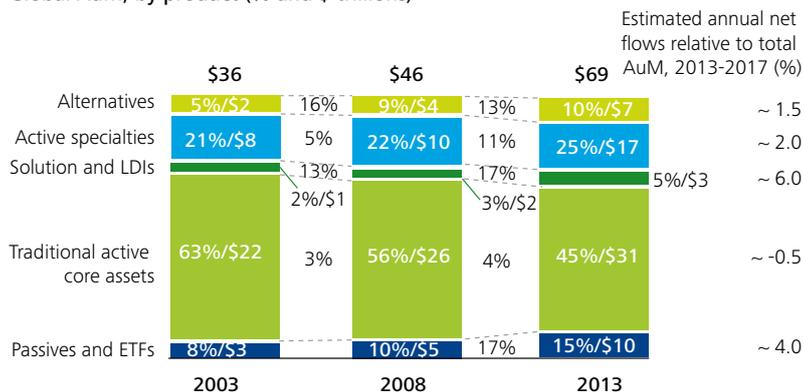
**Traditional "core" active management is shrinking**

**Nicolas Gausse:** One trend that has dominated asset management since the turn of the millennium is the shift in assets away from traditional, "core" active mandates. Investors worldwide have been moving away from traditional active management into alternatives, dedicated active mandates, solutions and liability-driven investment (LDI) schemes. There has also been a big rise in passive funds within allocations, including exchange-traded funds (ETFs).

- Passive and active funds are complementary for portfolio construction.
- Future portfolios will include a substantial allocation to smart beta, as well as to traditional beta and to active management (alpha)
- Combining traditional beta, smart beta and alternatives in a portfolio offers investors effective solutions
- Passive funds provide investors with extensive access to a wide range of asset classes with cost advantages

**The Shrinking Core**

Global AuM, by product (% and \$ trillions)



We are witnessing a polarisation of the asset management market: increased demand for specialist active management, on the one hand, and growing demand for passive mandates on the other. Traditional active managers are under increasing pressure to justify their roles.

Active core assets are expected to shrink to about 40 percent of global AuM by 2017.

### Passive funds are growing

**Arnaud Llinas:** Based on commonly observed market practices, we noted that passive mandates and ETFs had grown from \$3 trillion to \$10 trillion in assets under management between 2003 and 2013, this market segment is expected to continue growing healthily.

We think there are four explanations for this trend.

**First**, active managers continue to perform below their benchmarks in aggregate. According to a recent study by Marlène Hassine, Lyxor's Head of ETF Research, only 21% of active funds on average outperformed their benchmark over the last 10 years. The evidence indicates that there is little consistency in performance over time: managers that beat the benchmark in one year thus have a poor chance of doing the same the next year. (See Figure below)

**Second**, passive funds, including ETFs, have a clear cost advantage over active funds, leading many investors to decide that they would prefer to track an index rather than try to beat it. Of course it's fair to point out that passive funds don't replicate their indices exactly. Other things being equal, they will trail it by their annual management costs. However, passive funds' costs are relatively low and have been decreasing steadily.

**Third**, passive funds now offer access to a broad range of asset classes with a high degree of granularity, offering investors significant choice. Passive funds are typically highly diversified, giving wide access to individual market segments.

**Fourth**, smart beta investment strategies, codified as indices, allowing replication in a systematic, transparent method—is an increasingly important phenomenon.

### 10-year performance/volatility comparison between active funds and the index

	Performance		Volatility		% Active funds outperforming the benchmark
	Index	Active funds*	Index	Active funds*	
France Large Caps	5,4 %	4,9 %	16 %	16,5 %	16 %
France Smid Caps	8.8%	8.7%	18.1%	16.7%	38%
UK Equity	6,7 %	6,7 %	13,8 %	14,3 %	34 %
EUR Large + Mid Caps	6,3 %	6,3 %	14,4 %	15,3 %	31 %
Europe Small Caps	10.2%	9.4%	18.5%	18.0%	26%
US Large + Mid Caps	6,1 %	5,6 %	12,9 %	13,6 %	13 %
Japan Equity	2,0 %	0,3 %	14,3 %	15,0 %	13 %
World Equity	6,0 %	5,8 %	12,5 %	13,7 %	20 %
Value Equity	5.7%	6,2 %	13.0%	13,9 %	27%
Global Em Equity	10,6 %	8,8 %	19,5 %	20,0 %	27 %
China Equity	12,3 %	12,3 %	23,4 %	21,6 %	13 %
EUR Govies	4,7 %	4,0 %	4,1 %	3,9 %	24 %
EUR Corporate	4,7 %	4,3 %	3,9 %	4,3 %	21 %
EUR High Yield	N/a	n/a	n/a	n/a	n/a
Emerging Debt	8,7 %	5,1 %	9,0 %	9,2 %	0 %

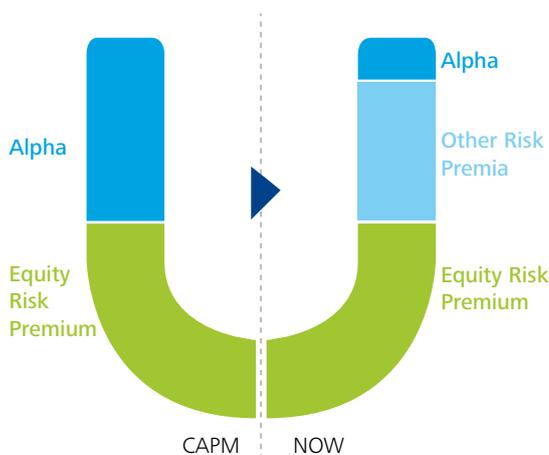
Source: "Active Funds vs. Benchmark", Marlène Hassine, Head of ETF Research, Lyxor AM, November 2014. Research based on Morningstar data and fund categories from 30/6/2004 to 30/6/2014.

### Smart beta expands the definition of Passive

**Arnaud Llinas:** Smart beta is expanding the traditional definition of passive investing, offering a valuable new tool to investors. Various types of traditional portfolio strategies by active investment managers can now be replicated efficiently and at low cost via smart beta indices. In other words, passive funds are increasingly being used to give exposure to strategies that were historically offered only in an active format. To some extent, smart beta is also likely to replace some of investors' traditional allocation to passive funds, tracking indices weighted by market capitalisation.

In a recent Expert Opinion from Lyxor<sup>1</sup>, Thierry Roncalli, Lyxor's Director of Research, provided an overview of the concept of risk factors. Risk factors help us understand the performance of equities and other asset classes, and an increasing number of smart beta indices offer exposure to individual risk factors. There are other popular types of smart beta indices, including those focusing on the reweighting of index constituents, on particular investment styles or on specific risk outcomes e.g. minimising volatility. In the future, we think that many portfolios will include a significant allocation to smart beta, as well as to traditional beta and to active management alpha.

### Smart Beta Gains Ground



Source: Lyxor AM, for illustrative purposes only.

### Alternatives offer uncorrelated risk premia

**Nicolas Gausse:** It may seem paradoxical that the demand for alternative asset management structures, such as hedge funds, has been increasing in the midst of this boom for indexing and passive solutions—yet investor inflows into alternatives have been very strong. Another study, conducted by Cliffwater and Lyxor, found that the weighting of alternatives in U.S. state pension funds has more than doubled recently, from 10% in 2006 to 24% in 2013<sup>2</sup>. Despite a period of great volatility in asset markets and negative headlines associated with some hedge funds, investors continue to be attracted by alternatives' ability to generate attractive risk-adjusted returns. Over the period between 2001 and 2014, U.S. equities (the S&P 500 index) and U.S. government bonds (the Citigroup US GB 7-10 year index) and hedge funds (in the form of the HFRI index) all gave total returns of around 6% a year.

But while U.S. equities had annual volatility of around 15% over the period, hedge funds had bond-like volatility of around 6%. Hedge fund returns were also negatively correlated to bond returns, and only weakly correlated to those of equities. These statistics reinforce the central attraction of alternatives: they can act as an effective portfolio diversifier, offering uncorrelated risk premia—the result of hedge funds' exposure to non-traditional asset classes.

### Risk/Return of Equities/Bonds/Alternatives

31/03/2001 -31/08/2014	S&P 500 TR	Citigroup US GBI 7 to 10 year	HFRI
Return	6.22%	5.88%	6.21%
Vol	15.06%	6.79%	6.04%
Sharpe	0.29	0.59	0.71

Correlation	S&P 500 TR	Citigroup US GBI 7 to 10 year	HFRI
S&P 500 TR	1	-0.34	0.6
Citigroup US GBI 7 to 10 year	-0.34	1	-0.33
HFRI	0.6	-0.33	1

Source: Lyxor AM, for illustrative purposes only

<sup>1</sup> [http://www.lyxor.com/fileadmin/PDF/20141106-EXPERT\\_OPINION\\_RISK\\_FACTOR RONCALLI\\_GB.pdf](http://www.lyxor.com/fileadmin/PDF/20141106-EXPERT_OPINION_RISK_FACTOR RONCALLI_GB.pdf)

<sup>2</sup> According to a study by Cliffwater and Lyxor AM.

### Alternatives as true active management

**Nicolas Gausse:** Alternatives are increasingly seen as the true home of active asset management. Hedge funds are often relatively unconstrained in the investment positions they are allowed to take. By contrast, in many traditional core active management mandates performance is measured relative to an index benchmark, and managers may be reluctant to depart too far from index weightings. The difference between traditional active mandates and hedge funds is also supported by extensive academic research.

For example, in 2009 professors Goetzmann and Schaefer reviewed the performance of the active management of the Norwegian Government Pension Fund, which was largely based on traditional mandates<sup>3</sup>.

The researchers concluded that a significant proportion of the fund's historical returns could be explained by exposure to systematic risk factors rather than active manager skill. It's increasingly possible to access these risk factors via transparent, low-cost index solutions, rather than paying extra to access them via active mandates.

In another study, published in 2012 and focusing on the period from 1990-2008<sup>4</sup>, academics Aglietta, Brière, Rigot and Signori showed that active management had contributed nothing to U.S. pension funds' returns within the equity asset class and very little to the funds' returns in fixed income. In fact, most of the equity and fixed income returns earned by U.S. pension funds came from broad market exposure—something the funds could have achieved by indexing. However, the researchers found that active management played a much more significant role than market movements in explaining pension funds' returns in hedge funds and other alternative asset classes.

### Definitions of Alpha and Beta are changing

**Arnaud Llinas:** As 'beta' expands to encompass not just traditional, capitalisation-weighted market indices but also smart beta indices, which embed different investment strategies and risk factor exposures, 'alpha' may also change its definition.

There is likely to be much greater scrutiny of the extent to which active managers truly add value, for example by studies focusing on managers' 'active share' against their performance benchmarks. Also, those benchmarks may be more tailored to managers' individual styles. For example, if an active manager specialises in small-cap U.S. value stocks, why not measure his performance against the relevant smart beta index, rather than against the broad market?

### Passives and Alternatives are complementary

**Nicolas Gausse:** We often see passive and active management described as fighting each other for investors' assets. I don't think this is the right way of viewing things.

Instead, index-based portfolio solutions (such as passive funds and ETFs) and truly active funds (in the form of alternatives) should be seen as complementary. In fact, in Lyxor's view these portfolio approaches can by themselves provide a full solution for the average investor.

Broad-based ETFs and other index products, typically tracking capitalisation-weighted indices, are well-suited to the portfolio core. They capture market risk premia and offer effective diversification at low cost.

<sup>3</sup> <https://www.regjeringen.no/globalassets/upload/fin/statens-pensjonsfond/eksterne-rapporter-og-brev/ags-report.pdf>

<sup>4</sup> [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1948726](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1948726)

# Smart beta is expanding the traditional definition of passive investing, offering a valuable new tool to investors

ETFs are ideal for tactical asset allocation, since they offer high granularity of exposures, ease of implementation and low execution costs. Such tactical positions could include ETFs based on strategy and factor indices. Alternative assets can then form the active part of the portfolio, based on the principle of uncorrelated exposures and unconstrained investment mandates.

A typical portfolio could be split 60/20/20 between core ETFs and index products, tactical exposures using ETFs and the active component, represented by alternatives.

## Combining active and passive

**Nicolas Gausse:** Asset allocation approaches are evolving to take into account the broadening range of low-cost, index-based solutions and the growing evidence that alternatives are the true form of active management. We believe that combining traditional beta, smart beta and alternatives in a portfolio provides a very effective and powerful solution for the average investor.

## Sample Asset Allocation

Investor need	Key benefits	%	Investment vehicles
Core allocation portfolio	<ul style="list-style-type: none"> <li>• Capture market risk premium</li> <li>• Diversification</li> <li>• Cost</li> </ul>	60 %	ETF Index products
+ Tactical allocation portfolio	<ul style="list-style-type: none"> <li>• Granularity of offer</li> <li>• Speed and flexibility of implementation</li> <li>• Execution cost</li> </ul>	20 %	ETFs
+ Alternative portfolio	<ul style="list-style-type: none"> <li>• De-correlation / diversification</li> <li>• Manager breath of action</li> </ul>	20 %	Alternatives

Source: Lyxor AM, for illustrative purposes only.

### To the point:

- Passive solutions are tools that help active managers to generate alpha, and are used to complement the equity or bond picking
- With the coming-up of risk factor ETF, assets allocators and active asset managers will be able to generate alpha by selecting specific regional risk premium