Beyond Active vs. Passive: Overcoming Public Safety Plan Challenges

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The Active vs. Passive Debate Rages On

<table>
<thead>
<tr>
<th>ACTIVE</th>
<th>PASSIVE</th>
</tr>
</thead>
<tbody>
<tr>
<td>PROS</td>
<td>CONS</td>
</tr>
<tr>
<td>• Outperformance potential</td>
<td>• Underperformance potential</td>
</tr>
<tr>
<td>• No underperformance</td>
<td>• Low fees</td>
</tr>
<tr>
<td>• Low fees</td>
<td>• Fees, regardless of results</td>
</tr>
<tr>
<td>• No outperformance</td>
<td>• No outperformance</td>
</tr>
</tbody>
</table>
Passive Is Currently Winning

U.S. Equity Funds Active vs. Passive Assets

Source: Morningstar
Unintended Consequences

Relative 5-yr annualized performance of the median public plan vs. 60/40 blended benchmark:

-48 bps

Forgoing outperformance potential can be costly

Sources: Allianz Global Investors, RVK Inc.
Data is based on underlying data from RVK Inc. of more than 70 US public pension and permanent funds, produced semi-annually, providing a comparison of asset allocation, performance, fees, and actuarial comparative data.
Typical Asset Allocations Can Be Problematic

• Core-Satellite is often backwards

Non-large cap equity allocations have to generate all the alpha — yet on the least amount of assets
Choices for alpha generation in your active allocation

Choice A
- 25% of total allocation
- Generating 60 bps per manager
- 15 bps to total portfolio

Choice B
- 5% of total allocation
- Generating 300 bps per manager
- 15 bps to total portfolio

➢ Choice A seems more achievable

Source: Allianz Global Investors, hypothetical example for illustrative purposes only.
It Should Be More Achievable, But Is It?

• The case can be made that there is alpha in other asset classes
• But not in large cap: the largest allocation bucket!

<table>
<thead>
<tr>
<th>eVestment Representative Peer Group</th>
<th>Median Excess Return (%)</th>
<th>1 Yr</th>
<th>3 Yr</th>
<th>5 Yr</th>
<th>10 Yr</th>
</tr>
</thead>
<tbody>
<tr>
<td>US Small Cap</td>
<td>2.40</td>
<td>0.23</td>
<td>0.45</td>
<td>0.98</td>
<td></td>
</tr>
<tr>
<td>Emerging Markets Equity</td>
<td>-3.30</td>
<td>2.27</td>
<td>3.81</td>
<td>1.99</td>
<td></td>
</tr>
<tr>
<td>US Large Cap</td>
<td>-1.11</td>
<td>-0.65</td>
<td>-0.68</td>
<td>-0.11</td>
<td></td>
</tr>
</tbody>
</table>

Source: eVestment, as of Sept 30, 2019.
So What are Plans to Do in Large Cap?

- **Passive**
  - Too much pressure on smaller alpha generators

- **Active**
  - Traditional strategies have not delivered

- **?**
  - If neither is the answer, a third choice is needed
Beyond Active vs. Passive: A Third Choice

- Non-Traditional Equity
Non-Traditional Equity

• Strategies that aim to outperform a large-cap equity index by looking outside the large-cap equity universe

Look to generate alpha where it exists – not just where it has historically been sought

Apply it to where it doesn’t exist
## Desirable Characteristics

<table>
<thead>
<tr>
<th>Category</th>
<th>Desired Characteristics</th>
</tr>
</thead>
<tbody>
<tr>
<td>Portfolio Efficiency</td>
<td>Higher information ratio</td>
</tr>
<tr>
<td>Correlation</td>
<td>Alpha behaves independently of beta</td>
</tr>
<tr>
<td>Implementation</td>
<td>Easy beta replication, listed instruments</td>
</tr>
<tr>
<td>Fees</td>
<td>Pay for alpha, not beta</td>
</tr>
</tbody>
</table>
Performance Fees: Pay Only for Excess Returns

• Active strategies must add value net of fees!
• Performance fees ensure a plan is only charged for excess returns

More-consistent outperformance potential = better fit for a performance fee structure
Fixed vs. Performance Fees in Large Cap

- Over 5 years, the average active US Large Cap manager has underperformed by **68 bps** compared to the benchmark
- Net of fees, the performance lag is even larger

- With performance fees, investors can pay a management fee as little as **0 bps** if there is no alpha
- The ratio of outperformance to fees can be much higher

Sources: eVestment, Allianz Global Investors.
Non-traditional Alpha Engines: Examples

1. Options
   - Insurance Risk Premium

2. Fixed Income
   - Carry Trade

3. Hedge Fund
   - Portable Alpha
     - Futures for Equity Beta
Example: Options

- **Alpha Potential Exists**
  Options are structurally mispriced

- **Non-directional**
  No need to guess if markets will rise/fall

- **No Borrowing**
  Margin mechanism

- **Client Friendly**
  Exchange-traded instruments, seamlessly combines with beta

- **Embedded Risk Control**
  Options are used as much for hedging as for return-generation
There is Oil in the Ground!

• Options investing requires skill and care
• But the opportunity set is worth the effort
Is Non-Traditional Equity Right for Your Plan?

- How much of your asset allocation is in US equity?
- How could consistent outperformance potential in your large-cap equity allocation improve the outlook for your plan?
- Is it appealing to pay a performance fee for alpha and not have to pay anything for beta?
Summary

• Hope is not a strategy

• Stop paying for beta (or worse, underperformance)

• Perhaps a non-traditional equity strategy that pursues consistent alpha potential and offers performance fees could help your plan get past the active vs. passive debate
Q&A