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Active investing in an indexed world

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While active management still plays a critical role in portfolios of all sizes and sophistication levels, it's hard to ignore the reams of headlines and research notes making the case for passive.

Even hard-core stock pickers can't ignore the increased adoption of indexed exchange-traded funds and the proliferation of "smart beta" indexes that aim to track territory that was previously the purview of active managers.

But we believe that a certain kind of active — active asset allocation — will be critically important to generating returns and reaching goals, and nominally passive ETFs should be equally important to this investment approach.

Before making the case for greater adoption of ETFs in an overall active asset allocation strategy, it's worth a quick review of how we got here.

The post-crisis years have featured the unusual combination of a rebound in domestic equity markets coupled with exceptionally low volatility. While most agree that the past few years have been hard for active security selection, the explanations for why that's so are varied. Some argue markets have become slaves to sentiment. Others blame higher correlations that obscure meaningful differences among companies. Still others point to the tendency for macroeconomic events to overwhelm the fundamentals of individual securities.

Regardless, for the five years through mid-2014, Standard & Poor's reports that 70% of active stock pickers across all capitalization and style categories failed to beat their respective S&P benchmarks — and in some equity categories, the rate of managers failing to surpass their benchmark is as high as 90%. The trend is similar in much of the rest of the world.

There are, however, active managers who are uniquely qualified to capitalize on the previously mentioned global macro trends, as well as managers whose pursuit of a specific investment outcome (such as steady income or downside protection, to cite two examples) make them worthy of consideration.

We believe fundamental company analysis is likely to continue to take a back seat to macroeconomic and fiscal and monetary policy developments when it comes to capturing opportunities in global stock markets. Indeed, with many governments seemingly eager to take a more active role in managing their economies and currencies, we believe these forces will drive markets for years to come across all regions, but especially in emerging markets.

Alpha through beta

The rapidly expanding set of ETFs has made active macro strategies far more efficient. We believe ETFs have been the key to a renaissance in active management through strategic and tactical allocation strategies.

Rather than being viewed as active-management headwinds, the increased stock correlations and sentiment-driven markets, as well as government economic policies can actually create a fertile environment for expressing global or regional views, and thus generating alpha. At the same time, the manic whims of a "risk-on, risk-off" trading environment are much easier to manage with a single broad directional investment than they are by juggling an array of single-stock positions. For example, the ability to predict a positive earnings surprise from a German car company could be rendered moot if immediately after the earnings release, expectations for European Central Bank policy shift dramatically.

We believe the tactical shifts between countries, regions or sectors based on investment opportunities and risk management considerations might be best implemented with ETFs that offer intraday liquidity and can readily absorb large trades. An additional advantage of ETFs is that they provide access to investment opportunities in difficult-to-reach parts of the world — and do so without the costs and operational burden of buying and selling individual stocks.

The next frontier

In much of the developed world, it only takes a day or two to open trading accounts. In many developing markets the process is far more onerous, taking weeks or even a month or more. The document demand can be crushing. Each emerging market country has its own set of regulatory issues and costs, such as hiring local accountants and lawyers. All of these factors translate to higher operating costs for your portfolio.

ETFs can minimize or eliminate these challenges and allow you to implement views quickly — often with tight trading spreads, which ultimately provides value to clients. In addition, the secondary market for these ETFs offers an easily accessible pool of investment options for investors who wish to go long or short an individual country, region, sector, market cap or style — and do so on an established, well-functioning stock exchange in the U.S.

ETFs can offer flexibility and access to markets that even the most sophisticated firms would have difficulty navigating.

Bottom line: In an industry where active still remains synonymous with stock picking, we believe the "activity" that might offer the best, most consistent returns should entail constructing a portfolio with passive underlying exposures. Should markets continue the recent trend, we expect investors to increasingly turn to tactical and strategic macro-oriented strategies to generate alpha. Indeed, the newest frontier of active management is being built on the back of ETFs.

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