IN A POST FINANCIAL CRISIS WORLD WHEN SEEKING TO OPTIMISE THE MANAGEMENT OF INVESTOR RETURNS IS ‘PASSIVE BETTER THAN ACTIVE’ AND IS ‘STRATEGIC BETTER THAN TACTICAL’ INVESTMENT?

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This dissertation is submitted in partial fulfilment of the requirements for the award of MSc Financial Planning and Business Management

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DECLARATION
The author has not, whilst being registered for the Masters award, been a registered Candidate for another award of a university.

The material in the dissertation has not been used in any other submission for an academic award, and acknowledging any assistance of Professor David Leece.

The dissertation is empirically-based research.
The purpose of this multiple case study is to investigate the four main investment styles used by the retail investment advisors when seeking to optimise investment returns. The investment style chosen is central to the investor’s investment experience influencing not only the likely investment returns but also the way that those returns emerge over time.

This dissertation is concerned with the question whether active or passive investment will optimise investor returns and whether the management of those fund types should best be strategically rebalanced to an agreed asset allocation or tactically managed according to a rules or judgement based philosophy.

The practical implications of these investment decisions are significant and every financial adviser should consider what combination of investment style can best help their client achieve their financial goals.

The multiple case studies considered by this dissertation have been framed by the financial crisis of 2008 and the more recent European debt crisis which was unfolding during the research period. These crises’s have the potential to change the economic back drop for a generation and the issues explored by the dissertation question are as relevant now as they have ever been. The financial future of investor returns will depend on the way that clients and their advisors reflect on the issues raised by the dissertation.
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Chapter 1 – Introduction

Preface

This section aims to set out the context of the research and gives a brief introduction to the multiple case studies it is based on. The rationale for the research is presented along with the study’s specific aims and objectives.

Introduction

This research is a consultancy-based investigation into the four main investment styles available to investors. Choosing the most appropriate investment style for a client is a fundamental decision that all investment advisers need to consider when seeking to optimise investor returns. Most UK advisers place the majority of their clients in just one investment style and it is often not clear if the other styles have been discussed with the client to make a more informed choice.

This issue is topical because the regulator, the Financial Services Authority (FSA), is proceeding with the Retail Distribution Review (RDR) which will legislate that adviser remuneration must be consumer agreed remuneration and not product-led commission. Many are arguing that this, and the twin objective to up the bar on qualifications, will lead a much reduced number of advisers from 2013 leading to less consumer choice. The researcher is a Chartered Financial Planning offering bespoke regulated independent investment. An analysis of the four main investment styles with their competing issues will help the researcher and his business to better understand if any one or more of the investment styles offers an optimised solution to benefit future clients.

Background to dissertation question

Traditionally, investors seeking long term capital growth and income are normally invested in to a diversified portfolio of different asset classes which are selected to be a match for their tolerance and capacity for loss. Investors with higher risk appetites will typically hold more growth assets such as equities and more cautious investors will typically hold more fixed interest holdings to help moderate volatility in line with Modern Portfolio Theory.

For retail investors in the UK, during much of the 1980s and 1990s, this traditional approach has resulted in them holding actively managed funds benchmarked against their peer group such as ‘balance managed funds’. During the 1990s and 2000s this single fund solution had
developed into a fund portfolio approach with specialist fund managers being used for different asset classes in an attempt to add more alpha (outperformance above index returns). This selection of star fund managers can add cost and there is a real need to monitor their relative performance and track that they haven’t moved on to pastures new (style drift). The technology crash and general stock market fall of the early 2000s caused the loss of a lot of wealth for a lot of people and these losses amongst other things caused investors to challenge the assumption that active management was better than less expensive more automated ways of investing.

The 2000s saw a rapid growth in the number of index tracking and exchange traded funds which opened up the alternative of passive investing. Since this time the debate about ‘Passive versus Active’ has prevailed with investment companies and advisers tending to choose one over the other. A significant body of research has studied the ‘persistency of active fund returns’ over different markets and time periods as considered in the literature review below.

**The Research question**

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<th>IN A POST FINANCIAL CRISIS WORLD WHEN SEEKING TO OPTIMISE THE MANAGEMENT OF INVESTOR RETURNS IS ‘PASSIVE BETTER THAN ACTIVE’ AND IS ‘STRATEGIC BETTER THAN TACTICAL’ INVESTMENT?</th>
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This ‘Passive v Active’ argument has won devotees on both sides of the debate as evidenced by the vocal groups of advisers in the industry press. Strategic investment relies on a pre determined asset allocation which is reviewed at agreed intervals with automatic rebalancing to bring the portfolio back to the agreed strategy. Tactical investment relies on an investment professional’s judgement or a set of rules to alter asset allocation and holdings to reflect the tactical views on the future prospects of investment markets.

**Basic styles of investment**

<table>
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<th>Active Strategic</th>
<th>Active Tactical</th>
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<tbody>
<tr>
<td>Passive Strategic</td>
<td>Passive Tactical</td>
</tr>
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Many traditional active funds are managed in a dynamic style with researched selection of individual holdings (bottom up) which are held within predetermined bands to allow some flexibility. Those advocating this style of investment claim that by picking winners and avoiding losers they can ‘beat the market’ (beta) and add extra performance (alpha). The theory used to prove some of these observations are set out in CAPM.

In truth many active fund managers choose similar holdings and asset allocations as they view any departure from the peer group average as adding risk. Benchmark hugging is all too common and those advocating passive investment have rightly pointed out that expensive active charges (typically 1%pa or more) are often being charged unjustifiably. There is theoretical and empirical work on herding behaviour among fund managers which supports some of these observations.

Passive index tracking and ETF fund advocates claim that the market is efficient and that active fund managers can not consistently beat the market. They argue that if you cannot beat the market then it is better to simply obtain market exposure with the least tracking error at the cheapest cost available. Most advocates of passive strategic investing agree an asset allocation and then rebalance the portfolio at fixed times or when the portfolio moves out of balance by more than any agreed limits. This forces the portfolio to sell down the best performing assets and re-invest in the worst performing assets and by taking profits this tends to dampen future volatility within the portfolio compared to a simple buy and hold strategy.

This basic passive strategy is sometimes enhanced by using index tracking funds that aim to tilt the portfolio towards size by market capitalisation or value investing by using the market index with a filter to favour cheaper value or smaller stocks which research suggests outperforms the general market over the longer term (Value versus Growth: The International Evidence," Journal of Finance (1998), with Eugene Fama.). These tilts don’t involve fund manager judgement and are based on a rule set which is applied consistently.

Research in to Tactical Asset Allocation of markets in USA include (Mebane T. Faber, Journal of Wealth Management Feb 2009). This was updated by Price and Momentum in a basket of world indices (Gwilym, Clare, Seaton and Thomas, July 2010) and this approach of investing in cheap passive index tracking investments has been developed to include a momentum based tactical aspect.
This passive tactical approach to investment avoids fund manager judgement but introduces a market timing aspect to the strategy. Typically the actual index price is plotted against the 200-day simple moving average (SMA). When the month end price falls below the SMA the index is sold and the funds held in cash until the month end price rises above the SMA when the index is re bought.

This risk on / risk off approach is reviewed at the beginning of each calendar month to avoid general ‘investment noise’. The approach aims to benefit from momentum of asset movements by being in the market during periods of gain and out during periods of loss. Research shows that this improves absolute and risk adjusted returns over buying and holding the index as set out in Stephen Thomas’s research.

In his book ‘Stocks for the Long Run’, Jeremy Siegel (2008) investigated the use of the 200-day SMA as above on the Dow Jones Industrial Average (DJIA) from 1886 until 2006 and concluded the same improved performance. This theory is applied by Way Hasley Momentum funds amongst others.

Another variation on the passive tactical approach is to use fund manager judgement to time investments and add or remove risk as their views on markets change. Again the cost is reduced relative to tactical managers and liquidity is maintained by using index tracking and exchange traded funds. This is demonstrated by Evercore Investment Management and 7 Investment Management amongst others.

The Tactical Active approach introduces fund manager judgement and unlike the other three quadrants of the investment style fundamental analysis and/or rules based formula are used to determine asset allocation and market timing. Also, whereas the other investment styles predominantly involve long only investment, Tactical Active managers often seeks to short markets at times of market stress.

These extra variables make Quantitative research less conclusive and suggest that a Qualitative approach might help to better understand the added value that this approach purports to offer. There are experienced investment professionals who firmly believe that their choice of investment style offers investors the best results. Clearly, they cannot all be right all of the time. By interviewing a number of advocates for each investment style I hope to explore the relative pros and cons of each quadrant and link their views to the established literature on the subject. Tactical Active investment is common in many hedge fund strategies in the institutional investment market and many Absolute and Total return.
strategies in the retail investment market.

Most advisers advocate just one quadrant investment style although a minority might use different styles for different clients. Passive is cheaper at fund cost level but you will never outperform the market with a simple buy and hold strategy without rebalancing or tilting or having some mechanism to manage downside risk.

Having considered the background to the dissertation question I will move on to review the literature to understand what the established research has to say about Passive versus Active and Strategic versus Tactical and how it optimises investor returns.
Literature Review

Modern Portfolio Theory

Central to the active, passive, strategic and tactical debate is the research behind modern portfolio theory.

In their paper ‘Investment Theory Explained’ Kevin E. Cahill and Shelia Campbell from the Centre for Retirement Research at Boston College USA considers risk and return. He points out that there are two measures to describe returns. The first is the average return over a time period and the second is the standard deviation of return which measures how much the rate of return varies over time.

They pointed out that ‘a larger standard deviation signals a greater likelihood that the actual returns in any period will differ substantially from the average’. Of course standard deviation alone can be misleading without a common sense check.

If there were a portfolio that reduced by 5% per annum in a straight line for 5 years it would have a standard deviation of zero and appear to be low risk. If another portfolio increased by 5% per annum in a straight line for 5 years it too would have a standard deviation of zero and appear to be low risk. Of course, the second portfolio is the one that most investors would prefer and yet selection based on standard deviation alone without considering average returns would not reveal the better fund.

Long term it can be shown that different types of assets produce different rates of return with different levels of volatility.

Annual Total Returns on various Financial Instruments 1926 – 2002 (inflation adjusted)

<table>
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<tr>
<th>Financial Instrument</th>
<th>Rate of Return (percent)</th>
<th>Standard Deviation</th>
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<tr>
<td>Smaller Company Stocks</td>
<td>16.9</td>
<td>33.2</td>
</tr>
<tr>
<td>Larger Company Stocks</td>
<td>12.2</td>
<td>20.5</td>
</tr>
<tr>
<td>Long Term Corporate Bonds</td>
<td>6.2</td>
<td>8.7</td>
</tr>
<tr>
<td>Intermediate Government Bonds</td>
<td>5.6</td>
<td>5.8</td>
</tr>
<tr>
<td>U.S. Treasury bills</td>
<td>3.8</td>
<td>3.2</td>
</tr>
<tr>
<td>Cash</td>
<td>-3.1</td>
<td>4.4</td>
</tr>
</tbody>
</table>

Investors need to decide what proportion of their assets should be invested in risky assets and how much in safer assets. There is no right answer for everyone. The choice depends on an individual's savings goals, tolerance for risk, and desire for large gains and capacity for loss. Once the individual investor has decided how much to commit to risky assets they need to decide which risky assets to invest in. Using Modern Portfolio Theory this is not an individual preference but rather an optimal mix of risky assets decided by the theory.

Harry Markowitz won the 1990 Nobel Prize for Economics for his portfolio theory. This provided the foundation of portfolio construction through advocating that by diversifying asset holdings in between stocks and bonds the investor can benefit from an investment 'free lunch'. The theory relies on the idea that the returns on all assets do not move in tandem and often move in different directions.

Two assets with the same expected return but react differently to different risks are less risky together than apart because they do not perform identically as one may falter while the other one gains. The investor can remove some of the risk while maintaining the same expected return.

As you add more assets classes to the portfolio the expected returns and risks change and economists can establish a combination of assets that maximise expected returns for any given level of risk. These results can be plotted to create an efficient frontier which gives you the optimal mix of risk assets.

In her paper ‘Alpha as a Net Zero-Sum Game’ Joanne M. Hill asked if alpha gains by one set of investors equal those lost by another set (after trading and research costs). In practice, the size of the alpha pie is not fixed. Investors' strategies, choice sets, horizons, benchmarks, and risk preferences vary, and investors face different constraints and access costs. However, over time, capital may be added to or taken away from any subset of the global financial system. It could be argued that over the next decade a portion of capital currently in the Developed Western countries will switch to China, India and other countries with an emerging middle class. It must be true, however, that global economic growth will drive the ability to provide net positive alpha (over the global risky asset market portfolio), as it influences aggregate wealth and capital creation.
Active vs. Passive

The active vs. passive debate is much discussed in the industry press and nearly all advisors have a view and tend to prefer one over the other. It is difficult to see that everyone, however strongly they hold their views, can be right. This debate can lead to some raised emotion at industry seminars so I would like to start this section of the literature review by examining some of the long held academic research behind this industry debate.

The active versus passive debate largely relates to whether active fund managers can beat the market and an important part of this is an examination of fund persistency.

Several studies have examined the performance of managed funds and whether relative performance persists (William F. Sharpe). This literature is useful in allowing us to examine a range of evidence. However, although there are studies of both unit trusts and pension funds in the UK these are not as numerous as those conducted on US funds.

Examining persistency in the performance of managed funds is a difficult process because there is a great deal of noise in the data. The returns that one might expect from a unit trust have a significant random element, capable of swamping any systematic differences in the skill of fund managers.

Some funds may perform consistently well even over relatively long periods of time. However if enough funds are examined to start with this outcome might be found even if relative performance is truly random. It is not possible to reject the claim that, in the case of any individual fund, such persistence is the result of skill rather than luck. What can be examined, however, is whether the general pattern of relative performance is random.

More has been written on the performance persistency of Mutual Funds in subsequent research. David Blake of University of London] and Allan Timmermann of University of California wrote a paper on this subject in April 2003 for the FSA. The Key points coming out of their analysis included: Consistent superior performance did not persist but that inferior performance did seem to persist. In the longer term it was the funds that were consistently in quartile two and three who performed well which could be viewed as an investment equivalent of the tortoise and the hare.
That the persistency of superior past performance was less relevant than the persistency of risk adjusted past performance

Measuring risk is not straightforward and becomes more difficult when combining different asset holdings due to the presence of covariance.

Fund management skill cannot be assessed simply by reference to the fund’s raw returns. Any fund manager can increase the fund’s average raw return over time by simply increasing its risk exposure. It’s the fund’s ratio of expected excess returns to the market risk that counts.

Alpha is a measure of the expected return a fund manager achieves over and above the expected return from the CAPM. It’s a measure of risk adjusted performance since it includes a control for the fund’s exposure to risk.

The concept of Strategic Asset Allocation is raised (1.3 s1.18) which is linked on the investors acceptable level of risk. This is then conceptualised in terms of a ‘risk budget’ which is spread across all the investors investment holdings.

This work follows on from three other studies on past performance persistency being:

Bacon and Woodrow (1999) on Comparative tables

Rhodes M (2000) on the Performance of UK Equity Managed funds


Bacon & Woodrow recommended that past performance on its own was no reliable guide to future success.

William F Sharpe in Mutual Fund Performance 1966 looked at the success that active fund managers had in beating their benchmark in the USA stock market.

He concluded that there were barriers to like for like comparisons between active fund manager performance and passive alternatives. In particular different active funds took different levels of risk to achieve their returns and you need to adjust the funds return to account for the risk taken to give a risk adjusted return. The Sharpe ratio is now one of the most widely used measures of fund manager success after adjusting for risk.
He also noticed that active fund managers who failed tended to close or merge their fund in to other more successful funds. This survival bias encourages the successful funds and eliminated the unsuccessful funds so that active fund manager data was if anything flattering its long term track record.

He went on to conclude that when the past performance results were adjusted for risk and survival bias then two thirds of fund managers underperformed their benchmark.

**Tactical vs. Strategic**

Central to the Tactical vs. Strategic debate is whether market timing, by adding and removing risk at different points of time, can improve the investment returns compared with an agreed fixed asset allocation re-balanced at agreed intervals.

Tactical asset allocation can take a number of forms with rules based systems and judgement based decisions. In each case there is a departure from the starting position with the aim to avoid a loss or seek a gain that a pure strategic strategy will miss.

The two pieces of work on rules based tactical asset allocation that sum up this variation on tactical investment are:


The main points and conclusions of Faber's 2009 working paper include:

2008 was devastating year for buy and hold investors and by inference strategic investors who are rebalanced annually would have had a similar experience. The S&P 500 declined 36.77%.

The normal benefits of diversification disappeared as most asset classes suffered losses over 35% as in this stressed market environment correlation increases closer to 1.

Heavy stock market drawdowns of 75%, such as those experienced by all G7 countries at least once last century, require a 300% gain just to get back to even – which is the equivalent of compounding at 10% for 15 years.

Most individuals do not have a sufficiently long time frame to recover from large
drawdown’s from risky asset classes.

Modern Portfolio Theory holds that there is a trade off for investing in risk assets – you get paid to assume risk.

If you analyse the period from 1973 to 2008 in five major asset classes, namely US stocks, foreign stocks, commodities, property REITS and 10 year Treasury bonds all broadly end up by similar amounts yet they exhibit different volatility patterns.

Given these observations and the clear need to protect against ‘buy and hold’ market falls Faber developed a simple quantitative market timing model. This didn’t rely on optimisation but used a market timing solution which is purely mechanical and that signals when investors should exit a risky asset class in favour of risk free Treasury bills.

He used a simple rule where he bought the S&P 500 when the monthly price was greater than the 10 month (200 day) simple moving average (SME) and sold the S&P 500 when the monthly price fell below the 10 month SMA. This risk on risk off rule based system benefits from trending markets.

The approach was back tested to 1973 where the empirical results are equity like returns with bond like volatility and draw down, together with over 35 consecutive years of positive returns.

Owain Gwilym, Andrew Clare, James Seating and Stephen Thomas in Price and Momentum as Robust Tactical Approached to Global Investing considered a variation on the tactical approach involving momentum investing across most world equity markets.

This research document examines the impact of momentum investing. Explanations include ‘herding’ (see Grimblatt et al [1995]) and under reaction to news (Barberis et al [1998]). This research is USA based but the evidence of momentum investing is not limited to the USA. Rouwenhurst [1998] reports that a similar strategy across 12 European countries also generated an excess return around 1% per month.

Faber [2007/2009] and Siegel [2002] all used simple moving averages and used a risk on risk off model. Faber used Treasury bills and Siegel used cash for the risk off holdings when markets are trending lower. In each case the trend following results produce better risk adjusted returns and were robust to different lengths of moving averages such as 6,
They observed that the availability of exchange traded funds in recent years make tactical international investing both practical and affordable. They sampled 32 individual countries with data from 1970-2008 on a monthly basis. These 32 countries fell in to two groups being 18 developed counties were data was available from 1970 to 2008 and 14 emerging markets with data available from 1988.

In each developed market case there was a positive relationship between momentum and positive average monthly returns. The highest momentum portfolios also had the highest volatility however this was more than compensated for by the additional return as evidenced by the Sharpe and Sortino ratios. In each case the difference in average return between Q4 and Q1 was statistically significant.

The emerging markets showed less conclusive results but still showed that momentum investing worked. The data from 1989 to 2008 showed less conclusive results with lower alpha and fewer periods where the results were statistically significant. It is interesting to note that momentum investing works best with the data set from 1970 to 1988 for developed markets and that more recent data and inclusion of emerging market data reduces the scale of the results from around 1%pm to less than 0.5%pm.

In summary they investigated the performance of momentum and trend following and concluded that it broadly caught the market return but with a much reduced volatility and therefore reduced investor risk.

The relative benefit of investing in ‘Active or Passive’ funds is well researched. It appears that quartile 1 performing active funds during most time periods have great difficulty in repeating this level of performance. Quartile 4 performing funds tend to stay as relative poor performers.

As passive investing is never aiming to outperform, indeed minimum tracking error is the desired outcome, value is principally added by lowering cost. Advocates of passive investing aim to add value through regular rebalancing back to an agreed strategic asset allocation. Some advisers take the basic passive approach but tilt the equity index to an over or underweight ‘value or size by market capitalisation’ position. They argue that this is not adding an active element as the process of tilting is rule based and does not involve individual stock selection.
The passive approach has generally used strategic asset allocation but some new funds have added a tactical overlay by using rule based momentum investing processes.

The use of passives with judgmental tactical asset allocation is now available although the data set is too small to conclude if this works consistently.

The active tactical asset allocation advocates, typified by some hedge funds and Multi Asset and Multi Manager Funds, do not benefit from the same level of academic research enjoyed by the other investment styles in the investment matrix above. Because active asset allocation involves judgement and opinion it’s difficult to explain why some funds do so well and other do so badly.

Rebalancing

The issues around rebalancing portfolios where discussed in Optimal Rebalancing for Institutional Portfolios Walter Sun, Ayres Fan, Li-Wei Chen, Tom Schouwenaars, and Marius A. Albota in 2006. Rebalancing is an important feature of any strategic asset allocation strategy. This takes a portfolio away from the ups and downs of a buy and hold return path and can help to boost performance and reduce volatility by selling the portfolios winning assets (taking profits) and using the proceeds to buy the portfolio laggards through purchasing the most distressed assets in the portfolio. This sell high and buy low strategy is the opposite of what most individual investors do in the real world which behavioural investment research supports.

In ‘Behavioural Bias and Investment’ Massimo Massa and Andrei Simonov showed that people changed their holdings of risky assets as a function of financial and real estate gains. As an investor makes gains they get more inclined to let their risky assets run on and are not inclined to take profits

Walter Sun, Ayres Fan, Li-Wei Chen, Tom Schouwenaars, and Marius A. Albota showed that Institutional fund managers generally rebalance using ad hoc methods such as calendar periods or tolerance band triggers. But another approach is to quantify the cost of a rebalancing strategy which aims to optimise the risk-adjusted returns net of transaction costs. An optimal rebalancing strategy that actively seeks to minimize that cost uses certainty-equivalents and the transaction costs associated with a policy to define a cost-to-go function. Stochastic programming is then used to minimize expected cost-to-go. Monte Carlo simulations demonstrate that the method outperforms traditional rebalancing strategies such as periodic and 5% tolerance rebalancing.
Mean Variance

In hind sight it becomes obvious when assets are under or overvalued but spotting these turning points before they happen is less easy. In 1987 Harry Markowitz, G. Peter Todd, William F. Sharpe wrote a paper called Mean-variance analysis in portfolio choice and capital markets. This suggested that there were period of time when some stock markets and other asset classes where over and undervalued. They established formula that tried to optimise the best time of entry and exit from any given asset class. However this is not an exact science as markets and the people who drive them are not always rational.

Conclusion

In conclusion the literature is helpful because it challenges some of the myths that surround successful investing and demonstrates that most of the investment return is a consequence of the chosen asset allocation. The market returns for each asset class is available for a small cost and to improve on these returns there needs to be some form of active fund outperformance through stock selection or market timing. This can add extra performances above the market return (alpha) but on average only one third of fund managers achieve this on a risk adjusted basis and fewer still do this consistently.

The difficulty in adding this alpha is compounded by the need to add even more out performance to cover the extra cost active management. This extra cost is a combination of increased Total Expense ratios and extra trading costs as active and tactical funds tend to have a higher turnover of assets than a typical passive fund.
Chapter 3 - Research Design

Methodology

The research question can be broken down into three main issues and these lead on to a sub-set of questions that add to the overall depth of the research undertaken. The main issues are:

1. The impact of the financial crisis
2. The analysis of the ‘Passive versus Active’ investment styles
3. The analysis of the ‘Strategic versus Tactical’ investment styles

Amongst other things the sub questions include the linked issues of:

- Rebalancing
- Mean Variance
- Investment time scales

These various issues need exploring but because the issues are all interrelated it is important that the question technique is not too prescribed so that the issues do not come across as being discrete but instead linked and interdependent to each other.

Each advocate of an investment style believes they can produce a better overall risk adjusted return after costs for investors yet clearly this isn’t possible all the time so the research methodology needs to be sensitive to the competing views of the participants.

The research will involve a series of qualitative interviews with investment professionals from separate organisations using open questions to extract a rich source of data at face-to-face interviews to allow triangulation of the information provided.

Investment provider websites were reviewed to help determine the shortlist for interviewee selection. The interview process will be funded by the researchers business. All participants were offered sight of their responses before inclusion in the research. Because the participants spend part of their time promoting and justifying their investment processes it is expected that all those invited will be happy to help subject to availability.

The researcher produced a list of possible questions with a view to leading a lively debate where participants could articulate why they believe they can offer an optimised investment outcome for investors. Data collection will be through one-to-one interviews with selected investment providers which will be digitally recorded so as to make sure that the interviewee’s comments can be accurately reproduced within the research analysis. In
practise the digitally recorded scripts will need editing to convert conversational feedback into useable research data while maintaining the originality of the comments made.

**Research methods and structure**

The research methodology was developed from first principles. A review of the personal finance trade press showed that although there were many comments about the growth of passive investing including index tracking unit trusts, open ended investment companies and exchange traded funds and how they compete with traditional active funds there was less on strategic versus tactical asset allocation and how this can impact on investment outcomes.

The aim of the research is to explore the pros and cons of all sides of the arguments and to produce a balanced and updated industry view of the issues involved. By attending personal meetings with investment providers the researcher will meet the participants on the ‘home territory’ which should put them at ease and encourage a full and lively debate in what could otherwise be a slightly pressurised situation. By treating each participant as a co-researcher the intent is to create an atmosphere of working together towards common goals.

Therefore the research is more inductive in approach and looking to generate a theoretical position that the participants have an investment offer that has the potential to optimise investor returns.

The researcher reviewed the grounded theory approach used to extract rich data. The classic grounded theory approach put forward by Glaser and Strauss (1967) entails interacting with the participants to interpret their world as they interact with financial advisers. This is done through interviews, transcription, categorisation, coding and memos. Memos written at the time of the meeting were not a feature of the research even though they were a pronounced feature of classic grounded theory put forward by Glaser (1978) as technology assists the research here through the use of digital recording to assists accurate reproduction of meeting records. All investment providers in the case study will be treated individually. As set out in Juliet M Corbin and Anselm Strauss grounded theory analysis the rich data can be encouraged through description, ethnographical fact finding and narratives that yield fuller answers.
So the format is:

<table>
<thead>
<tr>
<th>Selected participant Investment Providers</th>
</tr>
</thead>
<tbody>
<tr>
<td>Seen face to face</td>
</tr>
<tr>
<td>Case study</td>
</tr>
<tr>
<td>Treated as a collaborator in seeking to answer the dissertation question</td>
</tr>
<tr>
<td>Anonymity offered although no one took this up</td>
</tr>
</tbody>
</table>

Participants will be predominately London based and will be chosen from contacts known to the researcher who are known to be passionate about their selected investment processes.

The sample size will be restricted in view of the total time the researcher can give to one to one interviews. No time limits will apply to individual meetings to allow rich data to be maximised.

This research will follow the steps as outlined by Matthew B. Miles and Michael Huberman in their book Qualitative Data Analysis (1994).

- Define the research questions
- Determine data to be gathered and analysed
- Collect data using chosen method
- Analysis and evaluate data
- Summarise key points and draft report

It is hopes that any issues around external validity can be deflected by using a wide enough sample of investment providers with more than one in each quadrant using different sub strategies to avoid direct duplication of views.

**Limitations**

As each interview was open ended on time allowed it was only possible to interview 9 investment practitioners. Clearly a higher number of interviews might have given a better
representative sample but great care was taken by the researcher to include practitioners who were representative of the four investment style quadrants and held top positions within their respective companies and who had industry reputations to defend.

Finally, an important part of this research was based on the interpretation of qualitative interview based case studies, and so the results may have a degree of subjectivity and therefore might not be totally objective.

**Conclusion**

In summary, the dissertation is consultancy-based. This will take the form individual interviews making up the primary data being used. Interviewees will be treated as co-researchers to make the interview process as inclusive as possible and reveal the maximum amount of rich data.
Chapter 4 – Data Analysis

Preface

As the participants were very willing to provide abundant rich data the researcher was aware that a framework must be in place to make sense of the wide variety of views. That framework is to compare and contrast the research questions against the nine individual case studies.

The case study boundaries were the individuals own thoughts set within the business practices of their investment businesses. To triangulate the data it was decided to broaden out the sources of data by interviewing distributors, investment managers and where appropriate people who provided the academic theory behind the investment approach.

Interview data was recorded using Dictamus, an iphone application taking a perfect digital recording of the interview that can be typed up after the interview picking up all the detail that might otherwise be missed in a traditional note taking environment.

Participant background

An outline of the nine participants with a brief background for each are contained in the table below (all have agreed to be published). They have been listed in order of contact which occurred between the end of September 2011 and the early part of November 2011.

<table>
<thead>
<tr>
<th>Name</th>
<th>Company</th>
<th>Notes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Glyn Jones (GJ)</td>
<td>Vanguard Investments</td>
<td>Personal visit. Glyn is a senior business development manager responsible for the promotion and distribution of Vanguard passive funds in the UK.</td>
</tr>
<tr>
<td>Michael Azlen (MA)</td>
<td>Frontier Asset Management</td>
<td>Personal visit. Michael is the Executive Chairman and founder of Frontier who offer a range of multi asset funds using a blend of passive and active</td>
</tr>
<tr>
<td>Name</td>
<td>Company</td>
<td>Information</td>
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</tr>
<tr>
<td>Jeremy Nunn (JN)</td>
<td>Hasley Investment Managers</td>
<td>Personal visit. Jeremy is a Director and founder of Hasley Investment Management who distribute The Way Hasley Global Momentum Fund using passive ETF's with active risk management</td>
</tr>
<tr>
<td>Steve Waddingham (SW)</td>
<td>Insight Fund Management</td>
<td>Personal visit. Steve Waddington is director of investment selection at Insight Investment's multi-asset group. He is responsible for a range of tactical active funds</td>
</tr>
<tr>
<td>Allessandro Hor (AH)</td>
<td>Dominion Fund Management Ltd</td>
<td>Personal Visit. Allessandro Hor is a Director and joint fund manager on the Dominion CHIC fund which is an actively managed specialist Global Equity fund using tactical risk control to reduce volatility</td>
</tr>
<tr>
<td>Christopher Aldous (CA)</td>
<td>Evercore Pan-Asset Capital Management Ltd</td>
<td>Personal Visit. Chris Aldous is the CEO and an investment committee member. Evercore run funds and discretionary portfolios of passive ETF's</td>
</tr>
<tr>
<td>Name</td>
<td>Institution</td>
<td>Details</td>
</tr>
<tr>
<td>-------------------------</td>
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</tr>
<tr>
<td>Stephen Thomas (ST)</td>
<td>Cass Business School</td>
<td>Personal visit. Stephen is the Professor of Finance as Cass. Previously he was a director of the Bear Stearns’ Global Alpha Hedge fund. He advises on the Way Hasley Global Momentum fund</td>
</tr>
<tr>
<td>Tom Sheridan (TM)</td>
<td>7IM</td>
<td>Personal visit. Tom is the CEO and an investment committee member for 7IM. 7IM run funds and discretionary portfolios using passive ETF’s with strategic and tactical judgment for asset allocation and management</td>
</tr>
<tr>
<td>Samuel Adams (SA)</td>
<td>Dimensional Fund Management</td>
<td>Personal Visit. Samuel is head of Dimensional’s financial Advisor business in the UK and Europe. His primary role is to educate advisors on Modern Portfolio Theory and investment best practise.</td>
</tr>
</tbody>
</table>

The participants were chosen from a larger group of names.

All participants or collaborators were happy for their details to be published allowing for the
use of real names rather than pseudonyms.

What follows is a summary of the research data collected from each participant. The views collected bring out the issues surrounding the research question and the differing approaches used by each of the participants. It is the different views that help to answer the issues raised by the dissertation question. Therefore, the researcher has chosen to take the main research questions and then replay a summary of the participants' responses and then analyze the data before moving on to the next question. Some questions were more relevant to some participants than others, so only the relevant responses are reviewed below.

Referring back to the research question:

**Which of the 4 quadrants best represents your investment proposition?**

The researcher will now compare and contrast the nine participants or collaborators to this framing question.

**ST** Well the instruments we use are passive instruments in the sense that they're Exchange traded funds which are just tracking markets so I guess the word passive has to dominate. However, it's not passive passive, I like to think of what we do as the ultimate passive.

We are providing the equity part of any given portfolio so in a sense we are 'pseudo passive'. As we are going to move between equities and cash there's some tactical element as well.

**AH** Dominion are a boutique fund manager that selects individual shares based on fundamental analysis and we believe that we can pick stocks that will outperform in the medium to longer term. This makes us active stock pickers. Having selected our 50 or so holding from our total universe of about 220 stocks we are very tactical in how we manage them over time. We actively manage risk by reviewing each stock holding and either hold the stock or sell it and hold cash depending on the movement of the trailing 10 and 25 day share price against each other with strict stop loss limits on top of that. This risk on risk off management of investment risks make us tactical. So we must fall in to the active tactical quadrant of your but more importantly

**TS** If I had to put our investment proposition in one of your quadrants I would put us in tactical passive. Our view is that the asset allocation is the most important decision that you have to make when you're putting portfolios together and there are two kinds of
asset allocation being strategic and tactical.

We look at them in different time frames. Strategic is a long term asset allocation as far as we're concerned. We defined long term as a ten year period. Strategic is different from the tactical in that the strategic is backward looking and the tactical is forward looking. Going back over history combining the results of the individual asset classes together into combinations we looked for the optimal portfolio for a given level of risk based upon history. We then adjust our strategic view to reflect our short term forward looking tactical view.

CA I believe we sit in passive tactical based on your definitions and we sit there because for us the key long term priority is to keep costs as low as possible which is why we believe in passive investing. We then take tactical views depending on the opinions of our investment committee. We can and have held very high percentages of cash when we don't like the outlook for risk asset returns.

SA Dimensional is passive strategic but we call it the rational or the scientific or the academic quadrant. Some people call it the informed quadrant which is the non forecasting quadrant. All the other three quadrants have some form of forecasting, this is the only quadrant that removes the perils of trying to predict the future.

MA I would say strategic and passive with a tactical component. We believe alternative asset classes add tremendous value and they are by definition very active so for traditional asset classes we would be passive and for alternative asset classes we would be active. So we invest in eight asset classes, six of them we passively index and two of them, Hedge Funds and Managed Futures, we allocate to active managers because there are not any fully developed passive ways of accessing those asset classes.

SW I think there are reasons and times when active is absolutely appropriate and there are other times when passive is appropriate. The basic approach for active and the philosophy behind it must be, there is inefficiency in the market and there is an ability to exploit that inefficiency. So if you are looking for a market exposure that is in an efficient market then I see no reason to pay active fees when you're just trying to access a market exposure. In that respect you can just go for a passive, an ETF or Index fund to get that exposure.

If there is an inefficient market and an ability to exploit it then you have to assess the
active manager's ability to do exactly that. I think there are reasons and times for both of those, we certainly focus on looking for those areas where active managers can add value and repeat that process. I'm not looking for a single hit, I want a process that is consistent, reliable and have an expectation to perform in the future and be able to exploit it. One of the things we do is to try and capture the out performance of the active manager by offsetting his fund against a short against the [industries] that he's trying to beat. This aims to capture and isolate the active manager's pure alpha.

GJ Vanguard in the UK are passive advocates and we would expect to be used as a core holding within a strategic asset allocation. Our view is that successful investment is all about getting four things right, one is asset allocation, the second one is diversification, the third one is rebalancing to whatever you set those things up to be and the fourth one is making sure that you keep control of cost. So if you go right back to what Jack Vogel, founder of Vanguard, would say, Jack Vogel would say if you do those four things right you will be a long way to getting your investor return.

This question should have yielded a simple answer. The answers depended on the definition of passive, active, strategic and tactical. Most participants identified themselves as being predominantly in one of the investment style quadrants but with a twist or emphasis that tilted them towards another quadrant. The summary that the participants provided above helps to frame how their respective investment propositions work.

In order to answer the dissertation question it is important that each participant has a clear understanding of where they sit within each investment style. The answers to this first question are not grounded in any of the academic literature but are important to frame what follows.

**What are the main pros and cons of Passive and Active investment from your perspective?**

SW I think a passive approach can be appropriate but what we need to understand what is happening with buy and hold with occasional rebalancing. A buy and hold approach to a market exposure must mean that you always have that view that it's the right time to hold that market. Also you have to think longer term, if an inefficient market becomes efficient or more efficient, does that strategy still have the ability to capture that out performance, and that could mean that there's a time when you'd no longer want to
have an active approach in that market.

I think capturing the alpha is very important to what we're doing, I think there are times when you want risk and the times when you do not want risk so in that respect in your box I would be in the tactical approach and there are times when you want active and there are times when you want market exposure. I don't want to pay for market exposure because you can get that cheap but I am happy to pay for alpha where I can find it.

GJ Vanguard's view would be to be agnostic on passive versus active. The core thing that Vanguard would say is that what really affects what the investor gets back is controlling cost. The main reason that active managers underperform their benchmarks is the drag of their extra costs over time. So the important thing is not whether it's an active fund or a passive fund, it's actually the impact of cost.

The passive versus active debate has moved on over the last forty/fifty years of investing. Just 15 years ago we didn't have the internet, we didn't have the access to the information that we've got now, we didn't have the volume of trades that we've got now and therefore the opportunities for active management actually gets harder not easier. Vanguard is predominantly agnostic, it's not about an active passive debate it's about the cost effecting investor return. Now back to the original model, where do we think that investor return comes from. The majority of that return we would suggest comes from getting the strategic asset allocation right in the first place.

Vogel would refer to protecting clients from making dumb mistakes, the sort of things that clients do when they're investing on their own. They try to pick the next star fund manager, try to look at league tables, try and listen to the marketing noise that fund companies put out with their carefully selected time lines. Too often none advised clients working on their own end up buying a hot fund just as it starts to cool without understanding the risks it took to get its outperformance. At least passive investing removes that particular risk.

The academic literature for the passive versus tactical arguments revolves around consistency of active fund managers (William Sharp) and the impact of active trading costs on overall returns and (Mebane T. Faber).

The studies show that too many active fund managers underperform their benchmark after
allowing for management and trading costs. Do you give up on finding the 33 percent of fund managers that outperform or do you seek to find the out performance that better fund managers can generate.

Those participants preferring passive investments have given up on adding alpha and instead either follow a pure passive path or try an add extra value through momentum investing techniques, tilting towards higher risk higher return passive indexes like value and small or adding asset classes or combinations of these. These strategies seeking to add value over pure passive all come at a cost and this then begins to negate the real win of passive which is cost. William Sharp observed that what really matters is risk adjusted performance and too much so called extra performance was really added risk which happened to pay off.

Added value passive comes at a price with higher management charges and trading costs. If passive’s biggest win is saving in cost then any extra cost has to be justified in extra return or reduced volatility. We begin to move towards active cost and therefore we need some extra performance to make it worthwhile.

I’m very taken with Vanguards view which is that it’s not about an active passive debate but it’s about the cost effecting investor return.

The dissertation question refers to ‘in a post financial crisis world’ – has this changed anything about the suitability of your proposition in terms of expected returns and risks?

For these purposes of the dissertation question it is assumed that September / October 2008 is the start of the Financial Crisis which has moved on to a European Sovereign Debt crisis unfolding during the research period of this dissertation

ST Well I should think the main thing that's changed is that people must be much more aware of the ability to lose large sums of money by pure passive invested in the equity market. We'll see the same in the bond market when the bond market bubble bursts but that's not in people's radar at the moment.

The experience of say the world stock market index (MSCI) falling 50% in 2008 must have made people aware that passive can be very dangerous although the academic arguments suggest that active managers cannot do any better anyway so that's why
tactical has a chance.

AH I think that the world has changed, it's changed drastically. If you go back thirty years to when Harry Markowitz was writing his papers the idea of markets working along the lines of model portfolio theory worked. I think if credit crunch has done one thing it’s split world stock markets in to two. You have the developed world and the developing world. In the developed world you have debt leverage at every level, government, corporate and individual and it is not going to go away for a long, long time.

Add to that the fact that developed stock markets like the FTSE 100 have made little or nothing over ten years, how can passive possibly work? The requirement today surely must be to look at themes that breach geographic borders and social boundaries. Issues like urbanisation that will drive themes that have got nothing to do with an asset class because they are more robust than underlying stock markets. The stock market will drive short term index movement and sentiment but if you've got the developing part of the world that is growing at a phenomenal rate, where the population is growing at a phenomenal rate and then the West who has an ageing shrinking population it is apparent that things are likely to change.

The developed world (UK, Europe and USA) will be paying debt off, earning less and spending less over the next decade or more so it's hard to see where you will get economic growth from.

TS The financial crisis has without doubt increased sovereign debt and what we are now seeing in Europe is changing the way we look at risk. The financial crisis has changed things because we think there will be a gradual deleveraging that will have to take place which will translate into lower investment returns.

All the borrowed money from the last couple of decades has overvalued certain assets and so what you're seeing over the last couple of years and probably the next couple of years is a drift back to the long term average returns. So we think that your hundred year experience with equities is still an ok place to start from, your hundred year experience with fixed income is an ok place to start from but we also think that you need to impose a forward looking tactical view.

CA I think you’ve got at least ten years which is going to be very different. It might be quite a good decade for equities actually but it still seems reasonable to expect the western
countries to have a hard time of it if the consumer can't spend. Exporting may hold up but if the consumer can't spend then there's not going to be fantastic profit growth and there won't be much credit for the foreseeable future.

A year ago next month we had a big sell off in corporate bonds because the market was discounting a 1% rise on UK interest rates, a year later you wouldn't see interest rate rising for several years. I've talked about Government bonds being fully valued; there will be a point when the conditions are such that they start to sell off and the volatility dampening qualities of fixed interest may get challenged thus the need for tactical flexibility.

SA The financial crisis changes nothing. It can't, there's no set of economic conditions, good, bad or indifferent that change the decision between being strategic or tactical and active or passive because they're independent of each other. Let me explain that, in good markets two thirds of fund managers will underperform the benchmark, in bad markets two thirds of fund managers will underperform the benchmark when properly risk adjusted. We get confused because active managers tend to hold more cash than passive managers in down markets. However, if you do a proper risk adjustment for their cash levels it's the same. This is not a point of debate or a point of discussion for your paper, it's a mathematical pure and simple.

Let's look at your four quadrants. These four quadrants make up the investor universe, and represent the entire investment framework, if the world investment markets deliver 10% over the next time period the passive strategic guy will get 10% minus fees, that's mathematical which means that the rest of the other three segments have to do the same thing, they can't get more than the market rate of return in aggregate, they can't get less. On average they will get the market return. That's mathematical.

So the facts are that whoever has the least fees wins in aggregate so that passive generally has smaller fees than active investors and therefore they will give a better return.

MA In a short word no. I've been around financial markets now for twenty five years so I do have some experience of market crises. I think Sir John Templeton's words in this regard were spot on which is "the four most dangerous words in investing are this time it's different". The important question here is 'is there a link between GDP growth and stock market performance? Many people in the investment world have the view that
there is going to be higher GDP growth in the emerging markets so I want to allocate more money there and I say "why"? The academic research that has been done on this by my old professor at LBS indicates there is no link between GDP growth and stock market performance. Looking at the return of each of these asset classes ranged by winner and loser for the last twenty years there really is no pattern but each of these assets exhibit a return above cash inflation and certainly by combining these assets together we have the diversification effect.

SW  I think the financial crisis is changing clients' recognition of how they think about their portfolios so there's a much clearer recognition that just a buy and hold strategy may not be appropriate for clients. If the education of clients and the awareness is increased I think that is important and I think it could be a game changer in terms of the types of funds which are used by those clients.

JN  I think if you strip everything back it shows the utter unpredictability of equity markets and over the last thirty years many people in the investment world have become anaesthetised to equities being a one way bet.

What academic and industry research would you refer to when justifying your investment proposition?

ST - If you accept that there is some advantage in tactical then what we're really saying is there are rules, in our case systematic rules which are going to allow you to actually outperform the passive big falls but join in the passive big rises.

That academic research we are most persuaded by is momentum literature which goes back to mid 1980's on behavioural finance where we observe that winning positions tend to carry on winning and losing positions tend to carry on losing for a certain amount of time.

Why do things carry on winning, because markets adjust slowly, they don't make markets completely efficient, they don't jump to new equilibrium, a winnings announcement takes up to nine months to be absorbed in the share price, we know that from many studies.
If you don't believe in a fundamental asset valuations or you don't think that's a consistent easy way to manage valuations because assumptions change all the time then momentum is a concept which is independent of fundamental valuation and allows the market to reward you with semi-predictable returns. I call them semi-predictable because obviously momentum doesn't work every time but it happens often enough.

This was all started back in 1985 by Richard Faber. He looked at US stocks and the ones that had done best in the last year carried on doing the best in the next couple of years, after a point they actually do too well, investors get too confident in them and then there's a reaction backwards and the question is identifying those patterns. Those patterns have been observed particularly in commodity markets in the last few years.

Historically you can look at the South Sea Bubble or the Tulip Mania hundreds of years ago and you can see these patterns. It's the way these financial markets function so what we're trying to do in our context is to say we can make a tactical adjustment based upon momentum, when we see momentum disappearing we move into cash, when we see it re-appearing we move back into the risky asset whatever it is. These patterns occur not just in equities but across all risky assets.

MA William Sharp wrote an elegantly paper in 1991 called ‘The Arithmetic of Active Management’. In that paper he demonstrated that the sum total of the equities held by the active management industry was little different to the index they benchmarked themselves against. The mental leap that Sharp made in his papers was that the active industry collectively holds the same equities and the same proportions as the index and therefore we already know that the active industry collectively will deliver the exact same return as the index gross and not net. The research then focussed on what is the difference between gross and net costs.

This difference between the passive pure asset class return and the after active fund manager costs return is about 4% a year and it is hard for a manager to consistently overcome that kind of a cost disadvantage against the benchmark. That's the first part of the argument. We then move to the second part of the equation which is can you find managers that will beat the index because research from Morgan Stanley and Vanguard shows that 80% to 90% of active equity funds do not beat the index.
How much of the overall investment result should be attached to asset allocation?

ST The decision is closely related to your strategic position because 90% of total portfolio return allegedly comes from asset allocation. I think a lot of us would say that markets are efficient and, it’s hard to forecast markets but what I say is that there seems to be some evidence that is based on behavioural financing and the physiology of investing that does give you some edge because momentum is present in lots of markets. It is nothing very sophisticated mathematically in the sense of theories but it’s just an observation that momentum does exist. That gives you the tactical overlay but I’m a passive investor when it comes to strategic percentages.

SA Asset allocation usually drives 90 plus percent of the overall return and the rest would be the rebalancing. Going back to the first part of your question, passive strategic is better than active strategic and here’s why, over a ten year time frame you’re not assuming equities will outperform bonds, you’re saying I want to have a well diversified strategy to capture all the markets that we have in a highly diversified and strategic way so that I get the market rates of return. If the market rates of return are lower in the next period than they were in the past period I just get lower returns, it doesn’t change who wins.

I would say the most compelling research I have come across is about the Arithmetic of Active Management. Bill Sharp’s research talks about the zero sum game and active versus passive. It’s the mathematical nature of all investor returns that there will be a market. The passive guys will get that, the active guys will get that, both of whom will be hurt by costs. So in aggregate the passive guys are going beat the active guys because they have lower costs. William Sharps research says that this does not rely on time periods, on data, on market conditions, it is a simple mathematical fact that it holds for all time periods.

. When I facilitate an active passive debate I start with that because financial advisors, and individual investors think that smart well educated people should be able to outperform the markets. I believe it is the other way around, the markets are going to do what the markets are going to do and this is a difficult game to play, it’s very difficult. That’s the most compelling bit of research. Then all the studies that have been done make sense, every properly risk adjusted study that has ever been done shows that
two thirds of fund managers underperform because it's referencing that maths. If I see a study saying something other than that - that over half outperformed I know they did the study wrong because it can't happen. You can't make more money than the stock market made in aggregate.

**Do you think the clients investment time scale changes which investment style might be most suitable for them?**

**SA** People looking at passive and saying the index has not delivered a positive returns over ten years and therefore that means you can't invest in an index are wrong. The equity markets have not delivered a positive return in ten years does that mean you don't invest in equities? Ten year periods when equities underperform are quite common; there are several of them over the last hundred years. Small caps underperform large, common, value underperform growth, common, bonds underperform cash, common, all common things.

They happen about one third to one quarter of the time so this is a fact of life, this is not anything new. Some people are using the fact that equities have underperformed as a justification for their tactical strategy but it misses the point. If the client is invested in a well diversified 60 per cent equities and 40 per cent fixed interest portfolio over the last decade with diversified into emerging markets, small cap value, property then 7.5 per cent per annum is realistic from year 2000 to 2010. What's the problem with long term buy and hold? Which other strategy has beaten 7.5 per cent per year without taking more risk?

**SW** I think we need to be really clear that we should always have our eyes open. If you were to say I want to have a long term approach and you set your strategic asset allocation, that means you must have very high confidence that you can predict volatility, correlations and returns because if you get those wrong then that could hugely impact the outcome for your client. Do you think you're going to get the average return from the last ten or twenty years over for the next ten or twenty years?

If you look back over history that's only happened over both periods about 10% of the time so really it comes down to what is the entry point, what is your view on those returns at any point in time and that means that having a long term strategic asset
allocation approach simply is fraught with danger in terms of the assumptions you put into those models. I think it's far more appropriate to look at an outcome that you're trying to achieve and move the portfolios to achieve that outcome and keep that in mind rather than say I'll have a strategic view and hoping it will all come good in the end.

JN Investor time horizons are very important. In 1930 when Wall Street fell out of bed in real terms taking into account inflation the equity investor didn't get their money back until 1964 which is quite a long stretch and most passive processes say that you have to be in it for the long term. Most people only come into money when they are in the latter parts of their life, when they're maybe retired or perhaps a family member has died so they might not have that length of time to allow a passive strategy to play out.

I think if you've got enough time, by that I mean multi-generational time, then the passive approach is fine but it is probably better for an institution rather than an individual. If you have got forty years then a simple cheap passive investment is probably as good as anything but few of us have the luxury of a forty year investment time horizon and few of us have the strength of character not to be frightened by really quite sharp falls which are inevitable. Let's not forget that if an equity market falls by 50% it has to rise by 100% for you to get back to where you were and suddenly that looks like a tall order.

Nearly all participants felt that the financial crisis had focused investor's minds on the downside of investing in risk assets. I think that the strength of this argument depends on the time scale that matters to the investor. If the investment term is thirty plus years then risk management techniques are less important but as the investment term shortens then so does a clients tolerance to loss.

The shorter the investment term the less important the long term cost savings of pure passive investing and the more important the potential defensiveness of tactical and momentum investing techniques.
How much of the winning formula of passive over active is the saving in investment costs?

SA  All of it. Well it depends on how you characterise mistakes, if you say being out of the market is a mistake when I should have been in the market then that's an active management decision gone wrong, or you could call that an opportunity cost. You'd have the trading fees and the transaction costs and the stamp duty and the taxes of coming in and out, you can say I missed the stock market, that's an opportunity cost but in aggregate it's cost because the difference between everyone on the passive side and the active side is just going to be cost because the market has to do the market. In summary, the passive universe is tighter, safer, and cheaper. This is the opposite for active investing.

MA  Most of it but the active approach carries more risk because the chance of underperformance does go up as so many managers underperform the benchmark.

JN  Cost are important but if you own a tracker fund that has fallen by 43%, having held it for a long medium to longer term, it probably doesn't really matter whether you're being charged 0.25% or 2.25% for that passive fund, the result is still the same, you're down about 40%. I say 43% because that just happens to be the maximum fall in the MSCI World Index over the last ten years.

NM  How much value does rebalancing the portfolio add and what's your approach to rebalancing

MA  The beauty of rebalancing is being disciplined to sell high and buy low. I think that on a forward looking basis it is impossible to know what benefit this will have because who knows what the pattern of thing will be? If you take for instance four asset classes for thirty seven years which we looked at which were UK equities, UK Gilts, UK real estate and commodities hedged into Sterling (using an index of twenty four commodities) if you simply put 25% in each of those four assets and then rebalanced it back to that 25% each and every year over thirty seven years the rebalanced portfolio beats the combined average return of the constituents by around 1.5% per annum so there is a big rebalancing premium there. Of course the other nice thing rebalancing does is it keeps the risk profile in line with what was originally set by the client.

We calculated the optimal rebalancing frequency for the eight asset classes we invest
The results of that were two things, one the optimal period historically in any data sector was about every twenty four months so you should invest, let the weights move and then rebalance it back, sell high and buy low. The second result unfortunately was that that twenty four month optimal point was not a statistically significant result so in other words there is no likelihood that the future going forward is going to be every twenty four months so for us we chose an annual basis. We review things on an annual basis and also because we look at some endowment asset allocation data that comes out annually it made sense to use March 31 each year. We looked at using yearend but because markets can be illiquid and the bid offer spreads could be wider at December 31 (we suspect because people are away on holiday) we chose March 31 as our rebalancing point.

In a straight forward passive only portfolio made up of two asset classes, risky and less risky, much of the longer term added value is in the rebalancing strategy. It is the counterintuitive strategy of selling your winner to buy your laggards that allow you to bank profits and use those profits to buy cheaper distressed assets. The work of Massimo Massa and Andrei Simonov showed that rebalancing is best done when transaction costs are low and the idea of monitoring buy and selling costs and picking the most cost effective time to switch must make sense. The most appropriate frequency for rebalancing appears to be around the once a year mark but it should be driven more by the variance away from the agreed strategic asset allocation as there s little point in switching say 0.001% of the portfolio on an annual anniversary during flat investment year, especially if at the 6 month point the asset allocation was 10% adrift from the agreed asset allocation. Also, frequent rebalancing say quarterly or more often could add significant transaction costs which might override the benefits of rebalancing.

Without doubt one of the real benefits of having an advisor who imposes the discipline of rebalancing is to override the behavioural tendencies discussed by Walter Sun, Ayres Fan , Li-Wei Chen, Tom Schouwenaars, and Marius A . Albota who showed that people have a tendency to become riskier as their gains multiply. This can apply to equities even if the majority of the gains are in another asset like say the value of their home.

Rebalancing is not as much of an issue for tactical investors because the timing of any asset sell and buy is less about any move away from an agreed asset allocation and more about the value judgements any rules as analysed by the fund manager and his analysts.
Is investing a zero sum game?

SA  Investment management is a zero sum game. Investment is not a zero sum game in fact I would say that investment is a positive sum game. If you put capital to work in the equity markets or the bond markets you are owed a positive return on capital so the investor is rewarded for providing their capital for use by the capital markets, that's a positive sum game. Historically those positive sums have been cash 2 or 3 percent, bonds 4, 5, 6 percent and equities 7, 8, 9 percent. That's a positive sum game. The game of trying to outperform those numbers, active passive is a negative sum game because of all the management and trading costs involved.

If a clever hedge fund manager makes a profit over the market return then the loser on the other side of the trade is another hedge fund type manager. It is not the passive investors as you can't take growth from them, there's nothing to take. Index investors own everything so when this guy makes a smart trade and he buys something cheap or expensive or whatever he's buying it from somebody else that's doing something stupid. Passive investors are not making any decisions so they can't be stupid.

Putting it another way, if I own all twelve thousand securities on the planet and two active investors are trading and one wins and one loses, how does that effect me? It doesn't, now some people think that these guys can manipulate entire markets so that entire markets crash or something like the whole world's equity markets or bonds markets are going to be affected by a couple of hedge funds over here doing that, I don't think so. Can these guys temporarily drive a stock like Volkswagen to do some crazy things, well yes. Does that affect the long term buy and hold investor, no.

Who does it affect, the person he's trading with. Active investors have the problem of the zero sum game, am I on the winning side or am I on the losing side. The passive guy says I'm getting out of that, here's the analogy. When you go to the casino you're expecting to be a winner, that's why you go and you're either a winner or a loser. You come out of the casino with more money or less money and if you're playing poker other participants are winning and losing against you. The passive story is the house, it's the casino, they get their cut so they're always winning, they're not taking bets, they're just earning the rents from operating the casino so if I wanted to make money in a casino I'd be the casino owner, I'd own the whole market, I wouldn't be one of the punters.
ST If you look at the relationship between GDP growth and stock returns there is no relationship. If you look at a scatter diagram of equity returns and GDP growth round the world for the last fifty years and you'll see there's no pattern. What I would say to you is yes there is going to be subdued GDP growth. We've over consumed, there's been excessive demand because increasing debt. What it means for stock markets I have no idea but what I do know is that they will not be flat, there will be patterns of ups and downs and something like trend following momentum exists solely to pick up on those flows of change in sentiment, new information is coming but we don't know from where.

SA Using an investment rules based system to time a buy or sell sounds good. But just because a particular set of rules happened to add value in the last fifty years and in this particular case what's happened is, the pattern in security prices is moving, over the last fifty years if you happen to chop it into these rules by two hundred days it seems like you can give yourself some downside protection or whatever, what if security prices don't behave like they have in the last fifty years.

What happens if there's a decade where we have two crashes or where it is not a two hundred day moving average it is a three hundred and fifty day moving average? So there's nothing to say that a rules based approach like that won't work but you're relying very heavily on securities prices to behave in the future the same way they have in the past and there's no evidence that they have and in fact looking at the rules based approaches that have been used through time they sometimes look like train wrecks.

Rules based investing is not new. One of the favourites up until the 50's was when equity yields are less than bond yields, invest in bonds and vice versa. So you would have got out of the US equities in 1945 and you still wouldn't be back in, so you'd have missed sixty five years of investing in equities because of your rule. That's the problem with these rules.

The only rule I want to rely on is that capitalism works, that risk and return are related and there's a positive return on capitalism. These other strategies, you're relying on someone smart to continue to make the decisions, some rule to continue to work and there is always a chance that they might not.
It is true that investment is a zero sum game because there has to be two people on each side of every trade. If someone wins someone else has to lose. As shown by Joanne M. Hill in Alpha as a Net Zero-Sum Game it must be true that global economic growth will drive the ability to provide net positive alpha (over the global risky asset market portfolio), as it influences aggregate wealth and capital creation. However, the timing of these gains and which industry or company they emerge through is less predictable.

In a passive portfolio the investor will pick up the aggregate alpha of the market being tracked while in the active world the investor can do better or worse depending on the success of the active investment manager. Passive investors invariably have an exposure to world capital market broadly in line with world market capitalisation while the active manager can focus in on particular companies, industries or countries depending on their fund manager’s views. This can add extra return but all extra risk.

Please summarise why you believe in Strategic or Tactical Asset Allocation.

AH We are definitely tactical because of the nature of the volatility in the world. If there was no volatility, if it was just a growth story you wouldn't need to be tactical, you would just be strategic, but there is this thing called market sentiment and fear and bubbles and greed and stocks will be expensive at times and they will be incredibly cheap at times. Can we over time build a system to manage the downside out and to buy in using a tactical process, buy in when stocks offer greater value? Absolutely!

TS My view is to go with strategic for the reward looking longer term asset allocation framework and tactical for the forward looking implementation. The story goes something like this. We have a central asset allocation that we adjust up or down depending on our tactical view based on the investment committees shorter term views. So for us the two work together but working on different time scales.

CA I think market timing is an opportunistic technique rather than a precautionary one. I see market timing as something where you think there is an opportunity to be exploited and you wait for that opportunity and try and exploit it at the right time. We would argue that we have a sort of centre line which is pretty static/steady but around that we will withdraw when we see problems coming. We will for example continue for the foreseeable future to be quite Pacific centric because we just see that's where the long term growth in profits and income is going to be.
We believe it is the tactical approach that will give the optimal returns. Strategic asset allocation relies on believing past returns are going to be repeated, believing that everything will come good over time and it's hugely reliant on the entry point. The long term modern portfolio theory of optimising portfolios is not necessarily appropriate in that respect. Targeting returns for the client in our view is very much what it should be about and that means taking a more tactical approach and looking at the fundamentals that can drive markets rather than rely on historic correlations and returns.

Do you think that markets have an average return and do you believe in mean variance?

Asset prices fluctuate through time, they go high and low, so their expected return premiums change through time so that when they're low they have higher expected returns. There is weak evidence of mean reversion so you would see that, there's also evidence of momentum which is the opposing factor. The evidence for and against mean reversion, for and against momentum has nothing to do with the choice around optimum investment style.

If there is evidence of mean reversion now we can prove that it's time to move away from this asset class to this asset class and they use that as justification. The problem is timing. In 1995 it was obvious that stocks were overvalued by anyone's measure, they didn't fall until 2001, six years later. The stock market tripled in value over that time period. The question is when, so the cycle definitely exists, there is mean reversion and there is momentum, the question of whether or not you can time those almost isn't a question, because there isn't anyone that's been able to prove that they can do it through time, not one person.

Regardless of asset class over a long period of time a strategy of momentum investing will typically give you the long term return on that asset class but with half the volatility and possibly a fraction of the draw down. My example would be the multi asset we're looking to introduce, with a volatility of return of 9% per annum and maximum draw down is 6% top to bottom which is incredible over a ten year period. This compares with a with a typical passive equity fund with a volatility of 30% per annum and maximum draw down of 60% top to bottom over the same ten year period. Most retired investor would be happier with the multi asset returns if that repeated over the next ten years.
Mean variance occurs when markets crash and are most dramatic when investment bubbles burst (such as Tulip mania and the South Sea Bubble and more recently the Tech crash in 2000) but they are harder to see coming before it is too late.

The paper called Mean-variance analysis in portfolio choice and capital markets By Harry Markowitz, G. Peter Todd, William F. Sharpe printed in 1987 and updated in 2006 considered this and went some of the way to proving that it was possible to plan ahead but admitted it was far from a perfect science.
Conclusion and Recommendations

This chapter brings together the findings of the research and makes recommendations.

The research revealed there was no consensus on which investment style optimises investor returns. However, there is some common ground that all the participants agree on as follows.

**Cost Matters**

Regardless of whether the investor chooses passive or active investments and regardless of whether these are managed strategically or tactically all participants agreed that keeping cost as low as possible was important and every pound saved in costs improves the clients net of costs returns.

Cost for these purposes should be an all inclusive cost including any annual management charge, any total expense ratio and any trading costs not included within the disclosed fees. The additional management fee for an active fund over an equivalent passive fund is between 0.25 per cent per annum for a basic active fund and say 1.5 per cent per annum for a successful specialist fund with a typical performance fee of 10 per cent for any gains above cash returns.

Trading costs do not show in the total expense ratio and depend on the level of trading and turnover within the fund. These include trading commissions; bid offer spreads and stamp duty which in an extreme example could be up to 4 per cent per annum but with the prudent use of derivatives and institutional trading terms this can reduce significantly.

Cost is one thing but value is another. It does not follow that the expensive active fund with a performance fee is bad value. If the fund has made 10 per cent above cash and therefore paid an extra 1% success fee to the fund manager while the cheaper passive funds has made say four per cent the client is still five to six per cent better off overall. What matters is that any extra cost is rewarded either added performance, reduced volatility or both.

The scourge of the industry are the expensive funds, active or passive, that quasi track the market and have below average performance or tracking errors. Some of these funds are promoted by banks and other tied distributors who have a captive client base that they can exploit because the regulator only asks that they offer the most suitable investment that they choose to make available. These often have added extra margin added for the distributors own purposes rather than any benefit to the investor.
What is clear is that any extra cost above that of a low cost passive fund with a low tracking error should be justified by a better combination of risk or reward. It is important that any extra performance is adjusted for risk as researched by William Sharpe and in part quantified by his Sharpe ratio.

**Asset allocation is the main contributor to investment returns**

The work of Ibbotson and others that says that asset allocation contributes most to the return of any given investment portfolio is widely accepted by all participants.

The problem is that different asset classes perform differently at different times and being in the right one at the right time challenges most investment professionals. Even more important is that the correlations between different asset classes change over time. The problem is made worse by the fact that too often asset classes converge to a correlation close to one during a financial crisis (like in 2008).

When risk assets are trending upwards, as they broadly did during much of the 1980’s and 1990’s, a fixed strategic asset allocation can work well. For cautious clients a fixed interest element if often added to help dampen volatility. Again this has worked well and has been assisted by a 20 year bull market in the government gilts leading to historically low gilt yields.

When risk assets are volatile, choppy and range bound, as they have been for much of the 2000’s the ‘buy and hold with rebalancing’ approach of strategic asset allocation has struggled to deliver consistent inflation beating returns.

**Reducing the Tax rate can help to improve the net of tax investment returns**

Although not strictly part of the dissertation brief all participants agreed that controlling and limiting the tax that the investor pays on their investment returns can be very important. Often this can make a bigger difference to the overall return than the investment costs themselves and could be the subject of future research.

Having dealt with the common ground agreed by the participants to the research I will now consider the investment factors on which the different participants take different views:
Passive versus Active

The participants were polarised around their stated positions with the normal views that ‘the market is efficient so don’t try to beat it’ or ‘the market is inefficient and we will make money by finding the anomalies’ coming to the fore. There was some agreement that the developed stock markets where more efficient than developing stock markets and that for some asset classes there is no effective way of buying a passive version (e.g. managed futures and hedge funds) but after that any common ground fades away.

What we can say is that with the benefit of hindsight there are periods of time when passive beats active and vica-versa but spotting this in advance is a subject for further research. We can also say that in the very long term the differences between passive and active are less pronounced partly because the compounded lower costs make a bigger contribution and partly because market fluctuations even out over time.

The preference for passive or active should not be ideological but based on what can give the investor the best risk adjusted return net of costs. Some of participants used both within their investment propositions. All participants agreed that you can get good and bad passive and good and bad active funds it is finding the good ones that is the problem.

The researcher felt that the debate was moving away from distinguishing between passive versus active investments and towards the key decision between strategic and tactical investing.

Strategic versus Tactical

The participants were polarised around their stated positions with the differing views that you should ‘agree a strategic asset allocation and rebalance to avoid style drift’ or ‘only by being tactical can you take advantage of underpriced assets and market momentum opportunities’.

Strategic asset allocation can work very well when markets trend upwards but when they are range bound and volatile tactical strategies can come to the fore. These can be judgement based around fundamental analysis or rules based around price momentum.

Tactical funds normally works by risky assets being reduced or increased depending on the fund or portfolio manager’s analysis or in extreme cases moved from risk on to risk off by switching from risky assets to being invested in cash of short dated Global Treasuries. None of those participants advocating tactical strategies claimed to be able to consistently beat their benchmark but they did claim to be able to reduce risk by lowering volatility and
therefore missing the worst of any market falls.

Ultimately investor returns are optimised either by improving the returns themselves or lowering the risks taken to achieve them. These tactical funds do not have a long enough track record to prove that they can work but back testing for those funds that are rules based shows impressive results that cannot be ignored.

This doesn't mean that tactical strategies are superior to strategic strategies for all time periods but it does mean that for clients who have limited time scales to achieve their financial goals (like retirement or paying for a daughter’s wedding) should at least consider tactical funds and portfolios.

**Final Conclusion**

The reasonable conclusion to the dissertation question is that passive and active investments both have a place and can be blended together depending on the range and type of asset classes required to achieve the investor’s financial goals. The strategic or tactical asset allocation decision is a choice but for nervous investors or clients with limited time tactical strategies are likely to give a smoother overall return profile.

Of the nine participants in the research two were in the strategic passive investment style quadrant, one was in the strategic passive/active blend quadrant, two were tactical active and three were tactical passive.

In the researchers experience most retail investors are invested in a range of active funds chosen for their exposure to a given asset class within a model portfolio and measured against its benchmark. It is only when these funds are regularly reviewed for relative performance against its peer group and benchmark and rebalanced to correct asset allocation drift that modern portfolio theory is being applied. Too often these funds are expensive, are poorly correlated to the benchmark they are intended to follow are not rebalanced for optimal returns and therefore too many investors are experiencing less than optimised returns.

A better understanding of the issues raised by the dissertation question and the academic theory that leads to the conclusions drawn can only help to improve and inform advisors and investors judgements as to how hard earned savings should be invested.
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