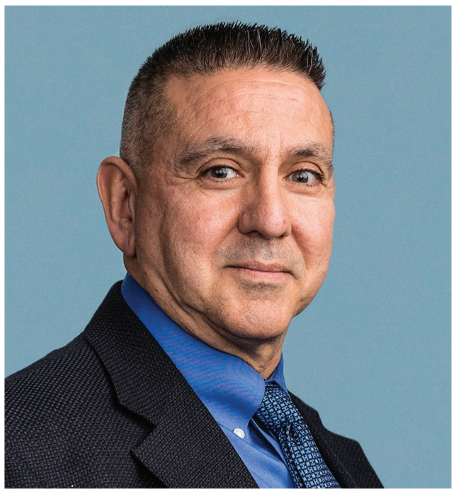
Investment INSIGHTS



Will the pandemic reverse the active-to-passive movement?

BIAGIO MANIERI, Ph.D., CFA
Managing Director and Chief Multi-Asset Class Strategist, PFM Asset Management

The onslaught of the COVID-19 virus has wreaked havoc with economies and stock markets around the world. In the U.S., while the S&P 500 stock index has rallied sharply off its pandemic-related March 23 low, which marked a 34% drop from its all-time high reached in mid-February, volatility remains elevated. Uncertainty is high as the economic ramifications of the pandemic continue to surface. Amidst this backdrop, institutional investors are thinking again about the value of diversification and examining their portfolios to decide whether to simply rebalance to existing asset allocations or restructure to take advantage of market dislocations. *Pensions & Investments* spoke with Biagio Manieri, managing director and chief multi-asset class strategist at PFM Asset Management, to discuss these issues as well as the question of whether passive or active strategies are better suited to take advantage of a market rebound.

Pensions & Investments: Do you think the heighted risk and volatility in capital markets from the coronavirus pandemic will cause a reversal in the trend of investors shifting assets to passive strategies from active ones?

BIAGIO MANIERI: At this point, it is too early to say, but based on first-quarter performance, I think the trend is likely to remain in place. Based on various databases, including PaRIS, a portfolio analytics and reporting system, most active managers underperformed in the first quarter. Particularly fixed income managers who invest outside of core areas such as high yield.

Some investors may be surprised by this since many believe active management outperforms during down markets. But we were not surprised. Indeed, we saw the same outcome during the financial crisis.

P&I: Is the question more nuanced than simply active vs. passive?

MANIERI: Yes, indeed. I think we need to distinguish between active management in selecting individual securities vs. passive replication of a benchmark, and active management of passive exposures or tactical asset allocation vs. mechanistic rebalancing to strategic long-term asset allocations.

At PFM Asset Management, we use a combination of actively managed funds as well as passive or index funds, but we actively manage the asset class exposures through tactical asset allocation. Because of our tactical asset allocation decisions, we were able to outperform both in 2019, when markets performed strongly, as well as in the first quarter, when most asset classes outside of Treasuries declined.

P&I: When you say PFM Asset Management outperformed in 2019 and in the first quarter of this year, what benchmarks are we talking about?

MANIERI: I mean outperforming the benchmark for each client's portfolio, which is a weighted average of various indices such as Russell 3000, MSCI ACWI ex-U.S., etc. The benchmark represents the policy portfolio or long-term strategic asset allocation. We attempt to outperform this benchmark by over/under-weighting various asset classes using passive vehicles as well as carefully selecting active funds that we believe will outperform in the current economic and market environment.

P&I: Most capital market assumptions forecast lower-expected returns going forward vs. historical long-term return levels. If institutional asset owners cannot count on active managers to outperform, how do they achieve the required rate of return to pay pension benefits, contribute to university budgets or support the goals of the foundation?

MANIERI: At PFM Asset Management, we use a combination of active managers who we believe can achieve excess return over time, and a core part of the portfolio that is passive. But we do not mechanistically rebalance back to target. In fact, we have been able to add excess return by actively managing our asset class exposures. Based on our fundamental analysis, we actively manage the over-weighting and under-weighting of various asset classes with the goal of achieving a return that is higher than that of a portfolio of either actively managed or index funds that stays close to the strategic long-term asset allocation or benchmark.

P&I: That sounds like market timing.

MANIERI: Some may see this as market timing, but we believe that tactical asset allocation done right is inherently different from trying to time the market. Those who try to time the market, for the most part, rely on technical analysis or looking at patterns in market prices and trends, e.g., a reversal in a market that is considered oversold. Our tactical asset allocation decisions are based on fundamental analysis of the economy, corporate profitability, monetary policy, valuation and other factors that drive capital markets. It was this analysis that led us to be risk seeking in our portfolio positioning in 2019 but significantly reduce risk in early 2020.

P&I: You raise the point of actively managing asset class exposures to manage expected return and risk as market regimes shift, but most investors rely on diversification to achieve the same purpose. Are you surprised that even well-diversified multi asset portfolios suffered significant drawdowns in the first quarter?

MANIERI: I am not surprised. We often hear that diversification is "the only free lunch that exists," as renowned economist Harry Markowitz put it. But as we saw in the first quarter, during the financial crisis and other times of economic distress throughout history, many asset classes such as equities, credit, etc., fall in unison.

Diversification is not the holy grail many believe it to be. Diversification works in normal circumstances when correlations, volatility, etc., are fairly stable. But as investors, we need to recognize that most asset classes, whether equities, credit, etc., have economic sensitivity. Therefore, when the economy gets hit, correlations go up as these asset classes are negatively impacted. For example, during a recession, companies earn lower profits. As a result, the value of the company is lower, and equities decline. As profits decline, the risk associated with corporate bonds, especially high yield bonds, increases and as a result, credit spreads widen and bond prices decline. This also works for commodities. In a recession — all other things being equal — we use less industrial metals, oil, etc., and as a result of lower demand, the prices of these commodities decline.

Modern Portfolio Theory is based on the notion that an efficient portfolio can be created if we know expected return, correlation and volatility. The implicit assumption is that these variables are constant. But that is not true. Correlations and volatility increase during times of stress. The asset classes that do well in times of stress and protect the portfolio best during times of crisis are Treasuries, the U.S. dollar, gold, put options, etc. But these investments have low expected returns over time. Therefore, it is a real question whether, over long periods of time, you want to allocate enough to these investments to protect your portfolio during times of crises. Is it worth it to hold these investments in large enough allocations to help protect your portfolio during time of crisis?

P&I: What's your answer to those questions?

MANIERI: We would rather tactically allocate assets based on our fundamental views and reduce equities, credit, etc., if we believe the economy is likely to go into a recession, rather than having asset classes that are a drag on performance most of the time, but will benefit the portfolio during times of crisis, which by definition, do not occur most of the time.

P&I: But most institutional asset owners rely on diversification and a long-term time horizon, right?

MANIERI: Most institutional investors do not rely or believe in tactical asset allocation. Some believe that the answer is in allocating a significant portion of portfolio assets to so-called alternatives, which they believe are able to outperform publicly traded markets in various market environments.

But if you examine the performance of endowments during the financial crisis, these funds did not outperform a simple portfolio of index funds. In our opinion, while alternatives can be useful under certain conditions, they do not obviate the need for tactical asset allocation. The approach that we have found to work best for our clients is to use a combination of passive and active funds along with alternative strategies in certain cases, but tactically allocate and manage our exposures based on fundamental analysis of economic and market conditions. ■

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