



An explanation of **Active/Passive**

Active asset allocation
Passive at the stock level

The most cost-effective way to manage internationally diversified equity portfolios

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SUMMARY

Most investors today recognise the importance of *asset allocation*, or exposure to types of assets and to markets within an asset type. Think stocks versus bonds versus cash. Think UK equities versus US equities. They generally expect it to be a dynamic or active process, whether the activity is fast or slow; whether it is conducted primarily for return-seeking motives or to manage risk. But when it comes to how the market exposure is to be implemented, there is an endlessly raging debate over whether to invest in 'the market' essentially in its entirety, a passive approach, or to pick securities (or funds that pick securities) and actively manage the selection and deselection.

That battle of ideas is often described as *active versus passive*, a phrase focused solely on the implementation approach: pick stocks or track the index. We have addressed this in a separate paper that focuses on the implementation choice: *Why passive dominates active management in equity portfolios*. This paper focuses on a derivation of active asset allocation that uses index tracking to implement its asset-allocation exposures: *active/passive*.

- Active/Passive is superior to an all-active approach that combines active asset allocation and stock picking.
- Active/Passive is superior to an all-passive approach that adopts a static asset allocation, with component country weights simply drifting with market movements.

Even if we were implementing our equity market exposures using active funds, the other two decision levels would explain almost entirely each of: long-term portfolio outcomes; short-run variance in returns; variance relative to benchmark returns. Active security selection would have little role, by comparison, in explaining any of these.

This dominance of asset-allocation decisions would apply even if we were not imposing a higher order of decision: portfolio separation between equity markets (as risky assets) and risk-free assets specific to each client's goal plan. Portfolio separation is how we control risk, in the sense of the probable real outcomes of the client's goal. This is explained in more detail in two other papers: *The Fowler Drew Investment Approach* and *Drawdown with Fowler Drew*.

In terms of both return-seeking and risk management, the whole approach is dynamic, responding to both time and market conditions. The Passive in Active/Passive risks being a misnomer: we are an active manager.

What drives the active decisions at the equity country level is a contrarian value-based approach based on observed mean reversion in relative sterling-adjusted returns.

Active/Passive as an investment category

In the early-90s, when Fowler Drew founder Stuart Fowler was promoting a new start-up in international equity investing, Valu-Trac Investment Management, the term Active/Passive did not yet exist or was certainly not widely used. Valu-Trac (as its name suggested) was a value-based manager that had developed quantitative techniques for investment decision making. Its target markets were institutional investors in the US and Canada and its target mandate was international equities, against a benchmark of EAFE (Europe, Australasia and Far East, or the world ex North America). It had a proprietary model for determining market exposures and its innovative idea was to use index-tracking commingled funds managed by State Street to implement the market weights, instead of selecting securities itself. This, as far as we know, was the first Active/Passive product to be offered.¹

The Active/Passive label was coined a little later by US pension consultants, to differentiate what they quickly identified as a very appealing approach for global and international equities. This was a time when international diversification was taking hold from a relatively low base, US investors having been much more insular than UK investors. Initially championed by smaller managers, it was the entry of Morgan Stanley that demonstrated that Active/Passive was scalable in broadly similar ways to passive funds, and that product charges could be massively cut accordingly.

Active/Passive is a generic approach to portfolio construction, not a style. The label tells you nothing about the investment beliefs or investment approach of the manager other than that they do not believe (for whatever reasons) that it is worth trying to add security-selection returns to the returns resulting from their exposures to different markets.

What all the early adopters shared was the message that asset allocation was the decision that would explain most of the return variance. This was an important educational process engaging professionals at the time. In terms of the technical integrity of an investment method, it is helpful to be able to isolate the risk and return contributions of each of the two components when both are active. Having a separate decision-making process for each, such as two separate models, helps. But most active managers are not able to separate the two. The market exposure may reflect the preponderance of attractive stocks, rather than being a function of index valuation metrics. That is not necessarily wrong, but it makes it harder for clients of the firm to see where the returns are coming from or how to react when returns deviate from a benchmark. You did not need to have a firm view on stock selection skills to believe that the KISS principle of simplification applied here.

These were all relevant considerations when Stuart Fowler formed Fowler Drew in 2004, as a private client service. We never set out to be stock pickers ourselves, as this would have been foolhardy at our scale. We were either going to implement our market exposures passively or develop a quantitative solution for selecting (and deselecting) managers of active funds in each of the markets we invested in.

As we explain in the paper *Why passive dominates active management in equity portfolios*, we were agnostic in our approach to the data evidence of 'plausible alpha' in the population of UK and foreign market funds available to UK-resident investors. If we could find an active solution that was sound in theory and worked in back tests, we would in principle adopt it. We developed the method, but we found that not enough funds, if any, could meet our statistical tests of plausible alpha to make it even remotely feasible in any market.

The Active in Fowler Drew's Active/Passive approach

In terms of investment beliefs and methodology, the construction and dynamic rebalancing of a Fowler Drew global equity portfolio are based on the observation of the following features of markets:

¹ Stuart Fowler has sometimes been credited with the concept and may have been first to market it as a product, but it was not his own idea. It had already been conceived by the trustees of the public-employee pension fund of the Canadian province of Saskatchewan and implemented for them by Barings.

- mean reversion in a market's cumulative real total returns measured in local currency
- reversion in real exchange rates against sterling
- correlations being what they are, reversion in relative sterling-adjusted returns

The deviations from observed trends are gradual and themselves trend but, though cumulatively large, they appear bounded. Seeking to exploit them for return purposes, relative to an index whose weights (exposures in %) are allowed to drift, therefore implies an investor has both the luxury of time (a function of the investment horizon) and the patience (a manageable behavioural characteristic). In words alone, our equity management approach might fairly be summarised as contrarian and value based.

The degree to which we seek to exploit observed deviations is nonetheless constrained by a set of diversification constraints in the form of lower and upper limits to the exposures in each of the six building blocks we can use, which are the UK, USA, Japan, Australia and two regional blocks: Europe ex UK and Emerging Markets. One effect of the constraints is to limit the amount we invest in any one market (we might be wrong), even if that market is one of the largest in terms of market capitalisation. A secondary effect is likely to be a more even distribution of weights than a world portfolio based on market capitalisation or GDP, but still much less than a notional equal-weighted index. The process is quantitative, using a portfolio optimisation logic that is designed to maximise risk-adjusted expected returns to each goal-specific time horizon, subject to not breaching any of the exposure limits.

Risk in a Fowler Drew portfolio is also managed at a higher level than the equity portfolio, if 100% in equities would breach the outcome constraints or volatility constraints a client chooses when planning the goal. It is managed by diluting the equity proportion by introducing a risk-free asset specific to the goal's horizons and to the amount of any required or target outcome at that horizon. If this does not apply, because 100% equity exposure is appropriate, risk is managed within the equity portfolio by diversification alone.

Both aspects of portfolio construction, the high-level mix of equity and risk free and the approach to the equity weights, are more fully described in the document *The Fowler Drew Investment Approach*.

Passive implementation

We use both index-tracking unit trusts and ETFs to track each of the six building blocks. Both types fully replicate the market indices we rely on when modelling real returns². We do not use trackers that rely on derivatives instead of physical securities.

Risk is already fully diversified within each market and there is no 'active manager' risk to diversify so we only need one per market except in taxable accounts, where we may want to substitute one fund with another to avoid 'bed and breakfasting' CGT rules.

New positions typically use ETFs as we prefer to be able to deal at known prices rather than future prices (typically determined after the market has closed). ETFs have also tended to lead the price competition that has significantly reduced the cost of tracking equity markets over the period since we started.

Tracker costs vary by market but the average that is built into our simulations of future portfolio weights (when calculating probable real outcomes) is 0.12%. This compares with typical costs for actively managed funds, including transaction costs within the funds, of at least 0.80%. Both sets of fees have been subject to erosion, and we believe the gap is now unlikely to alter materially.

² The only mismatch between the index used in modelling and the indices we use to implement exposure is in the UK where we may combine a FTSE 100 index with a FTSE 250 index as the combined cost is lower for virtually no tracking error relative to the FTSE All Share.