MACKENZIE Investments | CONFIDENCE IN A CHANGING WORLD

Building Portfolios with Active, Strategic Beta and Passive Strategies

It's a Question of Beliefs

Issues to think about on the Active/Passive spectrum:

- How important are fees to you?
- Do you believe markets are highly efficient?
- Does the index give you what you're looking for?
- How comfortable are you with being different?
- Is it possible to gain an "edge"?
- Do you have the stomach for active management performance cycles?
- Do you believe markets move in patterns that can be exploited?

An investing decision that continues to attract a lot of attention is whether to take an active or passive approach. Today's extreme focus on just one element of the investment decision—cost—continues to overshadow the rest of the discussion. It's not helpful that many in the investment industry present the decision in black and white terms. The argument usually goes, "Active is expensive; therefore passive is the better choice".

We believe it is a mistake to view this decision as an either/or choice. Sophisticated investors increasingly recognize that active and passive investments can both be useful within a portfolio.

Each approach offers benefits that can be useful at different times, and for different purposes, in a multi-asset context. As Mackenzie Investments has discussed before (The Value of Active Management for a Total Portfolio), active management plays an integral role in a thoughtful investment plan. As we will outline, active approaches can be complemented by passive and smart beta (also known as strategic beta) approaches to help achieve specific goals. A more useful discussion is how best to utilize the entire spectrum from active to passive to help deliver investment objectives.

To that end, there is no single ideal combination of active and passive in a portfolio, because there is no single type of investor. Each investor has a unique objective, liability profile, risk tolerance, time horizon, liquidity need and other sensitivities. This paper offers guidance on what to think about when building a portfolio using tools from across the active/passive spectrum.

Defining passive

Investing passively is to invest as closely as possible to the allocations found in well-known market benchmarks. It is the cheapest way to get market exposure. Passively following a market-cap-weighted index means following a specific investment strategy that creates a specific type of exposure. In brief, matching a market-cap-weighted index means buying those securities in proportion to their weight in the index—buying more of those with larger market values and holding proportionately more of those securities as their price rises (and vice versa, holding less as the security's price declines and the market cap falls). Therefore, investing passively is a momentum-based strategy that follows a specific set of rules; it is not a neutral strategy.

In contrast, active investing involves any degree of deliberate deviation from these benchmarks to achieve an investment objective. Because there is an active strategy at work, costs tend to be higher (sometimes significantly so).

Active and Passive: A question of beliefs

Investors' beliefs about market efficiency, performance patterns, fees and risks are critical in determining the extent to which they may choose to use passive, strategic beta and active approaches in portfolio construction. In the following section we identify some of the key areas where understanding our beliefs and biases will help determine our positioning on the active-passive spectrum.

1. Fees – How important are fees to you?

It has become trendy for some industry observers to focus primarily on the fees charged by investment managers, often to the exclusion of all else. If it is your belief that the fees you pay are the dominant consideration, then passive must be a large, or even total, component of your portfolio. The passive portfolio of low-cost, cap-weighted exposures is THE portfolio for the extremely fee sensitive.

But what is usually overlooked is that even passive strategies are not free. By the time a passive strategy makes it into a client's portfolio, both fees and trading costs (bid-ask spreads) have been added. By definition, this means that a passive strategy that aims to provide exactly the market return will provides guaranteed underperformance, after fees.

That said, passive strategies carry a significantly lower fee than active or strategic beta strategies. So even if an investor has only modest fee sensitivity, a blend of active and passive exposures may still be useful. Advisors are increasingly working with a fee budget, and engaging in what we call "fee arbitrage", where they utilize active strategies together with a passive component that is sized to achieve a certain fee target for the total portfolio. They accept that asset classes or strategies with a higher expected alpha can come with a higher fee, but in areas where the advisor sees less alpha potential, low fees become a larger consideration. These advisors have a certain total fee in mind for each client, and blend active and passive strategies that will deliver that fee.

Clearly, we believe fees should not be the only consideration. Investors and advisors should first build portfolios that deliver effectively on their objectives. However, once that is satisfied, engaging in "fee arbitrage" has become an increasingly popular strategy. The risk is that, in the search for cost reduction, investors stray too far and end up losing sight of their objectives.

2. Market Efficiency – Do you believe markets are highly efficient?

Embedded within the discussion over fee sensitivity is a deeper consideration about the efficiency of markets. After all, investors would not willingly choose a lower fee if they also believed this decision would guarantee a loss or create serious damage to their portfolio. No, choosing a lower fee comes with a belief that a passive, market-cap based approach is not going to produce all that different a return. In fact, some investors believe passive can produce a better return net of costs.

Those who believe a passive approach will always do better also believe markets are highly efficient. They believe security prices quickly reflect all available public information, and that investors are generally rational, profit-maximizing agents that don't let emotion cloud their judgement. In their view, if the sum of all investors are bidding up a stock's price, it's because that stock's prospects must have improved. Why second guess and try to outsmart the market?

But most practitioners do not believe markets are perfectly efficient. Some markets are not well followed, and some asset classes are too new to be well understood. Prices often adjust slowly to new information, or react incorrectly, or not at all, for extended periods. Even in highly efficient markets, investors react with emotion and display well-documented behavioural biases. This creates varying degrees of opportunity for active managers to profit from these inefficiencies.

3. Risk Characteristics of the Index – Does the index give you what you're looking for?

The media usually overlooks the fact that investing passively in a market-cap-weighted index is not a neutral strategy. It is important to look at the investment merits of the passive index and ensure that the index actually offers the exposures and risk/return characteristics that you are seeking from your investment.

For example, market-cap-weighted equity indices by their very nature invest proportionately more in a stock as its price rises, and can be dominated by a few large cap stocks or sectors. Therefore, investment performance will be driven by momentum in those names or sectors, both during the up phase and on the downside. Investors should determine whether this is the right type of exposure for their portfolio.

Market-cap-weighted bond indices contain the greatest exposure to the most indebted countries or companies. Aggregate bond indices often have high concentrations of government debt from a handful of developed nations. The exposure to CCC bonds in a high yield index may not be a desirable exposure near the end of the credit cycle.

4. Comfort with Tracking Error – How comfortable are you with being different?

The recurring theme in these discussions around active/passive decision points is what the industry calls "Tracking error" (TE). Tracking error quantifies how different a strategy is from a benchmark. The more different a portfolio is, the higher the TE.

TE is neither good nor bad, on its own. If high TE comes with vastly superior returns, investors will be happy and will gladly pay up for that active management. But not everyone can have vastly superior returns. By definition, someone has to be average and many will be below average. Some strategies are very different (high TE) but may consistently underperform, which means those investors would have been better off buying a low-cost, passive strategy.

The uncomfortable fact of active management is that it will be impossible to know in advance which strategies will be above average and which ones will underperform. The only thing we know in advance is what the fees are. So the rise of passive investing can also be viewed as a way of investors expressing discomfort with paying fees to become different from the passive benchmark. This discomfort with being different is especially acute when the passive benchmarks have been doing well and setting new record highs.

Unfortunately, the only way to outperform a passive index is to be different, which is to accept tracking error, and give your portfolio the ability to outperform. But outperformance is in no way guaranteed. Your level of comfort with the known versus the unknown will help drive your decision on how to mix active and passive strategies in a portfolio.

5. Active Management – Is it possible to gain an "edge"?

Professional active managers use a specific process that they have developed over time to help them decide which securities to over- and underweight versus their benchmark. If this process is quantifiable and repeatable, it should provide a performance "edge" over the benchmark. For example, an edge over the momentum-based strategy employed by passive cap-weighted indexes.

To invest actively, one must believe that gaining an edge is possible, at least for a certain length of time.

The evidence supporting active management exists but has been interpreted in many ways. Over various periods, active management has indeed beat the passive indexes net of fees, but the degree of value creation has varied. Since the 2008 financial crisis, North American active managers have, at times, struggled to beat market indexes. Moreover, few individual managers have consistently beat the index over long periods of time. They may still have delivered on their investment objectives but the momentum strategy employed by the index has, at times, produced higher returns, though often at a cost of higher risk.

6. Investment Styles – Do you have the stomach for active management performance cycles?

Investment styles come in and out of favour. A popular example of this is how growth and value seem to trade places on the leaderboard over time. It is not clear that one style is superior to the other, but one style can lag the other for extended periods of time, often measured in years.

Sophisticated investors with long time horizons—pension plans, endowments and foundations, for example—usually employ a variety of investment styles within their portfolios. Some styles will work when others don't, but over the fullness of time they may all arrive at the same neighbourhood by the end. However, unlike most institutions, individual investors do not have infinite time horizons. Even if they believe that active managers can successfully develop and maintain and edge, they have to determine whether they have sufficient time and patience to ride out a period of underperformance that may last years. Underperformance could afflict a specific manager or a whole investment style, like value.

There is also the question of stomach. Most investors like when an active manager says they will profit by doing things differently. However, in practice, investors show little stomach for even short but sharp periods of underperformance. If you know you will be uncomfortable with performance that lags the popular indexes, and if that discomfort may lead you to abandon ship on your investment strategy, then a smaller active allocation will make room for a larger allocation to a beta exposure with less tracking error risk.

7. Market Return Patterns – Do you believe markets move in patterns that can be exploited?

Many investors believe markets go through inevitable phases of under- and over-valuation. There are many metrics to measure valuation and there is no industry standard. We encourage most ordinary investors to avoid trying to time the markets. That said, many "professional" investors employ strategies that over-or underweight securities and markets based on valuation differences from long-term equilibria. Done poorly, this can destroy value but if it is done well, it can be a highly effective tool to manage risk and deliver alpha.

If you believe that a security, asset class or market can become overvalued, and you see benefit in managing your exposures in order to control portfolio risk, then you will likely see a role for active management. Even if you believe that over long periods of time, no investor can correctly time markets with a great degree of accuracy, your time horizon may be such that it is in your best interest to reduce exposure after prices have appreciated strongly. You may not have the time or desire to ride out the inevitable booms and busts. Even investors who highly value low fees will express a strong desire to avoid a market crash, and many active strategies are built on taking less market risk than found in the popular momentum-based passive indexes.

Portfolio Construction with Active, Passive and Strategic Beta Strategies: Core-Satellite Approaches

One of the most common portfolio construction philosophies that blends active, strategic beta and passive strategies is a core-satellite approach.

Perhaps the most common core-satellite methodology is to select passive and active strategies based on the perceived efficiency of the underlying markets. An investor may believe developed large-cap equity markets are quite efficient, and will allocate passively there (thus accepting the cap-weighted index's biases and concentrations), but look for active managers to access small-cap markets, emerging markets or more complex and less liquid areas of fixed income. In some cases, the only way to access an asset class is via an actively-managed strategy.

An alternative core-satellite methodology is to start with a core broad market beta exposure gained through strategic beta and/or passive strategies, and add satellite exposure to active managers in any segment based on the perceived skill of that manager and their potential to consistently generate outperformance. For example, an investor may believe there are several persistent market anomalies that can be exploited consistently by an active manager, such as the "value anomaly" or the "low vol anomaly", and will build satellite allocations based on those principles.

In a third interpretation of core-satellite portfolio construction, the investor creates an optimized core portfolio based on the combination of their beliefs about market efficiency, potential for manager outperformance, tolerance for tracking error and the risk characteristics of the investments. For example, an investor may believe that market-cap-weighted equity indices contain too many biases and will seek a more neutral strategic-beta strategy instead. Or they may believe passive bond market indices contain a suboptimal set of exposures to credit and interest rates, and will instead seek an actively managed core strategy for their fixed income.

With this approach, satellites take the form of opportunistic investments in active, passive or strategic beta strategies to take advantage of current market dynamics, or to implement a medium term tilt toward a certain set of risk factors. For example, investors may want to tilt toward style that is out of favour but that, historically, has staged powerful multi-year recoveries. The liquidity of passive and strategic-beta investment vehicles and the ease of using them to make tactical allocations make them valuable portfolio tools in this context.

> Combining proven strategies together in a scientifically-based and cost-conscious manner should result in a far superior outcome than simply juggling asset classes chasing the lowest fees. The core-satellite approach illustrates one way for investors to blend passive, active and strategic beta allocations in portfolios where they want to retain control over the levers.

Sophisticated Portfolio Construction: Target Risk Portfolios

Target risk portfolios represent a more advanced, outcome-based approach to portfolio construction. As their name suggests, these portfolios are managed to deliver a maximum return subject to a specific target level of volatility. A key advantage to these portfolios is that unlike core-satellite approaches, target risk portfolios tend to be managed by a single manager who takes control over all the available levers.

In a target risk approach, each asset class will be broken down to its constituents to measure and assess detailed exposures, expected volatility and correlation to other asset classes. An optimization process will allocate across the various asset classes to deliver the maximum expected return for the chosen risk level. In this way, a suite of portfolios can be built from the same building blocks, each with a different targeted risk level. Risk, or volatility, can be defined in either absolute terms or relative to a peer group (or, in the most advanced portfolios such as those managed by Mackenzie, both).

Further decisions can follow, such as the desired contributions to total portfolio risk from active management, currency allocation and tactical asset allocation decisions. Each of these activities can be scaled relative to the others to absorb a given pre-determined share of total risk.

The construction of target risk portfolios is typically beyond the reach of individual investors due to the extensive analytics required to measure the risk levels and correlations of each asset class across all of the various dimensions that define a sophisticated risk framework (asset class, country, currency, sector, risk factor, etc). Breaking active, passive and strategic beta allocations down to the security level and running them through a computer-based risk analysis and attribution system is the only way to successfully build and maintain a solid target risk portfolio. In most cases, this software must be custom-built and maintained by specialized professionals in-house.

Whatever the Combination, Oversight is Critical

Every security comes with a set of exposures. The sum of all the exposures in a multi-asset portfolio is what produces the desired outcome. Putting the pieces together on day one is just the first step. After that, investors should have some way to monitor the portfolio's exposures on a regular basis.

As markets change and as different securities enter and exit the portfolio, the portfolio's aggregate exposures will change. It makes little sense to implement an outcome-based portfolio that cannot stay on track or evolve with market conditions.

> An active oversight manager adds professional, holistic, total portfolio management to the portfolio. Using systems designed to accurately collect and quantify the portfolio's exposures, the Multi-Asset Strategies Team works to ensure portfolio exposures stay on target.

Implementing sophisticated asset allocation oversight accomplishes two things. One, it ensures the right amount of diversification. Proper diversification by risk factor prevents a portfolio from becoming too concentrated in one exposure. It also prevents the portfolio from becoming too widely spread among risk factors such that they offset each other. Utilizing passive strategies alone severely limits the ability to do this.

Two, professional oversight enables the implementation of strategic and tactical tilts across a wide range of asset classes, to take advantage of market opportunities and avoid risks. Blending passive beta exposure with systematic, quantitative strategic beta strategies and actively-managed components allows the portfolio managers to make use of a highly diversified toolbox to achieve portfolio objectives

Conclusion

Sophisticated investors increasingly recognize that they can take advantage of a wide range of approaches when building portfolios. Traditional active investing can be well complemented by passive and strategic beta approaches to help achieve specific goals.

There is no single ideal combination of active, passive and strategic beta investments in a portfolio. Investors should first determine where they sit with regards to a range of beliefs about fees, market efficiency and the ability of active and strategic approaches to gain an edge over passive indexes, either in performance, risk or some other outcome.

There are several common approaches to building portfolios using different investment styles. Fee budgeting allows investors and advisors to target a specific cost level. A core-satellite approach allows an investor to reflect their beliefs about market efficiency, potential for manager outperformance, tolerance for tracking error and the risk characteristics of the investments by building a core position and then layering on peripheral, targeted and flexible allocations. Finally, target risk portfolios represent a more advanced, outcome-based approach to portfolio construction, where a single manager builds an optimized portfolio using a blend of active, passive and strategic beta building blocks. Critical to any of these approaches is the application of regular and detailed oversight.

With a full complement of active, passive and strategic beta ETFs, Mackenzie Investments provides all the building blocks necessary for any of these approaches. Mackenzie has also constructed a suite of target risk portfolios using ETF building blocks—the Mackenzie ETF Portfolios. These portfolios include a selection of Mackenzie ETFs developed to provide exposure to many of Mackenzie's proprietary active and strategic beta strategies, complemented by a full array of passive index ETFs that provide cost-effective market beta exposures.

Talk with your financial advisor for more information on portfolio construction strategies.

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