HIGHLAND

INSIGHT
JULY 2017

A FREQUENT FLYER'S GUIDE TO THE ACTIVE VS. PASSIVE DEBATE

There's more than one way to fly in comfort

HIGHLIGHTS:

- The spectrum of investment options from active to passive provides different experiences of getting to the same long-term goal, which is why it is important to evaluate the range of expected outcomes not just the historical consistency of returns.
- Time horizon for decision-making is the most important factor in the active/passive debate.
- Passive investing has distorted the market as fundamentally-insensitive money drives valuations higher—helping as markets rise but adding to turbulence in drawdown periods.
- Highland prefers active management, however we do understand that emotional capital may be better spent investing actively in areas of the market that are more inefficient.

Investing is a journey with multiple routes to your destination. Everyone wants to improve the experience, which is why Highland encourages an approach that analyzes all investment options when determining the path that best meets an organization's goals and objectives. Many investors know exactly what type of return they want to achieve, but do not always know the best course for how to get there—much like selecting a vacation route. This is true when investing in equities, where there has been a significant route change from active to passive investing. J.P. Morgan estimates that passive and quantitative investors dominate the market with 60% of equity assets, up from less than 30% a decade ago. The rise of passive strategies has fueled the question, which strategy is the best course? We believe that the active versus passive debate is not mutually exclusive.

ACTIVE AND PASSIVE ARE NOT MUTUALLY EXCLUSIVE

As allocators of client capital, we are not limited to just one tool in the toolbox. The decision to invest either passively or actively is not an either/or approach. Time horizon plays a key role in selecting your flight plan.

In keeping with the toolbox analogy, the passive approach is like using a mallet. This is using blunt force to gain diversified market exposure. On the other end of the spectrum is active management, which is like using a tack hammer—a precision tool—to gain specific exposures. This involves buying a selected portfolio of securities that meet specific quantitative and qualitative goals to beat a benchmark. Each one has its place, depending on an investor's time frame.

INVESTING FOR THE TOTAL CLIENT

- *Investment services*
- *Reporting services*
- *Business services*

ABOUT OUR FIRM

Highland Associates, Inc. is an independent institutional investment advisor headquartered in Birmingham, Alabama. Highland was founded specifically to help develop, implement and maintain investment management programs for institutions. We serve a national client base of investors including not-for-profit healthcare organizations, foundations, endowments, defined benefit plans, defined contribution plans, and insurance portfolios. As of March 31, 2017, we serve as investment consultant on approximately $20 billion in assets. Please visit the website at www.highlandassoc.com to learn more.

THE RISE OF PASSIVE INVESTING

Since 2008, $1.4 trillion has moved into passive strategies while $400 billion has flowed out of active strategies. During that time, Vanguard, one of the largest passive managers, has grown from $1 trillion in assets to $4 trillion in assets. To put this in context, they have essentially brought in about $1.6 billion each trading day from the end of 2008 through 2016. Moody's predicts that passive investments will comprise 50% of the U.S. stock market by 2024. Why the meteoric rise in passive strategies? Unconventional monetary policy enacted by central banks following the Great Recession led to substantial risk reduction in the markets. The now decade-long period of accommodative monetary policy truly became "a rising tide that lifts all boats." Conditions were perfect for the takeoff of passive investments.

As active management has struggled in this low-volatility environment, investors have turned to other options. Passive is the main vehicle of choice, as these strategies offer investors low-fee options, which are important in a low-return environment. Investors can easily implement passive strategies and do so without the consequence of benchmark tracking error. Additionally, passive investing has morphed from broad market exposure to investing in specific sectors, factors, regions, etc., allowing for more intentional exposures for investors. There are nearly 6,000 indices today, up from fewer than 1,000 ten years ago. According to Goldman Sachs, ETFs are expected to purchase $300 billion in equities this year, more than in 2015 and 2016 combined. There is now an ETF for everything from climate change (ICLN) to cyber security (HACK) to even Quincy Jones streaming music, media and entertainment ETF (QJ).

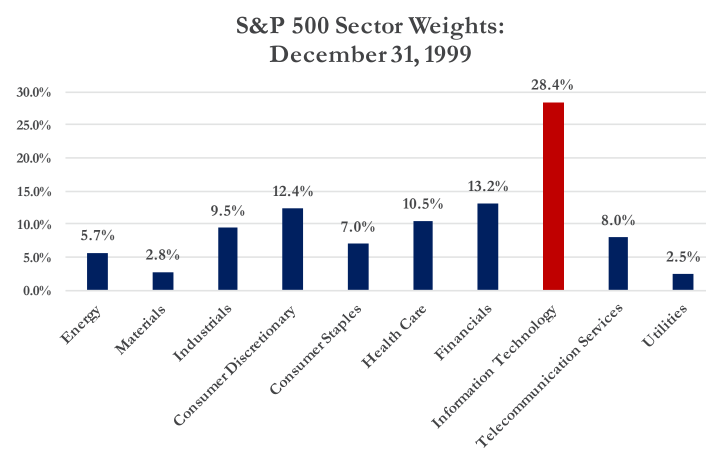
INVESTORS MAY EXPERIENCE TURBULENCE

There are some drawbacks of passive investing that investors must weigh. As passive investing becomes a larger part of the market, this fundamentally-insensitive money begins to distort the market. Forced passive allocations effectively prop up companies regardless of their underlying intrinsic value. This phenomenon is driving valuations higher in the U.S. across the board.

Per the *Wall Street Journal*, in 2005 Vanguard's passive mutual funds and ETFs owned 5% or more of only 3 companies in the S&P 500. As of today, this number has jumped to 491 companies. When the market obscures distinctions between good and bad stocks, it becomes difficult for active management, but also increases overall risks in the market. JP Morgan estimates that only 10% of trading volume originates from fundamental investors. Vanguard's founder, Jack Bogle, recently warned of the potential ramifications associated with the increase in influence of ETFs. In 2016, the dollar volume of trading in the 100 largest ETFs reached $13 trillion, yet the market cap of those was just $1.6 trillion. This has resulted in annualized turnover of 120% for individual stocks compared to 880% for ETFs.

Capitalization-weighted indices are momentum oriented. This is beneficial when the market is rising, but can lead to a turbulent landing in a down market. Historical analysis of the S&P 500 sector allocation/composition highlights these past periods. In December 1999, Information Technology made up 28% of the index and was double the next highest sector (see ***Figure 1***). The following two years the NASDAQ fell almost 80%, bringing the S&P 500 down almost 50% with it. Passive investors felt the full pain of the decline. After 17 years, the NASDAQ just recently surpassed its historical peak in 2000.

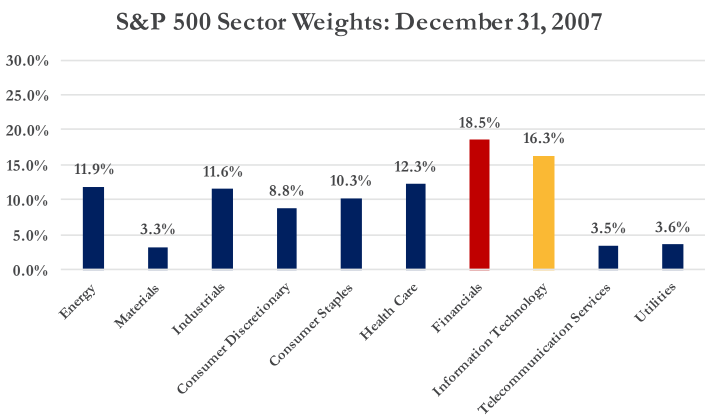
FIGURE 1



SOURCE: S&P; HIGHLAND ASSOCIATES

In 2007, Financials were nearly 19% of the index and the largest sector prior to falling as much as 80% (see ***Figure 2***). Interestingly, Information Technology climbed back to a mere 16% weighting eight years since its big drawdown.

FIGURE 2



SOURCES: S&P; HIGHLAND ASSOCIATES

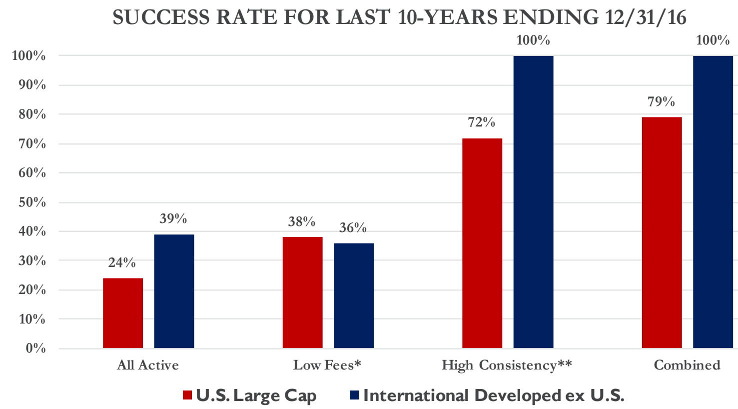
This is a phenomenon not just in the U.S., but it can also be seen with regional weights in the MSCI All Country World Index. In the late 1980's, Japan encompassed 44% of the index, whereas today it stands at only 8%.

ACTIVE INVESTING AS A FLIGHT PATH

The biggest advantage of active investing is the potential to outperform the index. This of course reveals the natural counter, which is the potential to underperform the index. When you have a market that is consistently moving higher, active managers can lag due to their fundamentals-driven approach. The active manager's goal is to weed out the companies with the least potential and focus on companies with attractive characteristics. They want to understand what they are buying, whereas passive managers must buy based on money flows. As the market is trending higher and valuations are rising, good active managers are positioning portfolios with cheaper equities that will have less downside when volatility spikes. While this positioning may prove a winning strategy long-term, the short-term higher tracking error can make it difficult to remain invested with the active manager.

Detailed in a previous paper, ***Highland's Active Edge***, Highland believes that there are certain traits that increase the probability of hiring active managers that beat their benchmark (e.g., low fees, high information ratio, long-tenured management team, etc.). In fact, using these metrics over the last 10 years, the success rate for beating the benchmark for U.S. large-cap managers increases three times, and for foreign managers it rises to 100% (see ***Figure 3***).

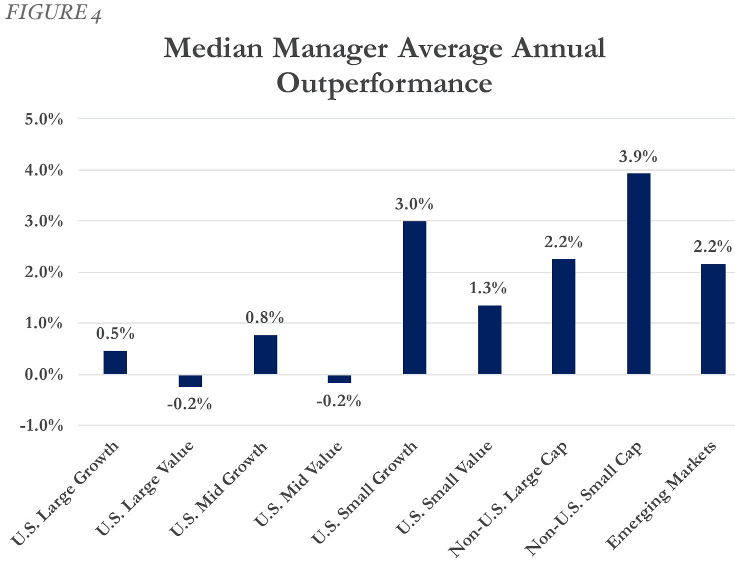
FIGURE 3



**Bottom 25% of peer universe in terms of fees*
***Top 25% of peer universe in terms of long-term Information Ratio as of 12/31/06*
SOURCES: MORNINGSTAR; HIGHLAND ASSOCIATES

Not all active management is created equal. There are some areas of the market that tend to be less efficient and more primed for active management. To aid our clients with these discussions, we created an efficiency spectrum (see ***Figure 4***). The chart looks at how the median active manager performs versus its benchmark. Historically, investors would have a higher chance of selecting an active manager who will outperform their benchmark within U.S. small cap, developed international, and emerging markets strategies. This makes intuitive sense, as these markets have less coverage by Wall Street, thus leading to higher informational advantages. International markets tend to be less homogeneous, providing opportunity to avoid certain regions and overweight others.

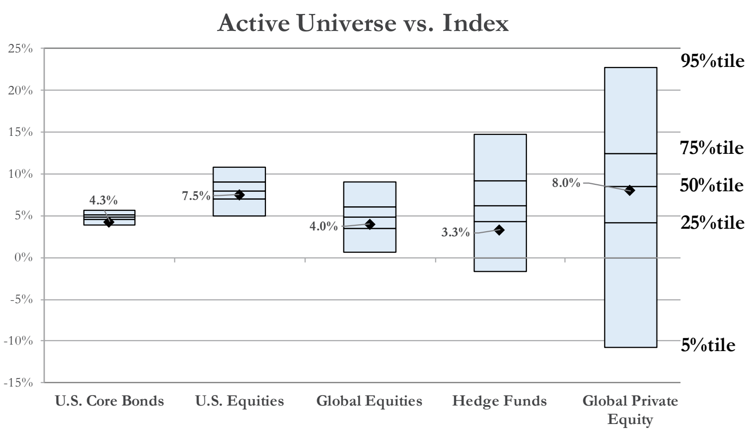
FIGURE 4



SOURCES: EVESTMENT; HIGHLAND ASSOCIATES; TIME PERIODS PER SUBASSET CLASS INCLUDE: U.S. LCG: 1990-2016; U.S. LCV: 1990-2016; U.S MCG: 1996-2016; U.S. MCV: 1999-2016; U.S. SCG: 1992-2016; U.S. SCV: 1994-2016; NON-U.S. LARGE CAP: 1991-2016; NON-U.S. SMALL CAP: 2003-2016; EM: 1996-2016

As clients commit more money to alternative strategies, the organization may look to reduce active manager risk through its equity allocation. They may believe it is better to apportion active manager risk into other areas of the market as part of a risk/return decision-making framework. Asset classes, such as hedge funds and private equity, have a much higher dispersion of returns between top quartile and bottom quartile managers (see ***Figure 5***). Manager skill is typically the largest determinant of returns in hedge funds and private equity, as opposed to market exposure, which is a large part of traditional strategies. The difference between a top and bottom quartile manager for private equity is 30%, whereas large-cap U.S. equity is 5%.

FIGURE 5

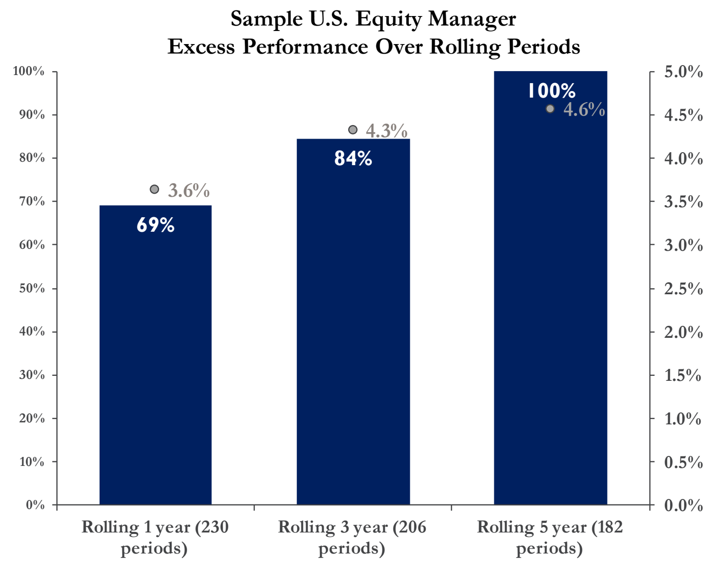


SOURCES: EVESTMENT; PREQIN; HIGHLAND ASSOCIATES; ALL DATA AS OF MARCH 31, 2017, EXCEPT FOR GLOBAL PRIVATE EQUITY, WHICH IS AS OF DECEMBER 31, 2016, AND SHOWS IRR

KEEP CALM AND TRAVEL ON - WHY TIME HORIZON IS SO IMPORTANT

Time horizon is crucial in selecting your travel route. The consistency of returns rises and the historical divergence of performance from the benchmark narrows with a longer time horizon. It is easy then to have inconsistent time horizons in decision-making when active managers underperform. While most clients express long time horizons for their active managers, we recognize that the emotional reality can differ from the stated objective. An example of this disconnect is illustrated in ***Figure 6***. Manager A, an example U.S. domestic manager, outperforms 84% and 100% over 3-year and 5-year rolling periods, respectively, with an average alpha, or excess performance, of more than 4%. This seems like a good trade-off, to underperform just 31% and 16% over 1- and 3-year rolling periods.

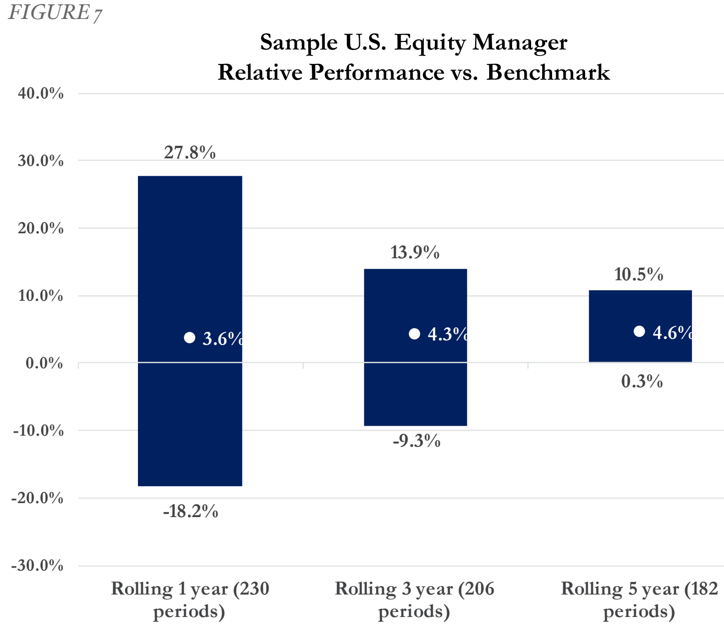
FIGURE 6



SOURCES: EVESTMENT; HIGHLAND ASSOCIATES
*Consistancy of returns beating benchmark on left axis; average alpha on right axis

However, those periods of underperformance can be difficult for clients. Active investment managers are able to achieve higher alpha by taking different risk positions from their benchmark. There will be times these managers' strategies fall out of favor and underperform. In fact, over a 1-year and 3-year time horizon, Manager A has underperformed by as much as 18% and 9%, respectively (see ***Figure 7***). It is during these times that investors find it difficult to stay the course. Long-term outperformance requires short-term patience, and timing is everything.

FIGURE 7



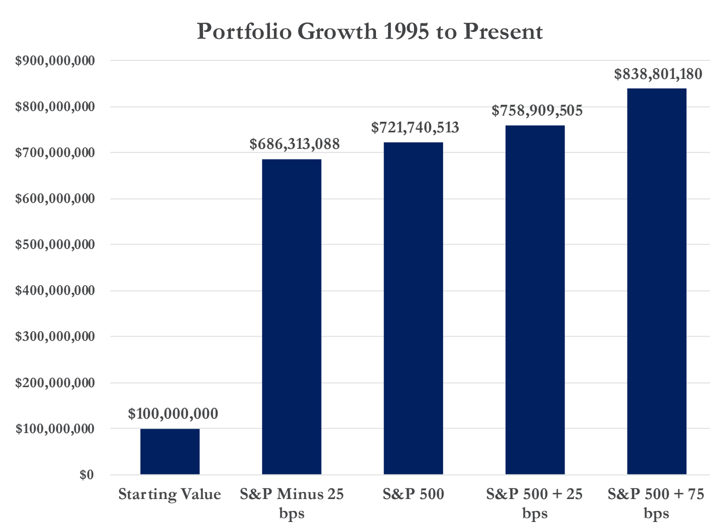
SOURCES: EVESTMENT; HIGHLAND ASSOCIATES

Clients have different goals and objectives that drive their investment choices and how they evaluate performance. A shift in some of these objectives has also led to a drive toward more passive investments. In this 24-hour news cycle, investors are becoming more focused on short-term results. Further, committees that are sensitive to peer performance may be more focused on tracking error and less willing to endure short-term underperformance. One common behavioral bias that affects investment decision making is social proof bias, which describes the tendency for committees to follow the herd as opposed to acting differently. This tendency leads committees to shy away from active managers who are by their very nature investing against the herd.

VIEWPOINT

The active versus passive debate continues to rage on, as 2016 was another difficult year for active management. While Highland utilizes all available tools (passive, active, factor investing, etc.) in client portfolios, our preferred route is to invest with active managers. Active management is a worthwhile pursuit. The chart below illustrates a $100 million equity portfolio invested in 1995 (see ***Figure 8***). Due to the power of compounding, achieving just 25 basis points of annualized alpha would result in $37 million more to the portfolio. If the portfolio compounds at 75 basis points of annualized alpha, then this number increases to $117 million. These types of gains could finance a new wing to a hospital, fund the mission of the organization, send more money into a client's community, and bolster the strength of an organization.

FIGURE 8

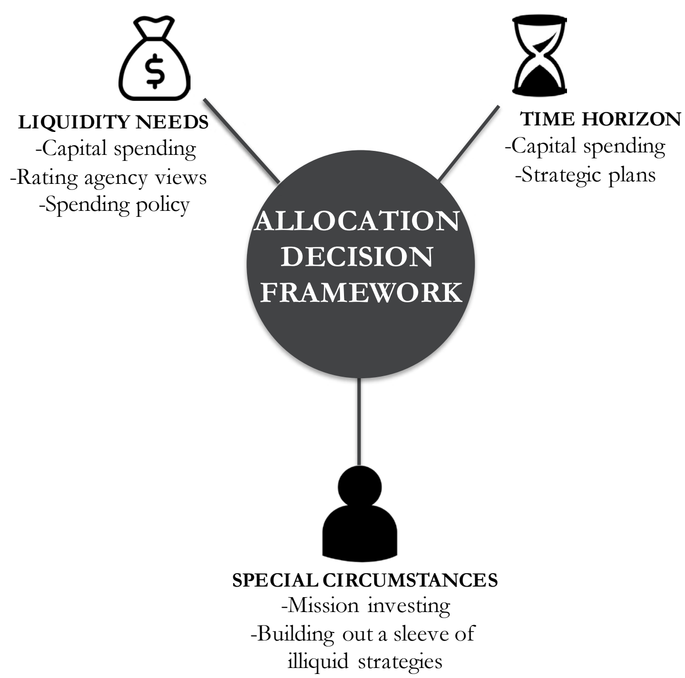


SOURCES: FACTSET; HIGHLAND ASSOCIATES

Passive investment strategies have benefited from lower volatility in the equity markets due to central banks' unprecedented asset purchase programs. There remains a lot of uncertainty as to how the markets will digest central banks stepping back from global crisis monetary policy. The U.S. is beginning to discuss unwinding its $4.5 trillion balance sheet, and the European Central Bank (ECB) has hinted it could begin tapering its purchases by the end of this year. Diverging monetary policy between these countries could result in higher volatility. It is in these periods—when risk creeps back into the market—that active management has historically shined.

Although our preference is active, we do understand that certain clients have portfolio constraints that limit the ability to utilize active management—for example, if a portion of the equity portfolio is being used to fund private equity over time and the client does not want to incur active manager risk in the interim. Another example is if an organization is expecting frequent cash flows to fund an expansion project and may utilize passive investments to maintain exposure to the market while minimizing trading costs. We believe the best way to understand the appetite for passive versus active is by incorporating a decision-making framework. When we look at the risk tolerance for asset allocation, we include the following in our decision-making process (see ***Figure 9***):

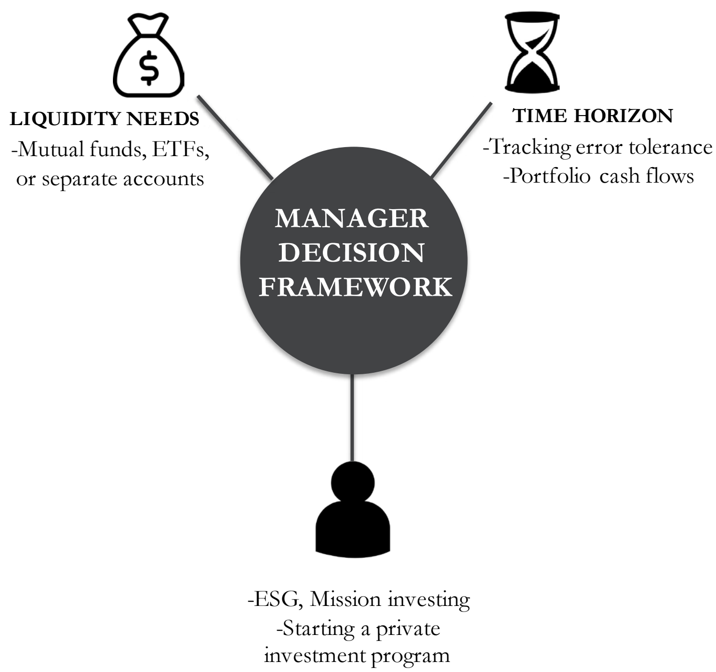
FIGURE 9



SOURCES: HIGHLAND ASSOCIATES; FLATICON.COM

Highland believes manager positioning (whether active or passive) should follow the same decision-making framework (see ***Figure 10***):

FIGURE 10



SOURCES: HIGHLAND ASSOCIATES; FLATICON.COM

Highland's stance is the longer the time horizon, the better the opportunity for active management to pay off. For investors who have a shorter time frame and want the potential for upside, but are concerned about tracking error, adding passive vehicles to an active manager is a viable option. This may be best suited to areas that are more efficient, such as large-cap U.S. equity. Emotional capital may be better spent investing in areas of the market that are more inefficient and lend themselves to active management. This approach may allow the committee and management to remain invested when there is underperformance, which will occur. According to Morningstar's annual study of investor returns, mutual-fund shareholders have lost out on between 0.74% and 1.32% of return every year due to poorly timed fund buying and selling. These are the types of mistakes we try to mitigate.

As we communicate with our clients, we encourage them to detail their priorities—tracking error, alpha, or fees. This response aids in developing a recommendation based on client priorities. Through this feedback, we have improved the way we communicate with our clients. Instead of focusing on historical consistency, we now show range of outcomes so our clients are acutely aware of the tracking error—or the overall investment experience—associated with these strategies.

There are many paths for investing as for traveling, and what is favorable for one may not be feasible for others. In the end, there is a spectrum of options available that we can utilize. Each option provides a different experience, but all are working toward the common goal of guiding our clients to their destination with an itinerary they can follow. Only then can they stay on the trip long enough to achieve their long-term goals and objectives.

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