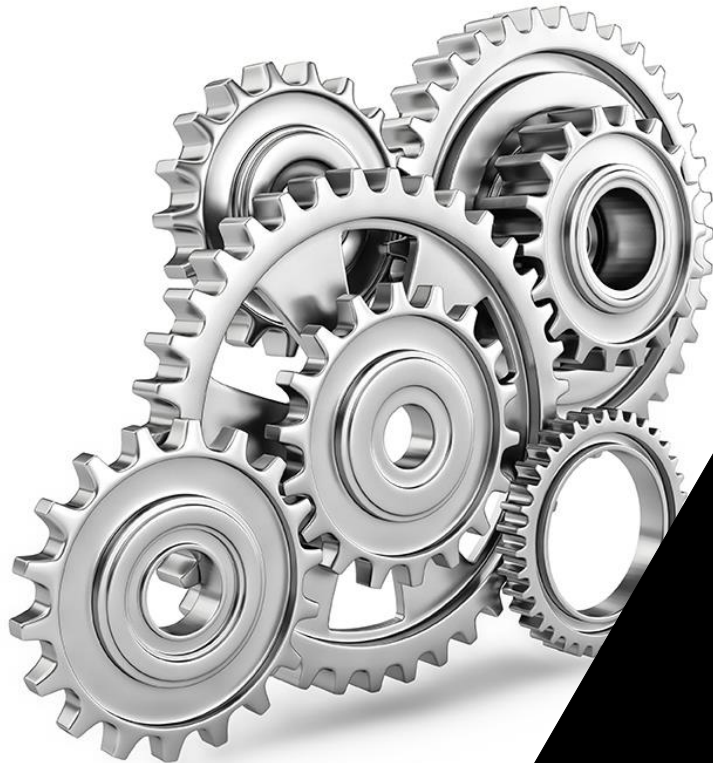


Active vs. Passive

Room for both?



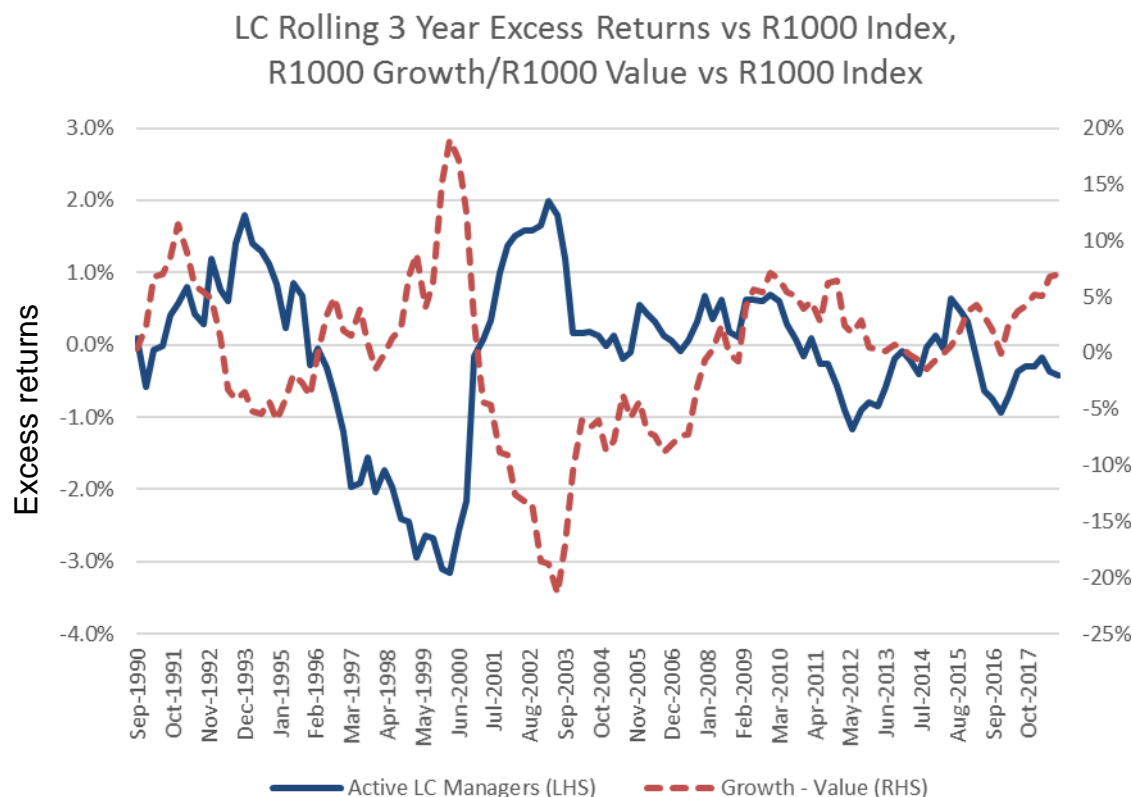
DAVID VICKERS
Senior Portfolio Manager
September 2019

What are the decision points?

1. Philosophy
2. Market environment - is the ground fertile?
3. Factor and mean reversion beliefs
4. Cost of active and passive
5. Performance of passive
6. Asset class availability
7. Frequency of trading
8. What is the fee budget and where is it best to spend it?
9. Desire for excess return versus risk aversion

The active management cycle

Fundamentals don't always matter

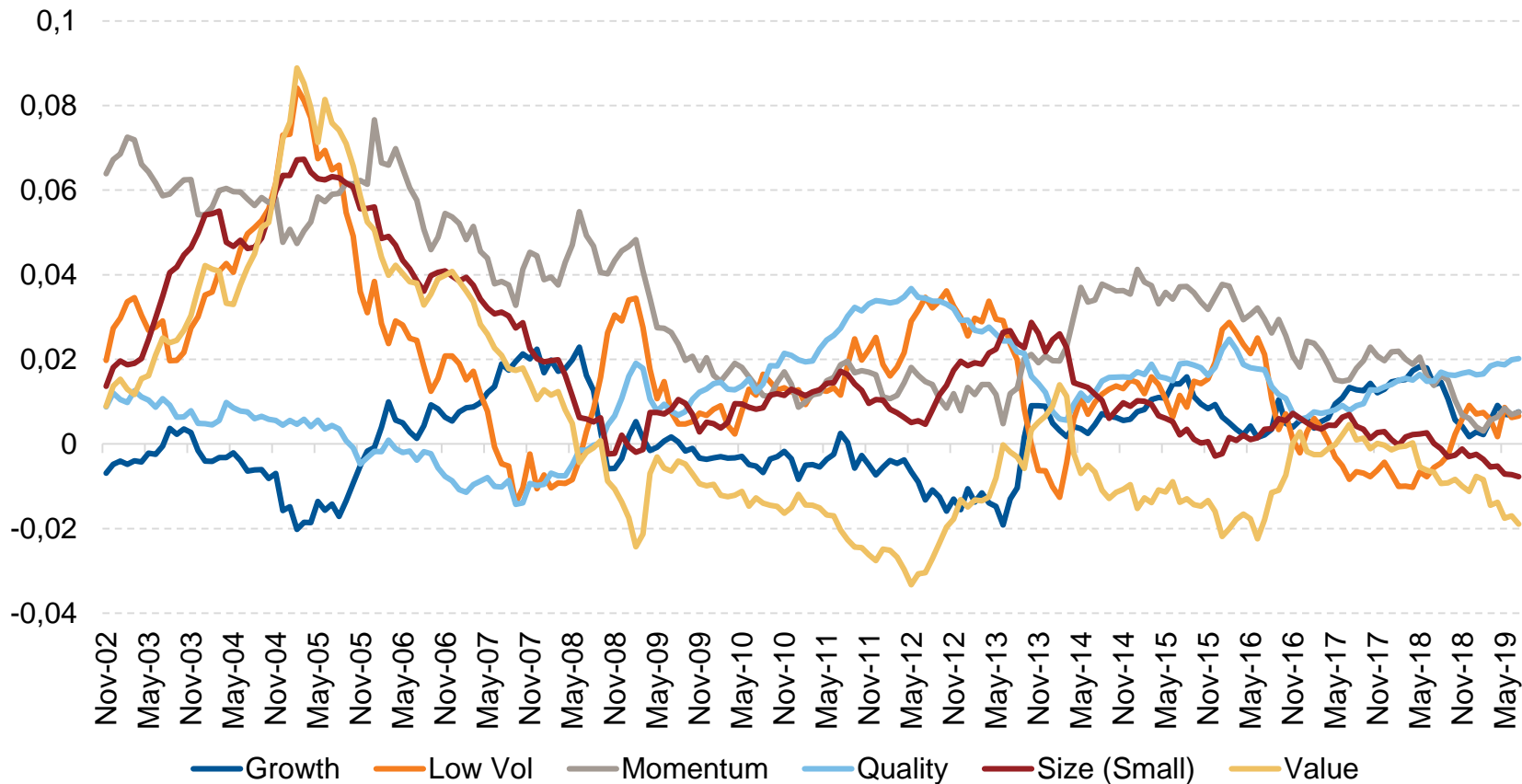


- > Active managers' excess returns tend to be inversely correlated with performance of growth stocks.
- > The majority of active managers select stocks on a combination of fundamentals (e.g. balance sheet strength, earnings growth) and valuation, less so on trends and momentum.
- > Periods of growth leadership can be extended, however periods where fundamental stock selection is rewarded are similarly durable.

Source: Russell Investments active management universes (equal weighted combination of market, price and earnings), gross of fees.

A third way

Rolling 5 year excess returns Russell Investments Factor Portfolios vs. MSCI ACWI

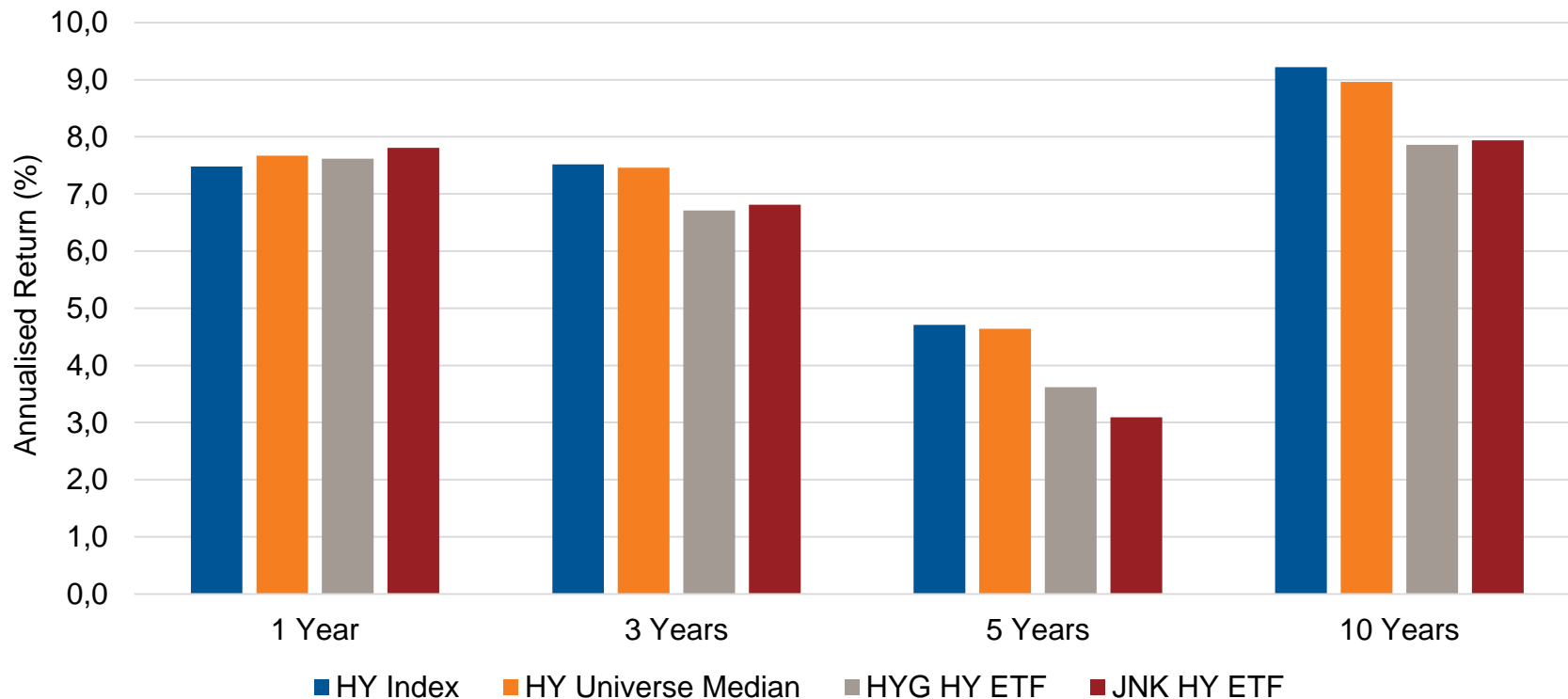


Source: Russell Investments, data as at 31 July 2019.

A different debate for a different asset class

High yield bonds

High Yield Investing Performance Comparison



Source: Russell Investments, data as at 30 June 2019.

Not all passive is created equal

Futures vs. ETF's

| Index Name | Jun-Sep Roll Cost | | Average Historical Roll Cost | | |
|----------------|-------------------|---------|------------------------------|----------|----------|
| | Region | Average | 1 yr avg | 2 yr avg | 3 yr avg |
| MSCI ACWI* | Global | 0.05% | 0.08% | 0.20% | 0.22% |
| MSCI EM** | Global | -0.41% | 0.07% | 0.32% | 0.44% |
| MSCI EAFE** | Global | 0.03% | -0.15% | -0.03% | 0.10% |
| S&P 500 | Americas | 0.17% | 0.13% | 0.27% | 0.27% |
| Russell 2000 | Americas | -0.03% | -0.08% | -0.01% | -0.07% |
| S&P Midcap 400 | Americas | 0.13% | 0.07% | 0.23% | 0.23% |
| S&P/TSX 60 | Americas | -0.27% | -0.31% | -0.24% | -0.17% |
| Euro Stoxx 50 | Europe | 0.04% | 0.20% | 0.12% | 0.16% |
| FTSE 100 | Europe | 0.27% | 0.12% | 0.13% | 0.22% |
| CAC 40 | Europe | -0.01% | -0.04% | -0.02% | 0.06% |
| DAX | Europe | -0.11% | 0.17% | 0.10% | 0.14% |
| Topix | Asia | -0.24% | -0.27% | -0.20% | -0.17% |
| S&P ASX 200 | Asia | 0.40% | 0.08% | 0.20% | 0.22% |

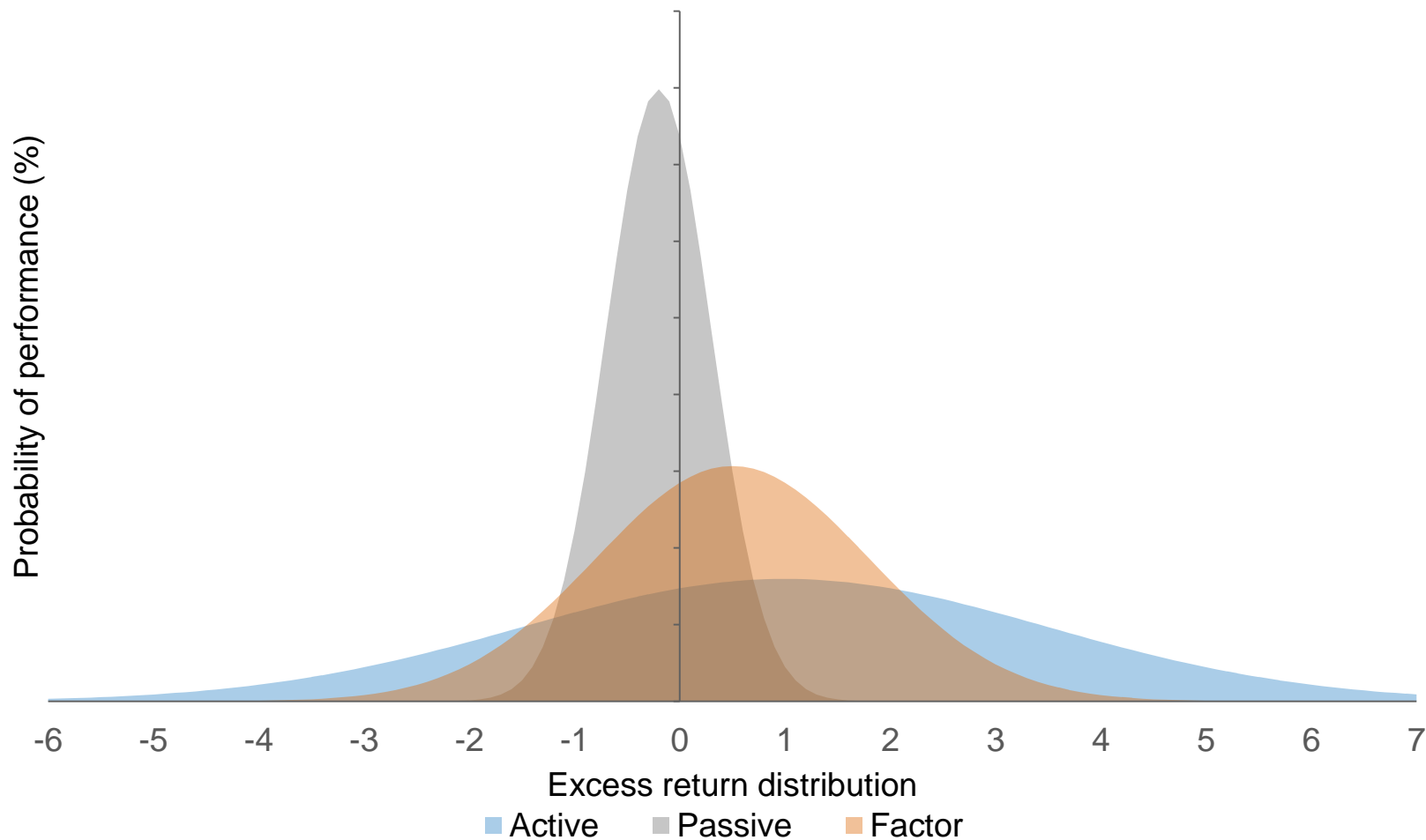
Source: Bloomberg, all mispricing values are annualised and calculated using forecasted gross dividends except for MSCI EM and EAFE which use estimated net dividends (i.e. estimated gross dividends less foreign tax withheld). A negative number indicates discount to fair value, a positive number indicates premium to fair value.

* MSCI ACWI roll cost is calculated using a proxy nine contract global futures basket where roll cost data is available.

**MSCI EM and EAFE historical roll costs prior to the June 2019 roll are based on net dividend assumptions provided by BAML.

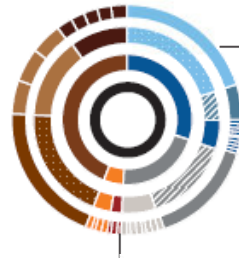
Fee budgeting and risk aversion

Understanding the trade-offs



Source: For illustrative purposes only.

Hybrid balanced model strategy



Three investment approaches

- 40% Active investing to help increase return potential
- 20% Multifactor investing to help target specific factor exposures
- 40% Passive investing to help capture market return with low costs

| 4 Asset Classes | | | | | | | | | |
|----------------------------------|-------------------------------|------------------------------|---|--------------------------------|----------------------------|-------------------------------------|---|------------------------------|--|
| 30% U.S. Equity | | | 21% International Equity | | | 5% Alternatives | | 44% Fixed Income | |
| 10 Funds | | | | | | | | | |
| PASSIVE | MULTIFACTOR | ACTIVE | MULTIFACTOR | ACTIVE | ACTIVE | | PASSIVE | ACTIVE | |
| 20% iShares® Core S&P 500 ETF | 5% Multifactor U.S. Equity | 5% U.S. Small Cap Equity | 15% Multifactor International Equity | 6% Emerging Markets | 2% Commodity Strategies | 3% Global Real Estate Securities | 20% iShares Core U.S. Aggregate Bond ETF | 14% Investment Grade Bond | 10% Opportunistic Credit ⁶ |
| 33 Manager Strategies | | | | | | | | | |
| BlackRock* | RIM† | Ancora ¹ | RIM† | AllianceBernstein ¹ | Mellon Capital | Cohen & Steers ^{1,3} | BlackRock | MIM* | Barings ⁷ |
| | | Boston Partners ¹ | | Consillium ¹ | PIMCO | Morgan Stanley ^{1,4} | | Schroder | DDJ |
| | | Calamos ^{1,2} | | Neuberger Berman ¹ | RIM† | RREEF America ^{1,5} | | RIM† | DuPont |
| | | Copeland ¹ | | Numeric | | RIM† | | | Voya |
| | | Falcon Point ¹ | | Oaktree ¹ | | | | | RIM† |
| | | Jacobs Levy | | Westwood | | | | | |
| | | RIM† | | RIM† | | | | | |

WHAT IS A 'FACTOR'?

Factors are simply specific, single attributes of investable securities, such as security's size, value, momentum, quality, low volatility. Understanding and actively managing these factors can both potentially drive returns and manage risk within a portfolio. RIM multifactor funds, Multifactor U.S. Equity Fund and Multifactor International Equity Fund, emphasize dynamic management of multiple factors.

*Effective 1 March 2019, the Global Opportunistic Credit Fund was renamed to the Opportunistic Credit Fund.

Source: Russell Investments, data as at 30 June 2019.

Base the conclusions in research

A Model for Building a Lower-Cost Portfolio Using Active, Passive, and Smart Beta Products

by Sam Pittman, Ph.D. Head of Retail Solutions, Global Client Strategy and Research

CONTRIBUTIONS | Pittman

A Model for Building a Lower-Cost Portfolio Using Active, Passive, and Smart Beta Products

by Sam Pittman, Ph.D.

Sam Pittman, Ph.D., is head of retail solutions, global client strategy, and research at Fidelity Investments, where he is responsible for global retail asset allocation and direct investment strategies. His research includes multi-period dynamic asset allocation, retirement sustainability, general fund returns, income real accounts, tax-managed solutions, and equity forecasting.

This debate to invest actively or passively has engaged the financial industry since the early 1970s, when all equity investors were active investors. The publication of *A Random Walk Down Wall Street* by Burton Malkiel in 1973, which presented an argument for passive investing understandable to the common investor, helped propel passive investing. In 2014, the amount of wealth invested passively by U.S. investors eclipsed 20 percent.¹ This represents a sizable shift in assets and thinking about investing. Moreover, the debate on whether to use passive or active investment strategies now includes a middle ground, smart beta² strategies, which generally are transparent and rules-based like passive strategies while focused on achieving factor exposures or investment beliefs like active strategies.

Given that the spectrum of multi-asset solutions can range from fully passive³ to fully active⁴, the question at the forefront is: which asset classes to implement with active, passive, and/or smart beta investment strategies? A commonly held belief is that one should invest passively where active opportunity is considered low, such as highly efficient markets like U.S. large-cap equities, and invest actively where markets are less efficient and opportunity is high, such as emerging markets equities and small-cap equities (Albhall, Iggona, Goff, and Sondhi 2014; Sondhi 2014).

Similarly, Karabel (2015) suggested focusing active management in asset classes that have more return dispersion among securities. From the investor's perspective of active management, this line of reasoning may be justifiable, but it doesn't include the risk perspective, which is a fundamental reason investors choose passive versus active investments (Iantasia 2015).

In addition to arguments for selective use of active management, studies have also suggested the sole use of passive management, including Fama and French (2010) and Malkiel (2003). Clients commonly seek passive investments to lower investment expenses. However, if the client believed with certainty that excess performance would cover the investment fees he or she is concerned about, the client may be content paying the fee because (in theory), they'd be better off. But active performance is uncertain.

A solution that addresses when to employ active, passive, and smart beta strategies needs to address both the opportunity for outperformance and the risk of underperformance. This article presents a model that balances a client's expressed preferences for excess performance from active management and the aversion to risk of underperformance.

Executive Summary

- A model is created to translate a strategic asset allocation to a product allocation using full active, smart beta, and passive investment options based on an individual client's aversion to active management underperformance risk.
- The model indicates that as a client's aversion to excess performance variability increases, they should move from active toward passive products; a suggestion that is likely not surprising, but the spectrum between the extremes will be of interest to advisors.
- For selected modeling assumptions, advisors may want to consider mixed solutions comprised of all three types of products.
- Further, if an advisor has low confidence in mean excess return estimates, this may increase performance variability, which in turn can lead the advisor and client toward lower cost smart beta and passive solutions per the model.

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COLUMNS
Understanding the New U.S. History-Based Retirement System | 27

CONTRIBUTIONS
A Model for Building a Lower-Cost Portfolio Using Active, Passive, and Smart Beta Products | 40

FINQ Articles developed by Equity Grouping and Publishing (EGP) | 25

CE PLAN
Earn the Most of Continuing Education Credit in This Issue | 60

June 2017 | Vol. 30 | No. 6
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Thank you.

Any questions?



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