

How to select the right benchmark or market index

“How active is Passive investing and what fee-structure should be applied?”

NIALL O’SULLIVAN

AMSTERDAM | 05 SEPTEMBER 2019

“Active managers tripped up
as just 19% beat benchmark”

FINANCIAL TIMES (January 2017)

“Both large and small investors should stick with low-cost index funds.”

WARREN BUFFETT (Annual Shareholder Letter 2017)



“The test of a first-rate intelligence is the ability to hold two opposed ideas in mind at the same time and still retain the ability to function”

F.Scott Fitzgerald



THE BAIT FRAMEWORK

BEHAVIOURAL



Source: Michael Mauboussin, BlueMountain Capital

ANALYTICAL



INFORMATIONAL



TECHNICAL

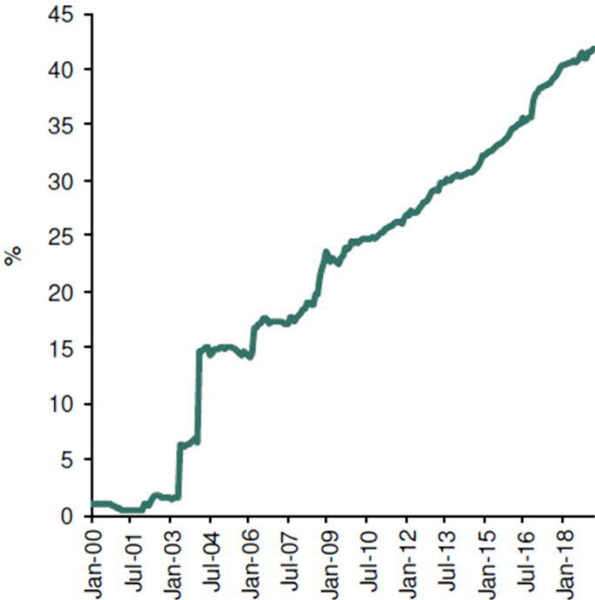


BE REALISTIC: FEES

$$\text{Manager Fee} = \left(\begin{array}{c} \text{Probability-} \\ \text{Adjusted} \\ \text{Expected Return} \\ \times \\ \text{“Fair” Share of} \\ \text{Alpha} \end{array} \right) + \text{Cost of Passive}$$

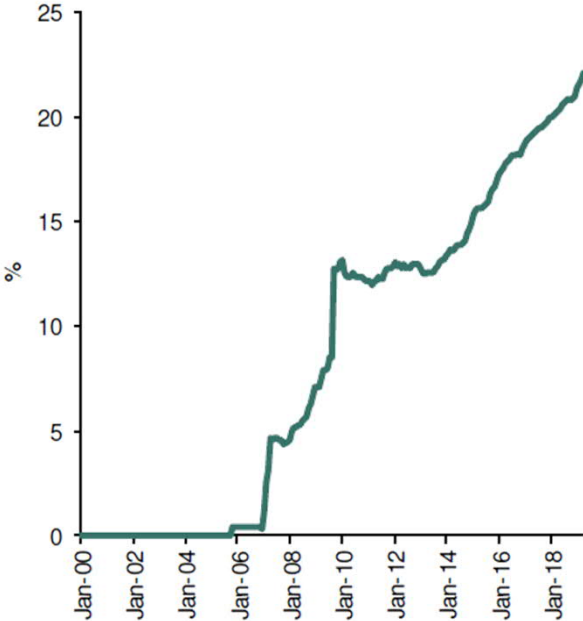
CONVICTION IN FACTORS

Proportion of global equity AUM run passively

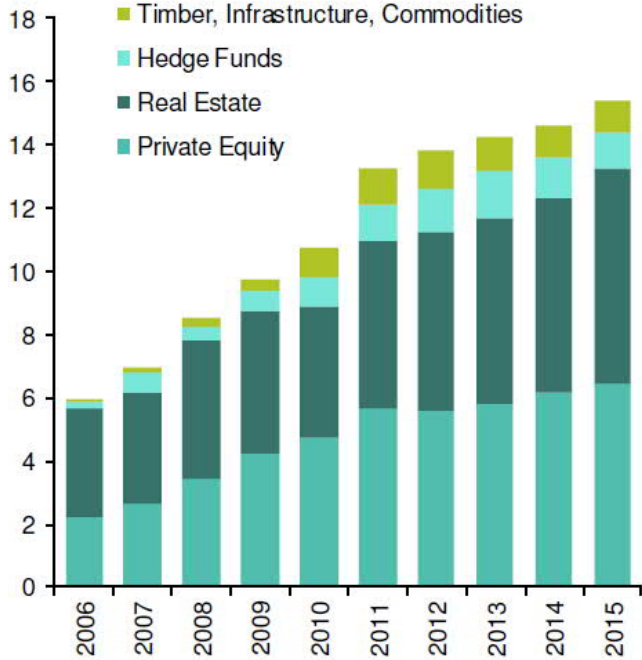


Source: Bernstein. EPFR Global, Bernstein analysis

Proportion of Global bond AUM run passively



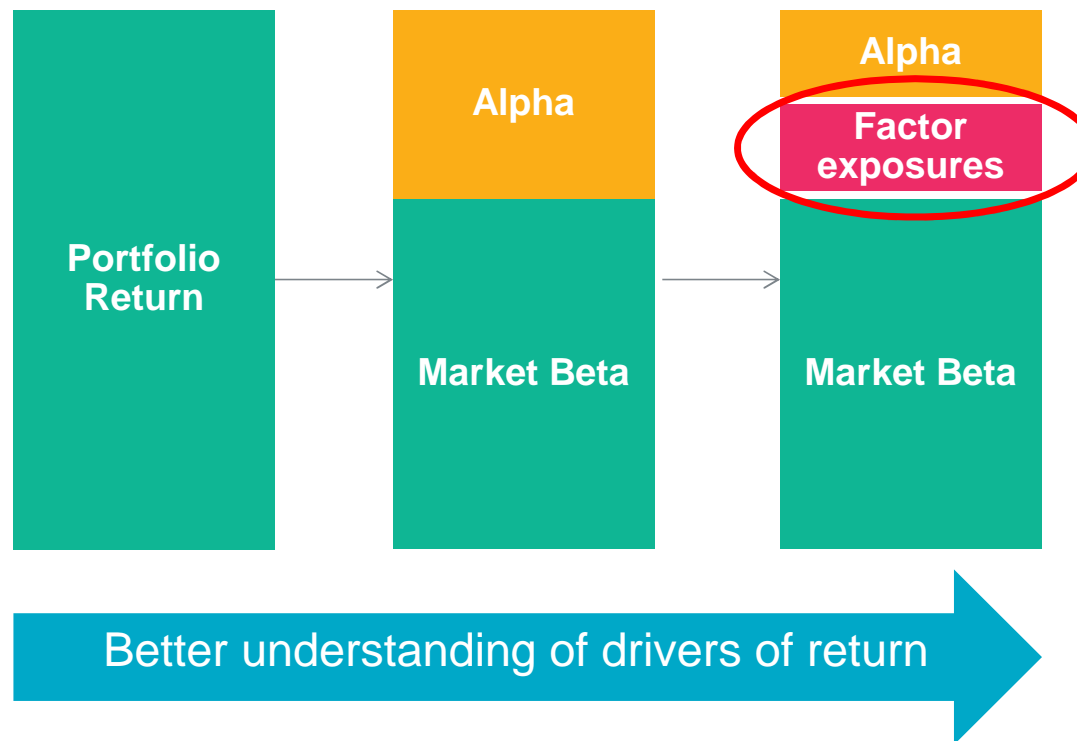
Pension fund allocation by type of alternatives



Source: Bernstein. "Looking for Alternatives: Pension Investments around the World, 2008 to 2017", Ivashina & Lerner, Aug 2018, Bernstein analysis

THE “STYLE FACTOR” PERSPECTIVE

- Many active equity strategies are systematically or periodically biased towards some style factors (some explicitly, others implicitly)



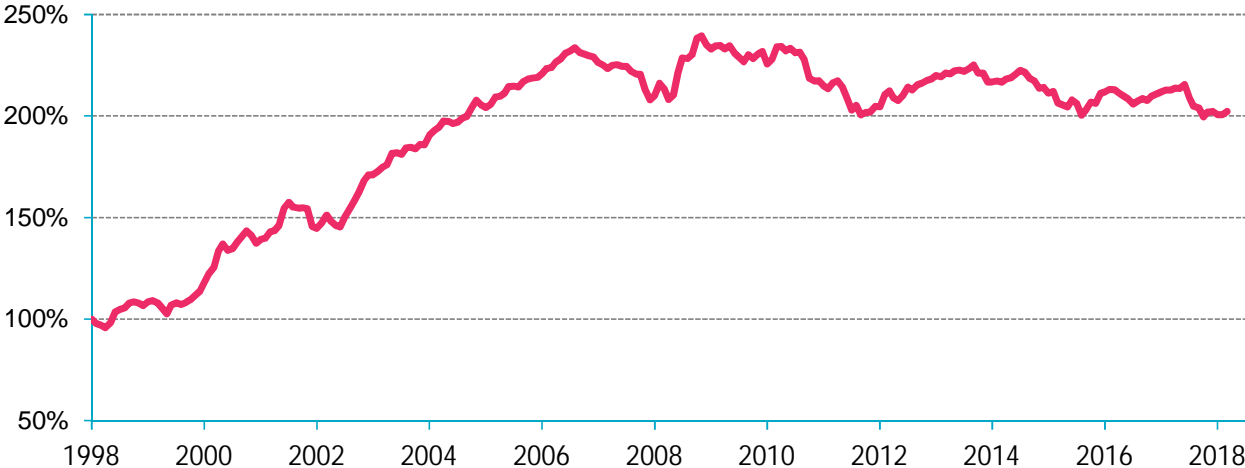
DESIRED STYLE EXPOSURES



Factor	Enhancement of:		Empirical Support?
	Returns	Risk-Adjusted Returns	
Value	✓		✓
Size (small)	✓		✓
Momentum	✓		✓
Low volatility		✓	✓
Profitability	✓		✓
Sustainability/ESG		✓	✓

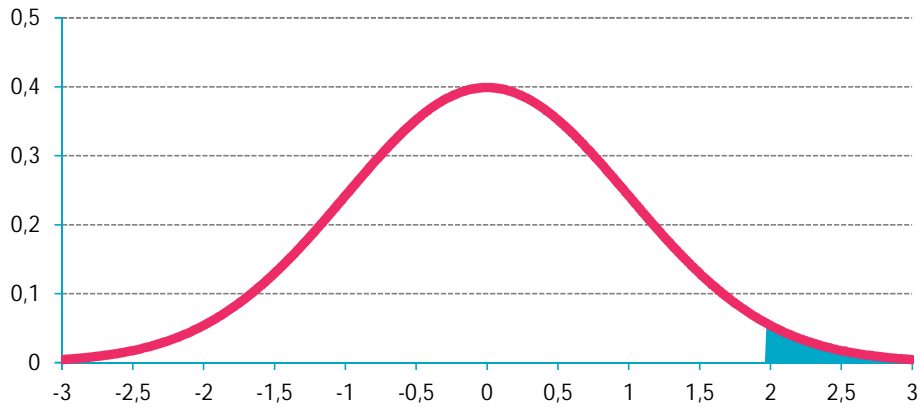
CONVICTION IN FACTORS

MSCI WORLD VALUE VS MSCI WORLD



Source: Bloomberg

FACTOR HUNTING



1 in 40 chance of False Positive



Imagine 4,000 people testing



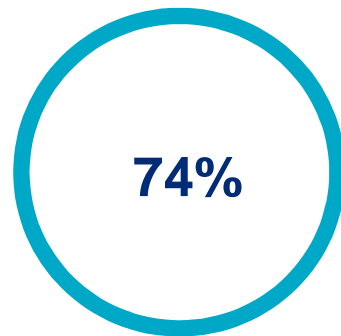
100 False Positives



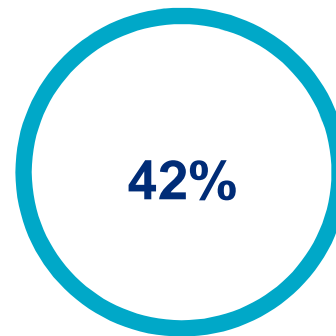
Before incentives come into play

FACTOR HUNTING

“Does academic research destroy stock return predictability?”
McLean & Pontiff (JF,2016)

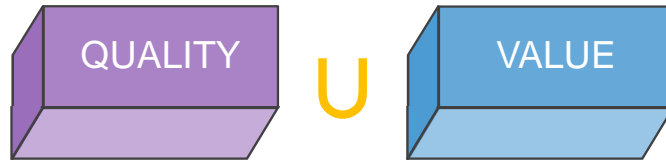


Circulation
Period



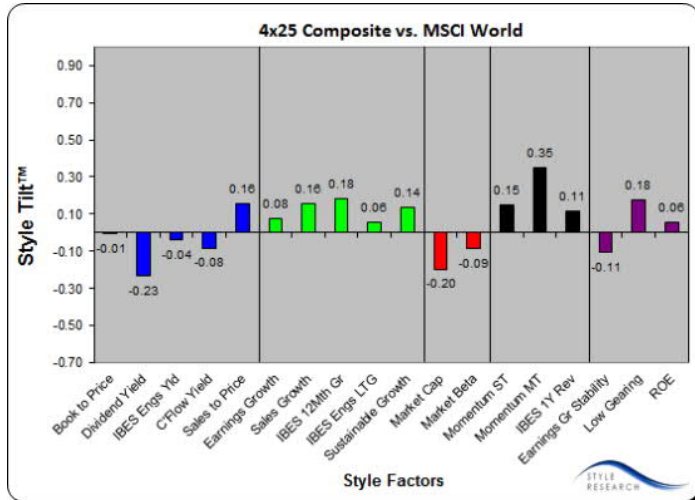
Post-Publication
Period

CONSTRUCTION UNION VS. INTERSECTION

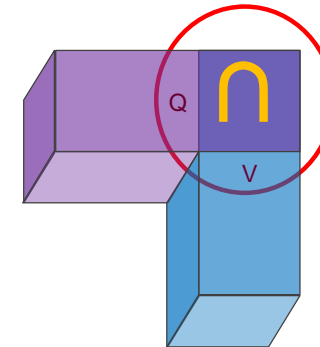


Result:

- Factors offset
- Can dynamically adjust weights to factors

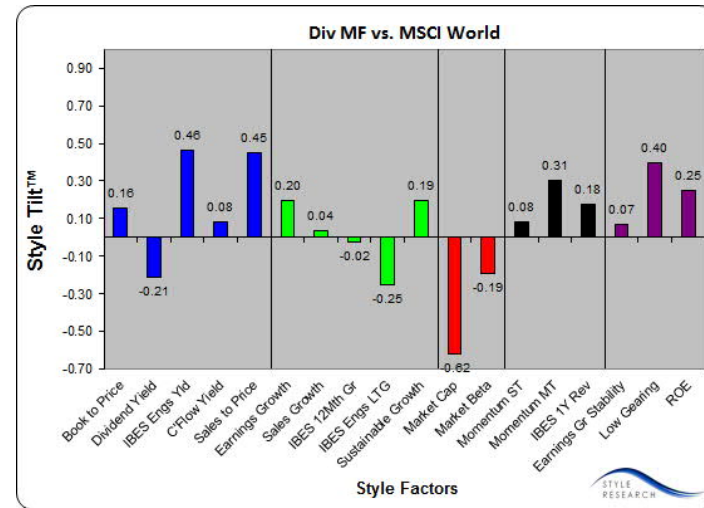


Targeting:
VALUE
QUALITY
MOMENTUM
SIZE



Result:

- Factors combine



PASSIVE SUSTAINABLE FUNDS



SUSTAINABILITY FOCUS

Integrates ESG factors into weighting the securities held in the portfolio



EXCLUSIONS

Excludes companies and activities that don't reflect the values of sustainability



FULL TRANSPARENCY

Assessment of companies ESG credentials outcomes are published for full transparency



DECARBONISED PORTFOLIO

Focus on significantly lower carbon emissions



ENVIRONMENTAL

Climate change

Water

Waste and pollution



SOCIAL

Health and safety

Demographics/consumption

Supply-chain labour issues



GOVERNANCE

Board structure and diversity

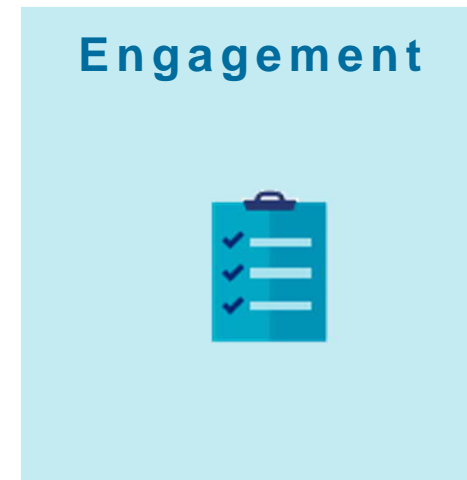
Remuneration

Accounting and audit quality

PASSIVE SUSTAINABLE FUNDS



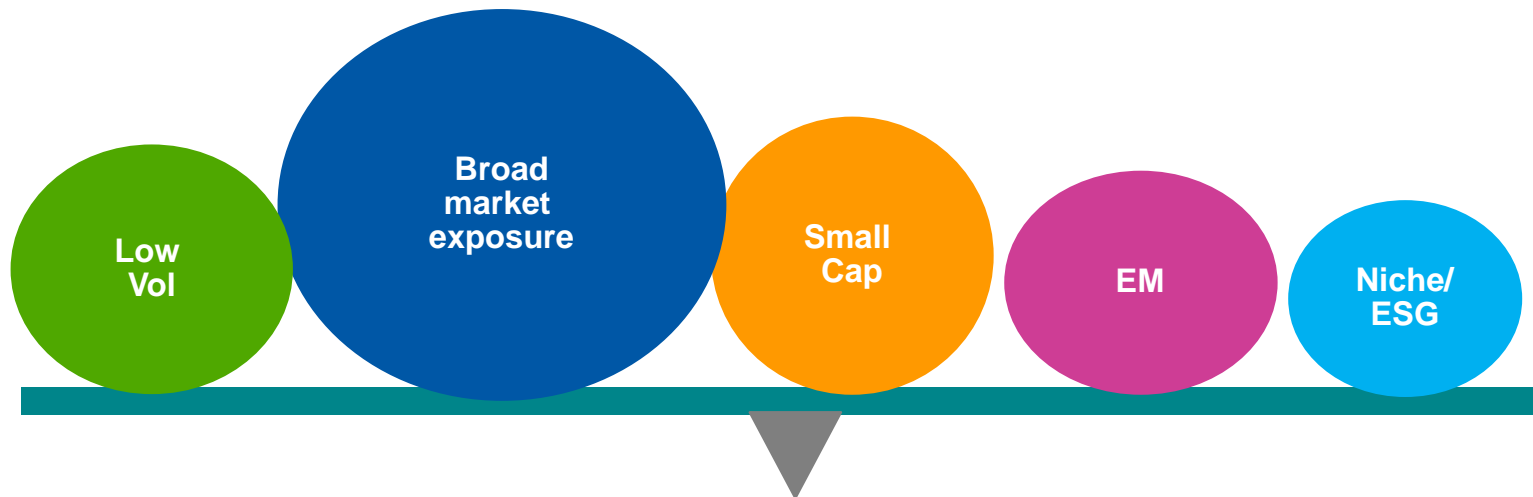
MERCER PASSIVE SUSTAINABLE FUNDS ESG AND ACTIVE OWNERSHIP



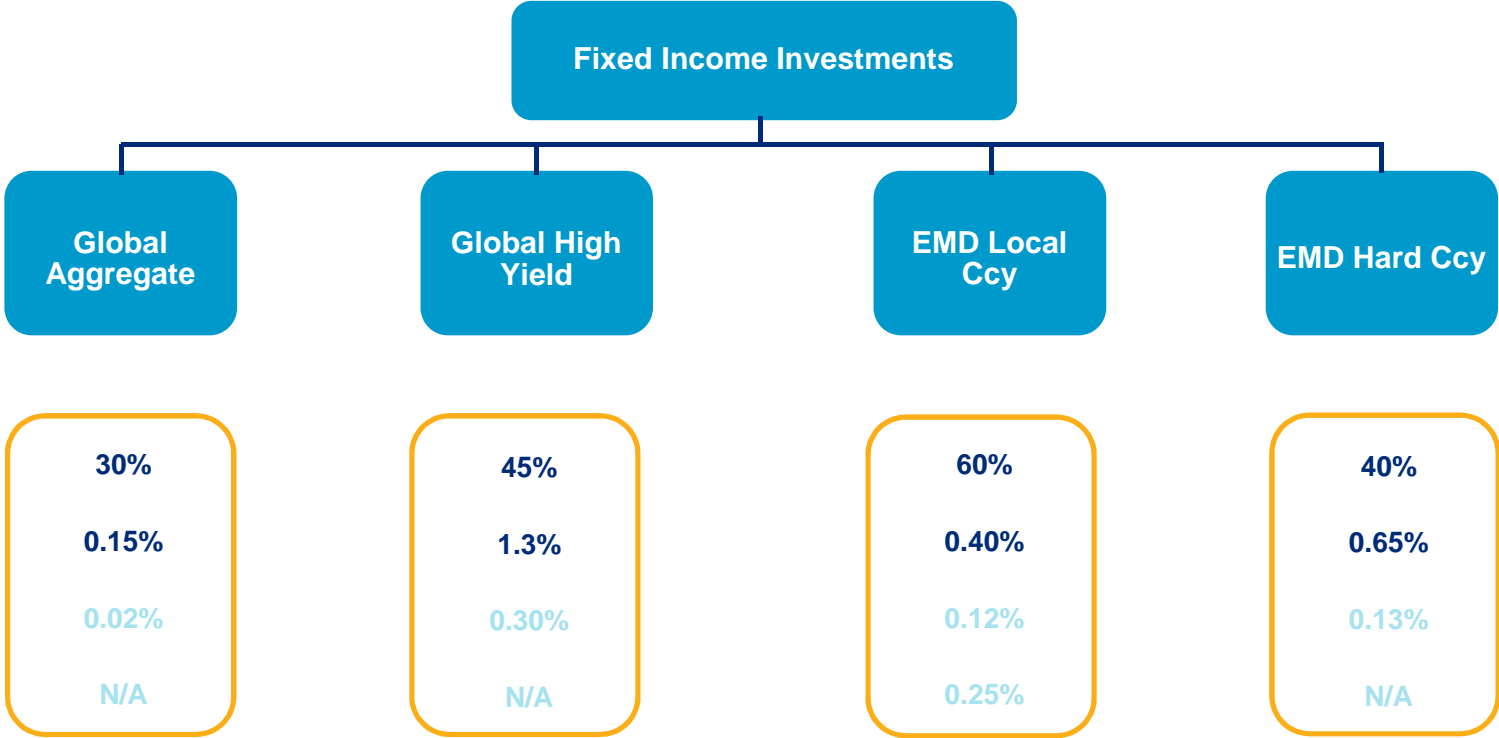
ACTIVE ASSET ALLOCATION WITH PASSIVE BUILDING BLOCKS

Consider a positive bias to:

- Value
- Size
- Momentum
- Profitability
- Sustainability / ESG



FIXED INCOME STRATEGIES



Estimated annual costs imply underperformance versus index. These assume the portfolio does not have new contributions/redemptions

FIXED INCOME INDICES EASIER TO BEAT?

Debt Weighted

Credit Quality Triggers

Maturity Triggers

Liquidity & T-Costs

Alternative Weighting
Schemes e.g. GDP
Weighted

Buy & Maintain

More Liquid Benchmarks



MAXIMIZING YOUR ADVANTAGES

Choice of
Vehicle

Choice of
Domicile

Choice of
Index Provider

With
Regulatory
Consequences

BE REALISTIC: FEES

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INVESTMENT MANAGEMENT FEES: SEEKING FAIRNESS AND ALIGNMENT

We believe investors are currently paying fees that are not fair and aligned given the outcomes active management has delivered.

	Example strategy return target ³	Probability of achieving return target	Realistic expected outperformance (REO)	Indicative passive fee ⁴	Median universe active fee	#1	#2 PBF		
Flat fee						Base fee floor	If hits REO	Cap	
Equity: developed large cap	3.0	50%	1.50	0.10	0.68	0.40	0.10	0.40	0.90
FI: Credit	1.0	60%	0.60	0.08	0.28	0.20	0.08	0.20	0.30

If investment manager fees do not represent an attractive value proposition, then active management may not be an economically rational decision for many investors.

3 This shows common strategy-level return targets. In practice, this will vary by strategy, with the strategy-specific target agreed on between the investor and the investment manager. 4 Passive fees are indicative of fees paid in each asset class for an average institutional investor.

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