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Unlocking Consistent Alpha

The Active vs Passive Debate & AQ's Innovative Approach

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Unlocking Consistent Alpha:

The Active vs Passive Debate and AQ's Innovative Approach.

Dear Reader, what do you remember the summer of 1976 for? Correct - the launch of the world's first passive investment vehicle. And there was some extraordinary weather, apparently. If you don't remember 1976 at all, then lucky you!

Vanguard's first attempt to make alpha obsolete was derided in many quarters for just that, its unsubtle implication that outperformance was a fool's errand. In 2023, assets held in passive global equity investments will almost certainly surpass those in active. But then again, The Shawshank Redemption flopped at the box office.

For as long as traders have been trading and investors investing, there has been an ongoing disagreement about active vs. passive investment. Well, that's not quite true, but since 1976 there has.

This is no attempt to settle the debate. But it is without question an attempt to refine and refocus it, and to explain how you can use it to achieve successful, repeatable client investment outcomes.

Research shows that the vast majority of investors would prefer consistent performance from their investments as opposed to the volatility associated with many actively managed portfolios chasing extraordinary returns.

We explore the challenges with active funds, compare and contrast with passives and introduce our methodology: a process which takes both investment strategies into consideration, using passive investment as a backbone while capturing the benefits of active funds, before they slink back into mediocrity and underperformance.

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The Active vs Passive Debate Through a New Lens

Historically, discussions about active vs passive investment have always been somewhat binary. But over time, this has developed into a bit of an echo chamber and nowadays it seems you either support active investment or you support passive investment, never the twain shall meet. Times are changing.

Investment advisers are now taking a more nuanced approach, stepping away from the black/white perception of active or passive, open to incorporating the best of both worlds.

Imagine an investment strategy with a solid backbone, a passive core, enhanced by leveraging outperforming active investments, quickly, as their alpha blossoms, before selling before all that outperformance is given back.

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The Advantages & Disadvantages of Active Investment Management

The pros of active management are well known

- Potential to outperform index
- Research-heavy, IP-based based approach to investment
- Potential for downside risk management

Cons of active management

- Typically higher fees and costs
- Potential to significantly underperform index
- Volatility of performance

The Advantages & Disadvantages of Passive Investment Management

Likewise, the pros of passive management are clear:

- Less potential for relative volatility
- Knowing that index performance will (largely!) be captured
- Low fees
- More predictability of performance

On the flipside:

- Positive performance is limited to that of the index
- Exposed to market downside in its entirety
- Replication strategies can cause performance variations

We contend that aficionados of either can have their cake and eat it.

Investing Over Market Cycles

We know that economies and markets are cyclical by their nature and stock markets tend to look between nine months and twelve months in advance. This suggests that by the time economic indicators show an improvement in the economy, it is baked into asset valuations. On the flipside, the feel-good factor created by a buoyant economy could be at odds with a market which sees beyond the peak and is predicting contraction.

How quickly do active managers with all of that resource, process and insight, turn over a portfolio to position for the conditions of the future not the now?

Average Periods of Expansion and Recession

Recessions can cast a long shadow over markets and investor sentiment, often long before they occur. The 'Dismal Science' at play. A report by Capital Group shows that since the 1950s, periods of recession and expansion in the US have varied significantly.

	Average Expansion	Average Recession
Months	69	10
GDP Growth	24.6%	-2.5%
Net Jobs Added	12 million	-3.9 million

Source: Capital Group

So expansionary phases outweigh recessionary ones, on a duration basis, by seven-to-one.

If we assume that an expanding economy is a driver of a buoyant stock market, and often it is, then this surely lends weight to the 'just buy the market' movement.

But despite the shorter economic timeframes, market downturns can do a lot of damage to a portfolio, and fast.

Plus, at the centre of it all there is the central factor – the human being.

The Impact of Sentiment

It is important not to underestimate the impact of investor sentiment on stock markets and individual companies. Often heavily influenced by the media and analysts, many with conflicting views, this can create uncertainty, prompting investors to take reactionary action that wouldn't previously have crossed their minds.

We know that fear and greed are the two primary emotions that drive investors, the active ingredient in both being ego.

It is as easy to get drawn into a market which continues to rise, despite your own concerns, as it can be tempting to cash in your profitable investment chips too soon. There also is a fine line between confidence in your ability and an ego that believes that everybody else is wrong and you are right, a flaw which haunts the most accomplished of professional money managers.

The Influence of Sentiment on Investors

Cyclical sentiment significantly impacts investor behaviour, both professional and amateur. Let's focus on the pros.

During bull markets, active funds tend to perform better as a consequence of positive momentum and a growing focus on high beta investments, whatever the asset class. If, as an active manager, you cannot perform on the upside, then you have serious problems. Many, therefore, well…. have serious problems.

Ah, but doesn't that alpha provide downside cushioning? Not with any consistency, no.

Remember – **only human.**

Humans will refuse to believe their day in the sun is over. They will not acknowledge warning signs, or wilfully refuse to see them. They will dogmatically cling to strategy, standing in their shorts and t-shirt applying Factor 30 while the rain hammers and the wind howls.

"It'll get nice out again soon" - they murmur through gritted teeth…

The hubris outlives the heyday, almost always.

Of the myriad of reasons for the professional money manager's inconsistency, the mental baggage outweighs those of process and resource.

The hubris outlives the heyday, almost always.

The Dilemma of Inconsistent Alpha

This brings us onto the subject of inconsistent alpha generation amongst active fund managers. Fund management stars are hard to find and don't usually remain stars for long enough to satisfy your client base. This isn't news and is potentially part of the reason you're here.

Berkshire Hathaway, held as one of the best-performing active strategies, has a record of beating the S&P 500 two-thirds of the time. So, even the best actively managed funds struggle for consistent long-term performance. And one of the blokes at the top has advised his significant other to hug the benchmark in the event of his demise.

Do the best performing active funds have a shelf life?

S&P Dow Jones indices analysts created a fascinating review of active fund management compared to the market between June 2017 and June 2022. After selecting the top 25% performing active funds, they went on to map their performance against random distribution (a 50/50 chance of outperforming the index). The following table is a summary of their findings:-

12 Month Period to	Random Distribution	Continued Outperformance
June 2019	50%	56.9%
June 2020	25%	51.9%
June 2021	12.5%	15.6%
June 2022	6.25%	1%

Source: Finax

Between years three and four, there was a significant drop-off in performance, and by year five the number still outperforming drops below the random distribution.

This suggests that active funds have a period of three to four years with the greatest likelihood of outperformance, and then the returns fall markedly. Ironically, on average, an active fund manager would be replaced/leave every four and a half years. Which we're sure is a coincidence!

In order to consistently outperform the market, the best active fund management minds need to be one step ahead of;

- The economy
- Business
- Consumers
- Policymakers
- Sociopathic dictators...

Generally, they will have chosen a strategy that works in most conditions, and have the emotional control to act without bias, and the systems and processes to enact their changes expediently.

Because this is not a hatchet job on active management, we rush to add that some do indeed tick the above boxes, at least for a period.

But we investors ***can*** use actively managed funds to enhance returns. We absolutely can. And at 8AM we do.

Reasons for Inconsistencies

It's our strong belief - a belief underscored by a significant amount of evidence - that to put a ring around those funds that will generate alpha, and do so at the right time, involves understanding why they underperform.

Closet trackers

Fund managers under pressure may well be drawn into a less active investment strategy, that of a closet tracker. The impact of being a statistical outlier for the wrong reasons is huge in 'Fund Land'. Portfolios with low active share will always struggle for alpha and when fees are deducted, you're often better off with Vanguard (other passive providers are available).

Confirmation bias

This is the scenario where a fund manager will seek to find information confirming their ideas. Effectively ignoring information at odds with their thoughts, this type of tunnel vision is very dangerous.

Hubris

There is confidence in one's own ability, and then there is hubris and overconfidence. Fund managers (with or without a god complex) can consistently go against either the market, their peers, or their team. In the good times, this can create outstanding returns, but the bad times can decimate funds under management.

Shaky risk definitions

Is risk the possibility of losing money, or not achieving the desired goal? What's the best proxy – maximum drawdown, volatility, VaR?

The point is that you've got hubris-driven, tunnel-visioned (though well-intentioned) people who all think differently. Within the IA Global sector, how many different asset allocation and risk approaches do you think there are?

They quite simply cannot all be right.

High cost

In 2022, average management fees charged by active funds were between 1% and 2%, compared to just over 0.1% by passive/tracker funds. To put this into perspective, let's assume you invested £100,000 into an active investment fund, returning 6% annually with a 2% management fee. Over a 25-year period, fees will be circa £170,000, but a fraction of those associated with passive/tracker funds. Consequently, an active fund is effectively 2% down before the year even begins.

Is risk the possibility of losing money, or not achieving the desired goal?

The methodology used by the 8AM AQ MPS creates a strong, passive-driven backbone as the core of any portfolio at any given time, selectively, algorithmically (and thus emotionlessly) adding allocations of alpha-generating, momentum-gathering funds until they have served their purpose.

Our message and our philosophy are easily explained. Of course, there's a sophistication and uniqueness to our algorithm which is what allows us to pinpoint the correct value-adding funds at the right time and exit in a timely manner.

This process has allowed us to deliver a win rate of 77.65%*

Historically, stock markets are dominated by periods of momentum which lend themselves to 2-to-3-year cycles of sentiment and "themes". These regular cycles of momentum can create opportunities where pre-existing upward momentum in active funds can lead to one-, three- and six-month periods of outperformance, and longer in some scenarios.

The 8AM AQ MPS philosophy is based on refreshing the basket of outperforming active funds on a regular basis. This means that only those actively managed funds currently on an upward trajectory are available to the managed portfolio service. The larger element of passive investment will dilute the impact of higher management fees charged by actively managed funds, also providing excellent long term return potential as asset allocation is, of course, a primary driver of returns.

*Source: FE Fundinfo & 8AM Global Limited – 01.11.2017 – 31.08.2023

Monthly observed rolling 12-month data - AQ fund picks versus relevant sector as binary win/lose outcome expressed as a percentage. Some sectors not in use throughout 'since launch' period – during periods of sector removal win/lose data has been removed from statistics. Back-testing performed using 'walk forward' methodology performing for 'standard switches' without use of 'responsive' – funds replaced based on fund with best score that had adequate platform availability and fund size.

A central aspect of the 8AM AQ approach is that we will never be positioned with relative aggression. We don't need to use significant sector overweighting, which can often be hubris-driven, to generate returns.

Continually maximising the risk/return efficiency of our managed portfolio service requires:

- Algorithmic, unbiased analysis for fund selection
- The ability to pivot style momentum on market conditions
- Top-down strategic asset allocation
- Selective use of defensive tactical allocation
- Continuous focus on investor value
- Concise, non-discursive investment committee meetings
- Independent and mandated portfolio risk management

While all investment funds are continually monitored for a change in direction, our quantitative and unbiased analysis allows us to identify active fund outperformance at a relatively early stage. Taking into account the profile of the fund and our asset allocation at the time, this will determine whether those outperforming fit the criteria for our portfolios.

As we mentioned above, by replacing active funds losing performance momentum, we are able to maintain a basket of investment funds with strong momentum. Whether we are able to enhance the returns on passive funds for one month, three months, six months and beyond will be determined by the performance of the individual funds.

Study: Active Funds in a Crisis

A few weeks of market mayhem can eradicate the lion's share of the profits built up in what can often be a multi-year bull run. It is, frankly, agonising to watch alpha conceded so quickly.

Case study: The 2020 market crash

During the 2020 stock market crash, between February and April, the S&P 500 fell from circa 3,400 to 2,300 in just over a month. There were four distinct phases prior to and in the aftermath of the crash: -

- Pre-crisis - 1st October 2019 to 31st January 2020
- Crisis - 20th February to 30th April 2020
- Crash - 20th February to 23rd March 2020
- Recovery - 24th March to 30th April 2020

Analysis of the performance of actively managed funds over this period provides an interesting insight: -

Time Period	% Funds underperforming S&P 500
Pre-crisis	67.1%
Crisis	74.2%
Crash	63.5%
Recovery	55.8%

Source: Visual Capitalist

It's unsurprising that actively managed funds performed better during the recovery process than they did across the immediate pre-crisis (COVID was rumoured in Q4 2019), crisis, and crash.

The worst performing period for active funds was the crisis itself, with active managers likely under pressure to not only protect portfolio values but also take advantage of new opportunities, as well as being late into any kind of rotation.

This lends weight to our contention that to achieve outperformance one can – should - do so with minimal active exposure and, where it is necessary, we should be absolutely laser-sharp with our use of active funds because not all conditions are born equal.

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Challenges of Selecting Top-Performing Active Funds:

Using the 8AM AQ MPS philosophy, it is important to identify top-performing active funds at the earliest opportunity, more specifically, the best opportunity.

Capturing the length of the optimal performance period, and therefore how long we should be 'in' for, requires algorithmic, data-driven robustness. What there is no place for, is finger-in-the-air, gut feel, *"I like the way they present"* decision-making, however experienced and well-qualified the person making the call.

We are led by facts and figures and cold hard statistics, and we will give you a holding-by-holding reason for any constituent of the portfolio's ongoing presence.

AQ: Reshaping the Debate & Generating Returns

The blending of passive investment funds with momentum-driven active counterparts can create a fertile backdrop against which to deliver consistent returns.

It is the ability to systematically identify the waxing and waning returns of these funds, sometimes over a short timeframe, which is critical to our investment approach.

The Importance of Investment Selection in a Consumer Duty World

By now no doubt imprinted on your office wall, screensaver, and frontal cortex, the four main elements of the Consumer Duty regulations revolve around: -

- Products and services
- Price and value
- Consumer understanding
- Consumer support

Products and services must be clearly defined; there must be value for customers together with transparency and an understanding of what is on offer.

In the context of your investment services, your MPS provider should be able to clearly explain the rationale for each and every portfolio holding. Something we deliver as a matter of course.

Delivering outcomes in the context of investing is largely ensuring the selected investments deliver the desired returns for the lowest risk budget possible and do so consistently.

At 8AM, we have built a proposition to do this. We'd love to tell you more about it.

Explore our MPS range here.

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