Excess returns or excess expectations?

A review of the active manager recession and "recovery"

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Introduction

Excess returns can be critical in achieving a targeted return with the lowest possible total volatility. For a fully active portfolio, excess returns may contribute an estimated 15% of the total return in the multi-asset portfolio. Even more importantly, the low correlation of excess returns with other return sources in a portfolio may allow investors to reduce their reliance on risky assets, such as listed equities, to achieve those return levels. Understanding the magnitude of realistically achievable excess returns and their correlation with other factors helps investors determine how much they can rely on this valuable return source.

As is the case for risky assets, excess returns carry no guarantee. That said, they have been a, mostly, reliable return source for decades - at least until the active manager recession of 2015-2018. During this period, quite a lot of what we *know* about active management was challenged. And the challenge was not isolated to a few segments of the active universe - we observed this recession across equities and fixed income universes and across the cap spectrum.

In this paper, we refresh our excess return expectations with recognition of this recession and with special consideration for active equity products where some recovery is evident in the period since then. We determine that listed fixed income, particularly in higher risk strategies, is particularly sensitive to transactions costs. As well, we observe that the recession was broad, but not universal, with lower risk fixed income, listed real assets, hedge funds and private assets continuing to add value through active selection strategies. Finally, we continue to place confidence in listed equities with more modest expectations in some parts of the market than we had previously recognized.

Simulating skill to build performance expectations

A straightforward methodology

Our goal is to identify the typical excess return a skilled active-manager selector can attain from a collection of active managers. Our methodology is quite straightforward:

1. From a Russell Investments active manager pool - either a single universe or a set of universes - we typically select five products to form a simulated portfolio.
2. Each portfolio has three draws from the top half of the universe - measured by excess return over a four-year period - and two draws from the bottom half of the universe, such that we engineer a 60% *hit-rate* portfolio.
3. We track the performance, excess return and tracking error of the simulated portfolio over a four-year sample period.
4. We repeat this simulation 5000 times to generate a *bootstrapped* distribution of skilled portfolios.
5. We repeat steps 1-4 for five sample periods - 1999-2002, 2003-2006, 2007-2010, 2011-2014, 2015-2018.
6. We repeat steps 1-5 for multiple universes from multiple asset classes - equities, fixed incomes, listed real assets, hedge funds and private assets.
7. With the simulated excess returns, we also create distributions of correlations among all pools and between excess returns and market returns.
8. Using the data to establish appropriate null hypotheses (i.e. default assumptions), we use these distributions to assign expected performance metrics for active performance universe by universe.

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Excess return expectations for all asset classes[1]

In Tables 1-3, we exhibit our formal excess return and tracking error expectations from 2015 (2016 for private assets) and from our current update. In this most recent update, we added an information ratio to our suite of expectations. Bolded numbers indicate where the 2020 numbers differ from 2015.

Table 1: Fixed income expectations by sub-assets 2015 and 2020

	EXCESS RETURN	TRACKING ERROR	INFORMATION RATIO
2015			
Fixed Income	0.50	1.50	n/a
2019 / 2020			
FI – Low risk	0.50	**2.25**	**0.40**
FI – High risk	**0.25**	2.25	**0.40**

[1] Note that individual universe expectations may differ from the sub-asset class expectations.

Table 2: Equity expectations by sub-assets 2015 and 2020

	EXCESS RETURN	TRACKING ERROR	INFORMATION RATIO
2015			
Single country	1.25	2.50	n/a
Multi-country	1.50	3.00	n/a
Small cap	1.75	3.50	n/a
2020			
Single country	**1.00**	**3.00**	**0.40**
Multi-country	**1.50**	**3.50**	**0.40**
Small cap	**1.75**	**3.75**	**0.40**

Table 3: Alts expectations by sub-assets 2015/2016 and 2019

	EXCESS RETURN	TRACKING ERROR	INFORMATION RATIO
2015 / 2016			
Real Assets	150	3.50	n/a
Hedge Funds	2.50	5.00	n/a
Private Assets	1.50	3.25	n/a
2019			
Real Assets	**1.75**	**3.00**	**0.60**
Hedge Funds	2.50	**3.50**	**1.20**
Private Assets	1.50	**5.00**	**0.30**

The default tracking errors for most universes increases. This increase is for a good reason - we are seeing active managers take risk.

In comparing the expectations for 2020 to those from 2015, notice three points:

1. The default excess return expectations for single-country equities and higher-risk fixed income universes drops by 25 basis points (bps). These changes are illustrative of persistent challenges in generating excess returns in these areas during recent sample periods.
2. The default tracking errors for most universes increases. This increase is for a good reason - we are seeing active managers take risk. We see a drop in our standard expectations for real assets and for hedge funds - these changes are reflective of our observations of active managers in these universes.
3. We have added an information ratio expectation.

The downward shift in excess return expectations in some areas requires some reflection on how we arrived here. It all began with the active manager recession of 2015-2018.

The active manager recession

In reviewing our four-year sample periods, we noted that the most recent, 2015-2018, exhibited similar performance distributions to other sample periods for lower-risk fixed income strategies, real assets, hedge funds and private assets. For higher risk fixed income strategies and equity strategies, the excess return distributions had *shifted to the left* compared with earlier sample periods.

Note that a shift to the left is more pronounced than simply observing a lower *average* outcome. A leftward shift in the distribution indicates that upside opportunities, even among skillfully selected portfolios of active products, were lower than in earlier sample period. In other words, for the 2015-2018 sample period, being skilful was unlikely to produce previously observed excess returns. More to the point, being lucky didn't help either. We named this period the *active manager recession.*

To illustrate this active manager recession, we compare equity and higher-risk fixed income excess return distributions from the 2015-2018 simulations, with 2015 published excess return expectations in Table 4.

In other words, for the 2015-2018 sample period, being skilful was unlikely to produce previously observed excess returns.

Table 4: Skilled equity and higher-risk fixed-income excess returns by group

From 2015-2018 portfolio simulations compared with 2015 era excess return expectations (all returns annualised)

	PERCENTILES OF SIMULATED SKILLED EQUITY PORTFOLIOS 2015-2018			EXCESS RETURN EXPECTATIONS 2015
	25th	50th	75th	
Equity				
Single Country	0.61	1.08	***1.59***	1.25
Multi-Country	0.25	0.66	1.11	1.50
Small cap	0.82	1.33	***1.85***	1.75
Fixed income				
Higher risk	-0.33	-0.05	0.18	0.50

What is clear from Table 4 is that median outcomes, from the 2015-2018 period, were well below our prior expectations. We note specifically that these medians are from distributions of simulated portfolios with skill built in. In the case of single country portfolios, we expected 1.25% excess return, while the median-skilled simulation generated only 1.08% excess return. In the case of small cap portfolios, we expected 1.75% excess return, yet the median skilled simulation generated a mere 1.33% excess return. Note that at the 75th percentile, single country and small cap simulations did achieve expectation, but this is not exactly encouraging. Ultimately, both skill and lots of luck were required to achieve 2015 expectations, and an expectation, by definition, should not require luck, only skill.

In the case of multi-country portfolios and higher-risk fixed income strategies, the outcome is even more dire. Neither the medians (0.66% and -0.05%, respectively) nor the 75th percentiles (1.11% and 0.18%, respectively) of skilled simulations came close to expectations of 1.50% and 0.50% excess returns. In other words, we didn't observe an upside for multi-country portfolios or higher-risk fixed income and assessed that neither skill, nor skill plus luck, could give investors the excess returns we expected.

Facing these unusual numbers, we added a 9th step to our 2019 active performance expectations methodology:

- **Step 9**: Expand the sample period for equities and higher-risk fixed income strategies through mid-2020 to assess the active manager recession.

We compare, in Table 5, the extended period, 2015-2020Q2, for equities and higher-risk fixed income strategies with the original period, 2015-2018.

Table 5. Skilled equity and higher-risk fixed income excess returns by group

From 2015-2018 portfolio simulations, 2015-2020Q2 portfolio simulations and 2015-era excess return expectations (all returns annualised)

	PERCENTILES OF SIMULATED SKILLED EQUITY PORTFOLIOS						EXCESS RETURN EXPECTATIONS	
	2015-2018			2015-2020Q2			2015	2019-2020
	25th	50th	75th	25th	50th	75th		
Equity								
Single Country	0.61	1.08	***1.59***	0.50	1.06	***1.72***	1.25	**1.00**
Multi-Country	0.25	0.66	1.11	1.07	***1.58***	***2.09***	1.50	1.50
Small cap	0.82	1.33	***1.85***	1.47	***2.16***	***2.92***	1.75	1.75
Fixed Income								
Higher risk	-0.33	-0.05	0.18	-0.26	-0.05	0.16	0.50	**0.25**

In the case of equities, it seems that time heals most wounds. The six quarters post-2018 completely compensate multi-country and small cap universes for the active manager recession. In the case of single country equities and, even more so, higher-risk fixed income, we see no such compensation, as the 5½- year period looks very much like the four-year period. For these universes, we feel compelled to lower our expectations based on a combination of these recent periods and a review of previous sample periods.

> *In the case of equities, it seems that time heals most wounds*

Excess returns as a portion of total returns

In light of our recommendation to re-assess excess return forecasts for several sub-asset classes, we include a brief analysis of the proportion of total returns that comes from utilizing active managers. We review these proportions in Table 6 and find that excess returns may be a material component of the total return of portfolios. Equities offer 12%-16% and alts offer 14%-38% expected return enhancements. In the case of high-risk fixed income active managers, we note again that passive products face a headwind due to trading costs so the 5% noted is potentially a lowball estimate.

Table 6: Contribution of excess to total return expectations

	EXCESS RETURN EXPECTATION	STRATEGIC PLANNING ASSUMPTIONS*	% OF TOTAL RETURN FROM EXCESS RETURNS
Equity			
Single-country	1.00	7.5	12%
Multi-country	1.50	8.0	16%
Small cap	1.75	9.0	16%
Fixed Income			
Low risk	0.50	4.00	11%
High risk	0.25	5.00	5%
Alternatives			
Listed RA	1.75	7.0	20%
Hedge funds	2.50	4.0	38%
Private assets	1.50	9.0	14%

Not updated with 2019-2020Q2 data. *Rounded composite based on 10-year annualised return assumption for the asset

Correlation expectations

Excess returns do not happen in a vacuum. Along with excess returns comes tracking error, as noted above, and possibly correlations to other parts of the portfolio. In Table 7, we exhibit the typical expectations for correlations across different components of a multi-asset portfolio.

Table 7. Expected correlations among excess returns by asset class, and between excess returns and market indexes by asset class

	ER TO ER | CORRELATION EXPECTATION		ER TO INDEX | CORRELATION EXPECTATION
EQ ER to EQ ER	0.00	**EQ ER to EQ index**	0.0
EQ ER to FI ER	0.00	**EQ ER to FI index**	0.0
EQ ER to HF ER	0.00	**EQ ER to HF index**	0.0
EQ ER to RA ER	0.00	**EQ ER to RA index**	0.0
EQ ER to PA ER*	0.00	**EQ ER to PA beta***	0.0
		FI ER to EQ index	0.2
FI ER to FI ER	0.00	**FI ER to FI index**	0.2
FI ER to HF ER	0.00	**FI ER to HF index**	0.2
FI ER to RA ER	0.00	**FI ER to RA index**	0.2
FI ER to PA ER*	0.00	**FI ER to PA beta***	0.2
		HF ER to EQ index	0.2
		HF ER to FI index	0.2
HF ER to HR ER	0.00	**HF ER to HF index**	0.2
HF ER to RA ER	0.00	**HF ER to RA index**	0.2
HF ER to PA ER*	0.00	**HF ER to PA beta***	0.2
		RA ER to EQ index	-0.2
		RA ER to FI index	-0.2
		RA ER to HF index	-0.2
RA ER to RA ER	0.00	**RA ER to RA index**	-0.2
RA ER to PA ER*	0.00	**RA ER to PA beta***	-0.2
		PA ER to EQ index*	0.0
		PA ER to FI index*	0.0
		PA ER to HF index*	0.0
		PA ER to RA index*	0.0
PA ER to PA ER*	0.00	**PA ER to PA beta***	0.0

*Imputed from other assets

As one might expect, the most frequent correlation result across all pairs is zero. We note that fixed income excess returns may be positively correlated to other parts of the portfolio. We expect to see this, given the heavy reliance of credit as a typical fixed income return play.

Conclusions

Every four years or so, Russell Investments provides updates to our excess return expectations. In 2019, we started out wondering if we had excess return expectations, or just excess expectations! By mid-2020, we gained quite a lot of comfort that the active manager recess we observed in the 2015-2018 period was broad and severe, but possibly reversing. To that end, by waiting for a longer sample period to evaluate, 2015-2020Q2, we were able to renew our confidence in the value-add that active managers bring to the table.

In this paper, we have highlighted our examination of excess returns, tracking errors and correlations. As well, we've shared our conclusion that single-country equities and higher-risk fixed-income have faced persistent challenges and we have acknowledged that with modestly lower excess return expectations. In other asset areas, with a noted recovery during 2019-2020Q2, we've largely re-affirmed our prior expectations.

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