Total portfolio management

Russell Investments approach to combining active, passive and everything in between

Russell Investments Research

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Most investors seek the best risk/return trade-offs that help meet their goals. While there is little debate that asset allocation, or the question of what to invest in, has the largest impact on total returns, the question of how to invest, especially within asset classes, has been a source of ongoing debate.

At Russell Investments, we have continually adapted our investment approach to keep pace with the evolution of investment vehicles designed to help investors meet their objectives. The goal has always been to use the full spectrum of available tools within a “total portfolio management” (TPM) approach. We believe this integrated process requires a well-informed set of investment beliefs, an open-architecture approach that can source the best active managers and strategies, and accountability for all portfolio exposures.

In this paper, we frame an approach to using the full spectrum of investment options as part of a total portfolio management approach.

Background

Russell Investments has always sought to help its clients navigate considerations of *how to invest* through its unique perspective as an investment consultant and asset manager.

In the 1970s and 1980s, the main implementation options were active providers with balanced portfolios or combinations of active specialists. We guided clients toward mixed portfolios of specialists, noting the typically stronger results generated by specialists and the potentially greater risk diversification achievable by combining their offers.[1]

As index providers started delivering low-cost, passively managed portfolios in many liquid markets, we helped clients evaluate market characteristics, skill sets and the governance required to achieve sufficient returns to justify forgoing the passive investment option.[2]

During the early years of passive investing, investors were often urged to see the *how to invest* question as a matter of faith – either you believe that markets have become highly efficient and that active management can no longer add value, or you believe “market efficiency” is an illusion that lures investors into going fully passive and possibly missing out on substantial return opportunities. At Russell Investments, we believe that while there are plenty of passive investment vehicles, there are no entirely passive investors.

Our view has always been that the method of seeking returns is secondary to total portfolio investment objectives, given the investment options available. If passively implemented beta exposures more effectively help the investor meet a portfolio goal, they should be combined into a solution. If higher returns are required, the most compelling active strategies and positions may be employed alongside passive exposures, if needed.

Active management is only one of several options that can be used to enhance return potential. Increased allocations to equities, greater use of leverage or illiquid assets, and the targeting of excess return via active management are levers that can be dialed up or down to help achieve better outcomes, albeit while understanding that all of the approaches carry risks that must be accepted along with them. We focus on total portfolio objectives, risks and constraints as we work to identify an optimal combination of sources of return.

Our approach has been bolstered by two developments in the industry:

1. An enormous proliferation of smart beta strategies, which have expanded the toolkits available to construct portfolios, and
2. Increasing recognition that assessing performance relative to an index matters less to investors than actually achieving their total portfolio investment objectives.

These changes have blurred the line between active and passive and, we think, have moved the industry away from the often unproductive active vs. passive debate, a variation on the question of *how to invest*.

As they seek to achieve their objectives, the majority of investors – both institutions and individuals – now hold a combination of active and passive investments. They are sensibly focused on a different question than active vs. passive; when passive benchmark exposures have historically offered only modest returns, where can investors find enough return to meet their goals, at a level of risk they can accept? Most believe there are return opportunities beyond the strict replication of indexes – for example, through the active exposures provided by smart beta solutions. Many also recognize the efficacy of skilled active management, but are not willing to hand over an entire portfolio to a single active manager (and rightly so!). Almost all are looking to find an optimal mix that can better help them achieve their investment objectives.

The good news is that many of the key insights required to get the best from this broader investment opportunity set are well established, both in the industry and in academic literature. The problem is that they have been underutilized by most investors. The proliferation of smart beta strategies has unfortunately not made investors' jobs any easier, and despite the fact that many of the strategies may provide powerful benefits, knowing how and where to deploy them in a portfolio context is a non-trivial problem.

The *how to invest* issue has, as a result, taken on a new form. The pressing question now is "How do you manage a mix of active, passive and smart beta strategies to produce desired results?" In this paper, we frame an approach to using the full spectrum of investment options as part of a TPM approach. We start by defining some key terms and evaluating the standard method of blending active and passive management, and follow with a brief description of Russell Investments' process.

The basics: the utility of active with passive

Before laying out the benefits of putting together the "right" mix of strategies, let's group them into three buckets – passive, smart beta and fully active strategies – and define them.

1. Passive

We define *passive investing* as investing to replicate returns from standard benchmarks. Passive investing limits costs, due to low turnover and low (or no) management fees, while capturing the overall volatility and the correlation of a given market segment with other investment opportunities.

2. Smart beta

Smart beta strategies are typically transparent, rules-based portfolios designed to provide focused exposure to specific factors, market segments or investment strategies. Smart betas are generally accessible at lower cost relative to active management, are not limited to cap weighting and can be used by investors to express active factor positions in the long or short term.[3]

3. Active

Active managers seek to add value from ongoing selection and management of portfolio positions. By doing so, they can take advantage of opportunities across various sub-segments of their mandate and on multiple time horizons using a proprietary (less transparent) approach to achieving excess returns. One additional benefit of active management is that, when it is truly driven by skill, strategies can be mixed together to deliver an efficient source of extra return without substantially altering total portfolio volatility.[4]

Putting these pieces together has taken different forms. Over the years, many investors have adopted a simple approach to blending active and passive components: "core-satellite," by starting with a passive core and adding a collection of highly active strategies. With the availability of so many investment options spanning passive to fully active, now is a good time for investors to rethink the use of these building blocks to target their investment objectives.

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Challenges with core-satellite

Core-satellite[5] has been the dominant "blending" framework and is seen as an intuitive way to seek excess returns while managing costs and risks. While this approach is a reasonable starting point, it does come with significant challenges.

1. Risk dilution is not risk management

As Don Ezra showed back in 2000, the blunt passive instruments typically used in core-satellite simply reduce the magnitude of bets while leaving the bets themselves intact. As he puts it, investors are "still playing the same game as before, just with the positive and negative outcomes scaled down proportionately" or are "simply turning the volume dial down"[6] rather than truly managing risks. An alternative solution, which we call a TPM approach, allows investors to use the passive portion to actively shape the portfolio in the desired direction. This can be accomplished through smart beta strategies, which can increase exposures to certain factors or offset unintended exposures. In this way, an investor can retain bets with expected rewards while eliminating or reducing unwanted exposures.

2. Picking good managers can still lead to bad outcomes

While blunt passive instruments dilute the excess returns and risks attributable to active management, a passive core-satellite approach is still reliant on combinations of active managers to find opportunities for excess returns. As a result, investors are faced with all of the challenges of constructing an effective multi-manager portfolio. However, investors are often frustrated when they have been diligent in selecting skilled active managers and still do not achieve strong results. There are three common reasons why a portfolio of good managers may deliver bad outcomes: poor timing, herding and manager weightings.

1. Poor timing

All active strategies go through cycles of strong and weak performance. Unfortunately, behavioral biases often lead investors to "identify" skill during periods of outperformance. Conversely, investors often become skeptical of a manager's abilities following bad performance. In reality, these good and bad periods are often the result of factor tailwinds or headwinds. This leads to a buy-high, sell-low trap for many investors. They find themselves locked in a vicious cycle of firing underperforming managers and replacing them with recent outperformers. A disciplined, high-conviction approach to evaluating the timing of portfolio changes can help investors avoid these pitfalls.

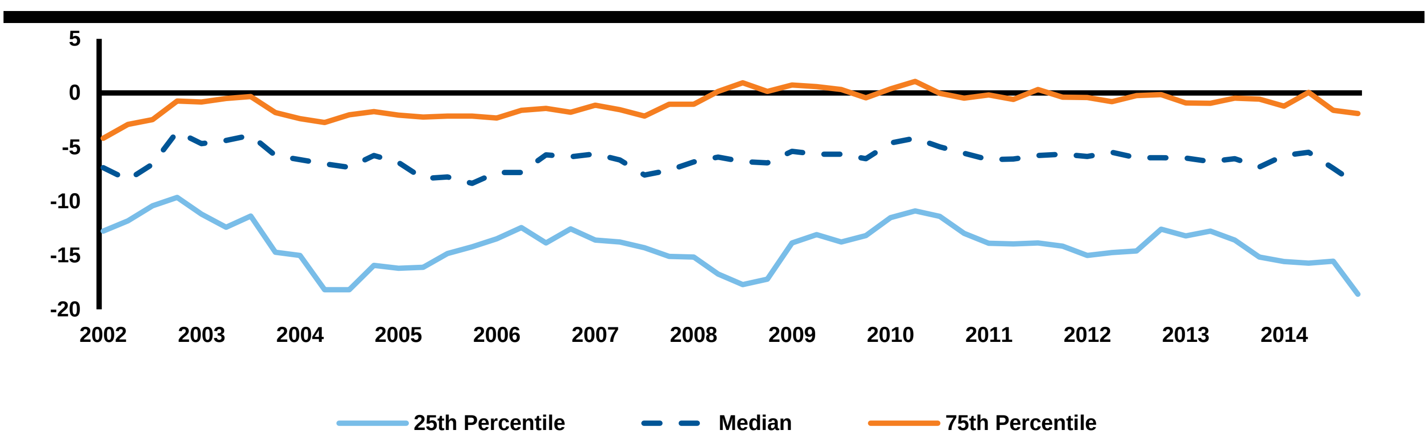
As seen in **Exhibit 1**, it is common to see persistent bets in active manager universes that drive the group's performance. Below, we show a significant and persistent underweight to the U.S. across most active global equity managers. This can apply across asset classes – e.g., an underweight to Taiwan in emerging markets, an avoidance of REITs by U.S. small cap managers, overweights to credit in fixed income and almost universal overweights to volatility.

2. Herding

It is common for groups of active managers to "herd," or all move in the same direction. For example, global equity managers tend to be overweight emerging markets and U.S. Fixed income portfolios usually feature consistently large overweights to spread sectors. These positions are often not the result of differentiated skill, but are rather the result of structural biases.

Some common active manager biases can be persistent over time, and others can evolve as managers' collective bottom-up insights lead them toward the same market segments. Yet, the herd is not always right – the shared common bets that are pervasive across the active manager community can be a large driver of active returns, because they are the primary exposures that remain after others have been diversified away.

Exhibit 1: The impact of common factor bets on active manager returns (United States)



For illustrative purposes only. Past performance is no guarantee of future results.

To succeed in active manager selection, an investor needs to be aware of where the herd is positioned and how this relates to the investor's chosen group of managers, and to consciously decide whether to remain with the herd or move against it. Obviously, success also requires some skill in making those decisions.

3. Manager weightings matter

Many investors don't have the resources or experience to maintain a point of view with confidence on optimal portfolio positioning, so they pick skilled active managers in an effort to outsource that decision.

All investors should arrive at a set of investment views and "own" the shape of the total portfolio. Even a 60/40 equity/bond portfolio implies certain expectations around the returns to those assets and their relative attractiveness. Selecting and weighting multiple skilled active managers constitutes an embedded view. Whether investors explicitly intend to express it, they have bet on which total portfolio exposures are likely to pay off. Similarly, choosing a smart beta strategy expresses a view on expected factor performance (e.g., that value stocks, low-volatility stocks or momentum strategies will outperform the broad market over time or improve the portfolio's risk profile).

Any combination of managers, no matter how skilled, will result in a total portfolio that none of those underlying managers would have constructed alone. Hiring more than one active manager implies some level of offsetting. The good news is that if all are skilled – meaning, if each has an ability to generate excess return through idiosyncratic risk-taking – their excess returns should not be diversified away.

In order to weight managers successfully, a holistic approach is required, where best-of-breed active managers are combined as appropriate with targeted smart beta strategies.

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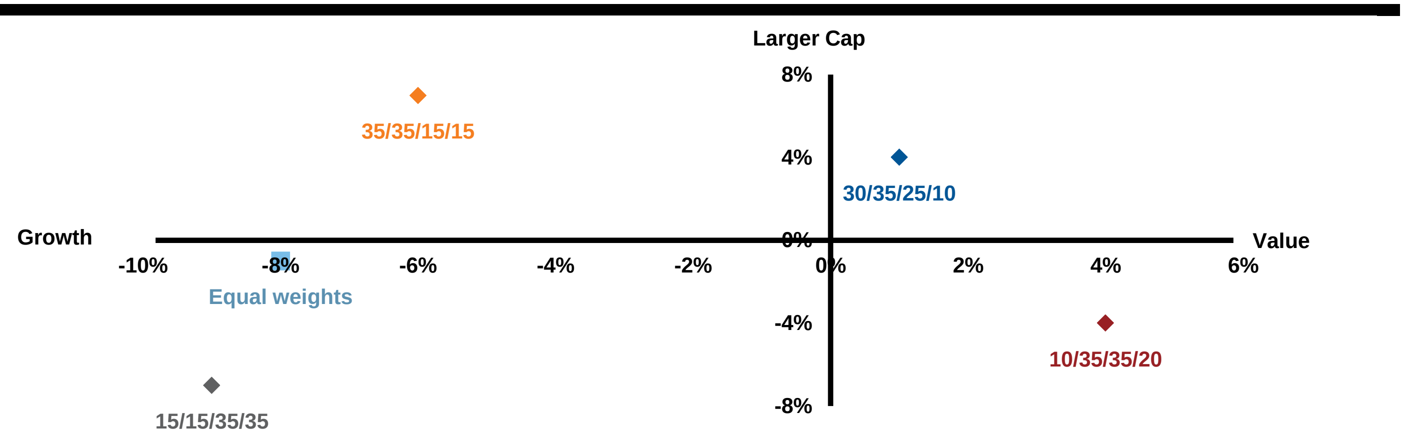
We all know that different manager selections will lead to different sets of portfolio exposures. This fact is why we believe a TPM approach is so important. Indeed, even combining the same managers at different weights can lead to vastly different portfolios. Investors should choose these weights carefully and have a view about the desired aggregate positioning.

Exhibit 2 shows the style exposures of four active managers, measured with z-scores using the Axioma risk model (for example, a positive value for Value and Size suggests a manager with a larger cap and value tilt relative to the benchmark). Four different sets of weights, each of which leads to a significantly different total portfolio, are plotted. This highlights the importance of having a view (in this case, does the investor prefer to have a value or growth tilt? A smaller or larger bias?) and of thoughtfully constructing the total portfolio to reflect this view. With this manager lineup (and many real-world applications, for that matter), equal weighting would result in a meaningful growth bias. Is this really what the investor wants?

A core-satellite approach does address the first question of how to allocate between active and passive management in a simple way. But simply splitting capital between aggressive active and simple passive strategies is insufficient, especially since more robust toolkits now exist.

Exhibit 2: Beware the accidental portfolio; weightings matter



Total portfolio management

Having considered the challenges of simply combining multiple active managers and the inefficiencies of using blunt passive instruments to dampen risk, we maintain that there is a better way. As it turns out, the availability of new investment vehicles makes this a good time to rethink the standard approach. At Russell Investments, we believe this new spectrum of instruments has opened the door to a more complete, total portfolio approach to intelligently combining active management, passive management and smart beta strategies.

With a TPM approach, investors get a mix of potent return sources with long- and short-run expected payoffs diversified to appropriate risk levels. Many investors believe insightful active managers can deliver all the necessary excess return. Others believe that smart beta strategies are the silver bullets, while a third group looks to passive indexes. Investors need all three and, no matter which components are used, an informed point of view about the optimal combination is required to manage effectively toward strong total portfolio outcomes.

Our approach can be summarized as follows:

1. Have a view and a belief set of what factors or return sources will perform well over the long run and shorter run
2. Build the portfolio with the best active strategies, and complete the portfolio with targeted exposures or smart betas to ensure that it lines up with your views
3. Dynamically monitor and manage exposures

Step 1: Have a view

At Russell Investments, we believe that while there are plenty of passive investment vehicles, there is no such thing as a wholly passive investor. Decisions – positive, negative, or neutral – need to be made on key return drivers, with a sense of desired magnitude and direction of exposure.

Views begin as judgments about the best risk/return trade-offs across the following dimensions:

- Betas: What factors are expected to outperform over the long run?
- Alphas: Is it possible to identify skilled (truly active) managers who can add value on top of the factor exposures they deliver?
- Tactical views: Is it possible and profitable to exploit shorter-term opportunities to dynamically allocate across factor exposures?

Step 2: Build a portfolio to reflect those views

After identifying these views, portfolio construction becomes a thoughtful calibration of the chosen risk/return trade-offs. Investors need to simultaneously think about where to employ active management and where passive opportunities may exist.

Using one approach, investors can first seek a diverse portfolio of the best active managers and strategies. Every active strategy needs to justify its unique value-add by providing pure alpha separate from static factor exposures. There is no need for “filler” active strategies (those that provide factor exposure, but have minimal excess return potential) to dampen risk, as they can be imprecise and expensive vehicles to use for risk control.

Next, investors can examine the gap between the unconstrained active portfolio and their held beliefs. Smart beta strategies can be used to hone in on factor exposures to obtain the precise expression of the investor’s view. This is different from core-satellite – by using the complete toolkit of available investment options, it is possible to be much more targeted. This is crucial: Every dollar of allocated capital should, and now can, be used to emphasize the desired risks and avoid or rein in unwanted ones.

The full use of active management, passive management and smart beta strategies allows investors to create a portfolio that better seeks attractive returns from where the investor has greatest conviction, with appropriate precision and an eye on costs.

Exhibit 3 shows the process in action – starting first with a clear set of investment beliefs, which can be hard to reflect with a portfolio of high-conviction active managers. In order to get the most out of the active managers and the initial beliefs, a targeted portfolio of factor exposures (see chart at right in **Exhibit 3**) is required to address the gaps left from the active managers.

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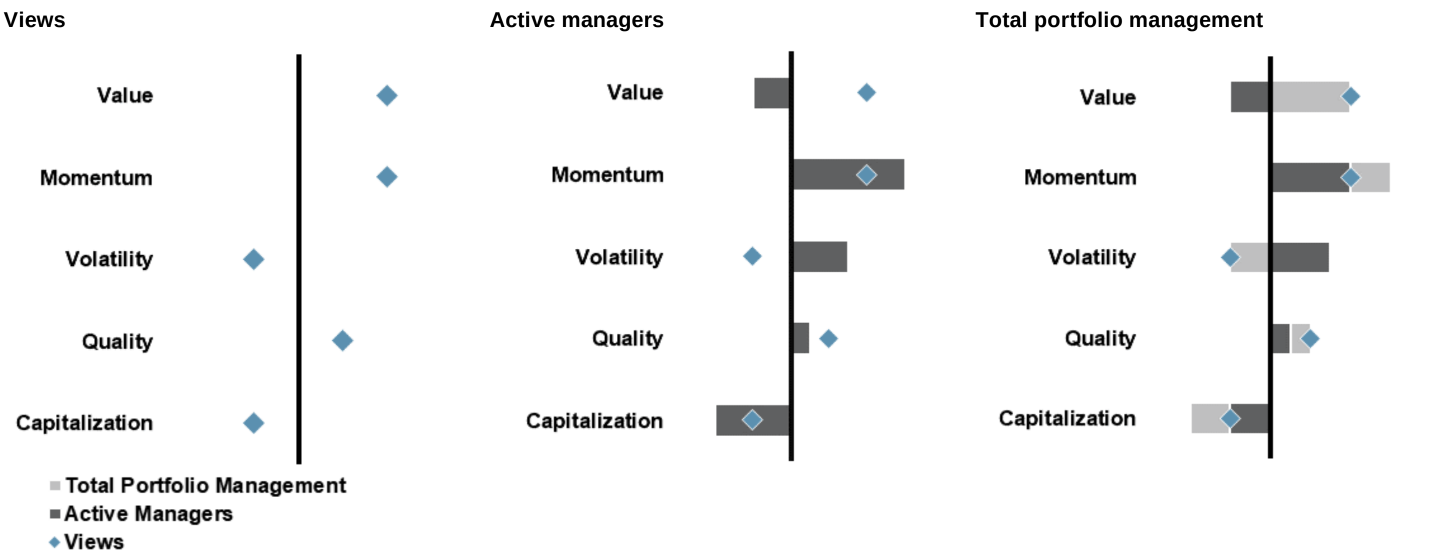
Exhibit 3: TPM in action



Step 3: Dynamically monitor and manage the portfolio

In time, investor views will change, active managers will change their portfolios and the currently prevailing market opportunities and risks will change. The TPM approach provides full ability to manage the portfolio in real time, in order to respond to and take advantage of these changes. The mix of active management and smart beta approaches offers flexibility, on an ongoing basis, so that views are optimally reflected. If it is possible to successfully time these exposures intentionally, this ongoing monitoring can also be allowed for opportunistically adjusting exposures.

We believe this TPM approach is superior to existing methods, as it allows investors to fully benefit from the best investment thinking and modern portfolio management tools across asset classes and to use all available investment options. The total portfolio can work as hard as possible by combining passive, smart beta and active instruments. And investors can get more out of each piece, rather than being forced to choose between just two options.

Putting it all together

Russell Investments, we believe high-quality, active investment management can provide for meaningfully higher returns than are achievable via passive investing. That said, we seek investments with the best risk/return trade-offs, and combine active and passive management, to help our clients reach their goals. We recommend integrating skilled active management with carefully targeted factor exposures using a dynamic, TPM approach to help meet investor objectives.

[1] Ilkiw, J. (1998, August). “Understanding and Selecting Manager Structures: From Fully Passive to Active Multi-Manager Specialist”. *Russell Investments Research*.
[2] Warren, G. and Ezra, D. (2010, January). “When should investors consider an alternative to passive investing?” *Russell Investments Research*.
[3] Goodwin, T. (2014, October). “Smart Beta Guidebook: An Overview of Russell Smart Beta Indexes”. *Russell Investments Research*.
[4] Oberhofer, G. (2001, April). "Active or Passive Management? A Logical Decision Model". *Russell Investments Research*.
[5] See, for example: Martorana, R. “Simple, Safe, and Cost-Effective: Using a Core/Satellite Approach in Your 401(k)”. *Inside Investing–CFA Institute*. Issue date: August 1, 2012
[6] Ezra, D. (2000, February). "Active versus Passive: A New Perspective". *Russell Investments Research*.

About Russell Investments

Russell Investments is a global asset manager with a unique set of capabilities that we believe is essential to managing your total portfolio and to meeting your desired outcome. At Russell Investments, we stand with you, whether you're an institutional investor, a financial adviser, or an individual guided by an advisor's personalized advice. We believe the best way to reach your desired outcomes is with a multi-asset approach that combines: asset allocation, capital markets insights, factor exposures, manager research and portfolio implementation.

For more information

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