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A NEW ERA OF ACTIVE MANAGEMENT LOOMS

The period ahead will likely be less suitable for passive strategies.

- Strong returns from passive strategies since the financial crisis were partly due to aggressive quantitative easing (QE) by central banks. Effects of such policies on market returns are expected to diminish going forward.
- The perception that passive strategies are lower risk may need to be reassessed. For example, simple factor investing (smart beta) is a form of active management, with associated risks that need to be actively managed.
- The growth of passive funds has led to high ETF trading volumes. Potential mispricing when ETF volumes spike can create profitable opportunities for active investors.

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The surge in popularity of passive investment strategies has been one of the most notable developments in markets since the financial crisis. It has led to frequent and often intense debate over the merits of active investing versus passively tracking an index. Such discussions frequently ignore the context in which passive strategies have grown in recent years and the specific risks that may be associated with them. As financial markets move into the next decade, investors may need to re-think how they employ passive investments within their portfolios and what returns they can expect from them. In this context, we would highlight the impact of quantitative easing (QE) policies on market returns: the world has become addicted to ample liquidity pushing higher all assets' prices. We note that 2018 – a year of negative global equity and bond returns – also saw the sharpest reversal in central bank liquidity provision since the start of the QE era (see Figure 1).

Central Banks Created a Favorable Environment for Passive Funds

The strong returns of passive strategies since the global financial crisis were partly due to the policies followed by the major central banks over this period. Ultralow and falling interest rates combined with trillions of dollars of quantitative easing (QE) enabled risk asset valuations to rise sharply.

Market returns (or beta), upon which passive strategies are built, have been much higher than the excess returns (or alpha) achieved by active managers during this period. Some argue that this era may now be drawing to a close. They believe there is a limit to how much more QE central banks will be prepared to undertake in view of its questionable macro-economic success and potentially negative consequences for financial stability and income inequality. With or without QE going forward, we still doubt that market returns from the last decade can be repeated in the next decade. Given today's higher starting valuations, expected returns from equities and bonds are diminishing and are forecasted to be lower than actual returns since 2009.

Even if more rounds of QE are announced, it is unlikely that 10-year bond yields will fall by anything like as much as they did when QE policies were first introduced. This is important for investors. When beta return is 10%, for example, an alpha of 1% is nice to have, but may not be essential. But when beta return is 5%, an additional 1% from alpha could be critical to achieving the investor's goals. In the latter case, investors face the choice of either accepting lower returns or adopting a different, riskier strategy in pursuit of similar returns. Figure 2 makes this point in a simple diagram. It shows how 1% of alpha could potentially make a bigger percentage contribution to total returns as the portfolio's expected return declined.

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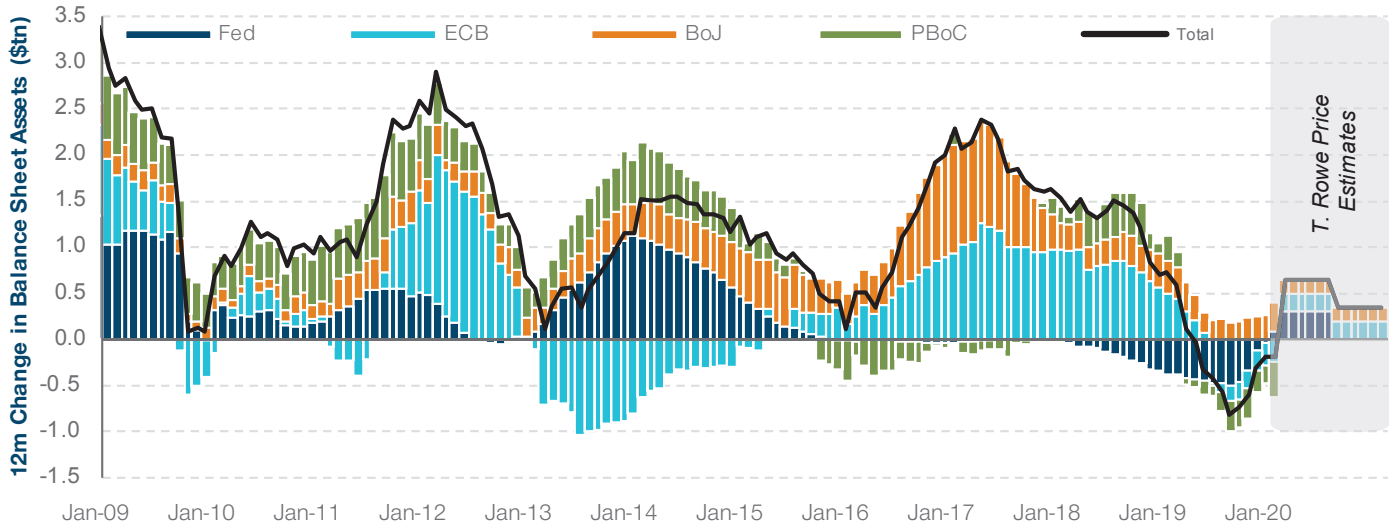
Passive Strategies Not Positioned for Disruptive Change

The perception that passive strategies are lower risk may need to be reassessed. Most equity indexes are weighted by market capitalization, so that large companies have a bigger index weight than smaller companies. This means that investing passively in a benchmark index is effectively a bet that the most recently successful companies will continue to be successful. History shows us that this is not always the case. IBM, Philip Morris, Coca-Cola, and General Electric have all been among the largest 10 firms in the S&P 500 Index in the past, yet over the ten years to August 31, 2019, cumulative returns of these stocks lagged the index by 189%, 112%, 63%, and 270%, respectively.

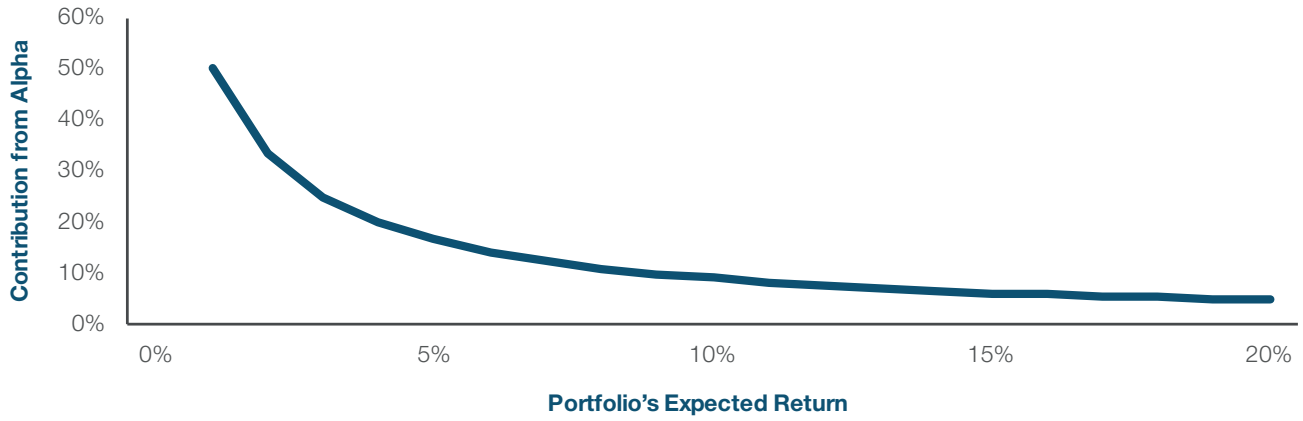
Passive investment strategies can make it more difficult to be on the right side of disruptive change.

FIGURE 1: Era of Large Scale QE is Over
Year-on-year rolling 12-month change in Central Bank assets (US$ trillion)
As of December 31 2019



Sources: Federal Reserve Bank, European Central Bank, Bank of Japan, People's Bank of China, T. Rowe Price. Analysis by T. Rowe Price.

FIGURE 2: If Returns Are Lower, Alpha is Worth More
1% alpha as percentage share of portfolio total return



Source: T. Rowe Price calculations.
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Kodak, Nokia, Xerox, Blockbuster, and Yahoo were all giants in their respective fields that failed to identify disruptive forces and lost. Today, the biggest firms are digital companies such as Apple and Amazon. These companies may continue to perform well over the next decade and beyond. But relying on them to do so is an active bet, not a passive one. It is important that investors are aware of this. A good active manager, with a keen sensitivity to change and disruption, is free to actively tilt the portfolio not only to avoid disrupted firms, but also to potentially benefit from the disruptors.

> *Passive investment strategies make it more difficult to be on the right side of disruptive change.*

Passive bond strategies are arguably even more vulnerable than passive equity funds. The Bloomberg Barclays Global Aggregate Bond Index weights issuers by the amount of debt they issue, meaning that any passive strategy tracking the index will be overweighting the most indebted issuers. And while it may not be a problem to have an approximately 40% allocation to U.S. government debt, holding around a 16% weighting in Japan is likely to carry more risk, as is an overweight allocation to Italian government bonds. Moreover, passive global bond funds cannot avoid giving a large weight to developed government bond markets with negative yields, to the detriment of overall portfolio returns.

Factor ETFs No Substitute for Active Management

Factor-based index strategies or 'smart beta' funds have become increasingly popular in recent years. They have played a major role in the rapid growth of passive investments.[1] Supporters of factor investing believe it offers investors exposure to well-defined sources of risk, with relatively low correlations between factors and with macro risks.

Regarded as a new asset class, quant-based indices and associated ETF or funds have been misinterpreted by some investors as delivering 'active strategy returns at low passive fees. However, investing in factor products in the hope of replacing active management with relatively simple quant tilts to indexed passive funds is unlikely to prove a successful strategy, in our view. Historically, single-factor performance has shown periods of excess returns (ER) relative to index benchmarks, but at the cost of considerable cyclicality. Typically, short bursts of strong outperformance are followed by longer periods of underperformance, which is not an attractive risk-reward profile for many investors.

Investing in a number of single factor funds, such as value, growth or quality, effectively passes the asset allocation decision back to the client not the fund manager. Few individual investors are likely to possess the necessary skills for such a task. Holding a few smart beta ETFs is not a 'standalone' strategy, since there is still going to be a need for active decisions concerning the weight of the various factors within the portfolio.

We believe that a better strategy is a multifactor portfolio approach that seeks improved risk-adjusted

[1] One recent estimate places the total AUM (assets under management) for factor investing and similar systematic strategies within a US$200 to 400 billion range. See Societe Generale, 'The Systematic Investor Report,' January 2020.

returns. However, this requires active management skill besides quantitative analysis. All told, we believe successful multi factor-based investing demands skills that are comparable with other forms of active management. Our own research shows factor investing is no simple panacea or short cut for investors. It is best thought of as a particular type of active strategy that requires considerable skill to implement successfully.[2]

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Growth of Passive ETFs Can Create Opportunities for Active Managers

Thanks to the growing popularity of passive investing, ETF trading volume on U.S. exchanges has increased significantly in recent years. This may create new opportunities for bottom-up stock pickers as when ETF volumes spike, correlations among constituents may rise to levels that are not justified by company fundamentals, giving rise to the mispricing of some stocks that can then be bought cheaply.

Heavy ETF trading can lead to mispricing of constituent stocks. From time to time, ETFs trade heavily around a particular investment theme or macro event, causing correlations between constituent securities to rise significantly. Some securities may be forced to trade in lockstep with other ETF constituents even though they have little exposure to the theme or event itself. Our own research suggests that pricing abnormalities created by heavy ETF selloffs present potential alpha opportunities to active stock pickers.[3]

After losing ground steadily to passive vehicles in recent years, active stock pickers may now be able to take their revenge on ETF investors. We tested a simple, hypothetical, contrarian trading strategy of buying cheap stocks after high-volume ETF market corrections. Our study suggests ETF investors might have left as much as 200–300 bps of potential alpha on the table for stock pickers to capture over the following 40 days.[3]

Concluding Thoughts

When markets are flooded with central bank money, most asset prices are lifted. Selectivity then becomes less important as investors can effectively "buy" the market by investing in a passive fund and enjoy the rally. When markets return to more normal conditions, there will be more potential opportunities for the good active asset manager to select outperforming investments and underweight lagging investments. We think we are currently heading into such an environment, where active management will have more opportunities to excel and add value than it did during the QE era of ultralow interest rates. Combine this with much lower absolute returns than in past decade and investors' need for alpha may come back strongly. ■

WHAT WE'RE WATCHING NEXT

We will be closely monitoring central banks for indications that they plan to wind down monetary stimulus. As QE is withdrawn from the financial system, we may expect average returns to be lower than in the past and volatility and dispersion of returns to increase. There are signs that some investors are already tilting back more towards active strategies. We will be watching to see whether this continues.

[2] See "Factor Investing is Not a Simple Panacea", T. Rowe Price Insights, November 2019.
[3] See "The Revenge of the Stock Pickers", T. Rowe Price Insights, September 2019.

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