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# Will the trend towards passive investment sweep away the human investment advisor?

tetralog client day 2014

Munich, 09/29/2014

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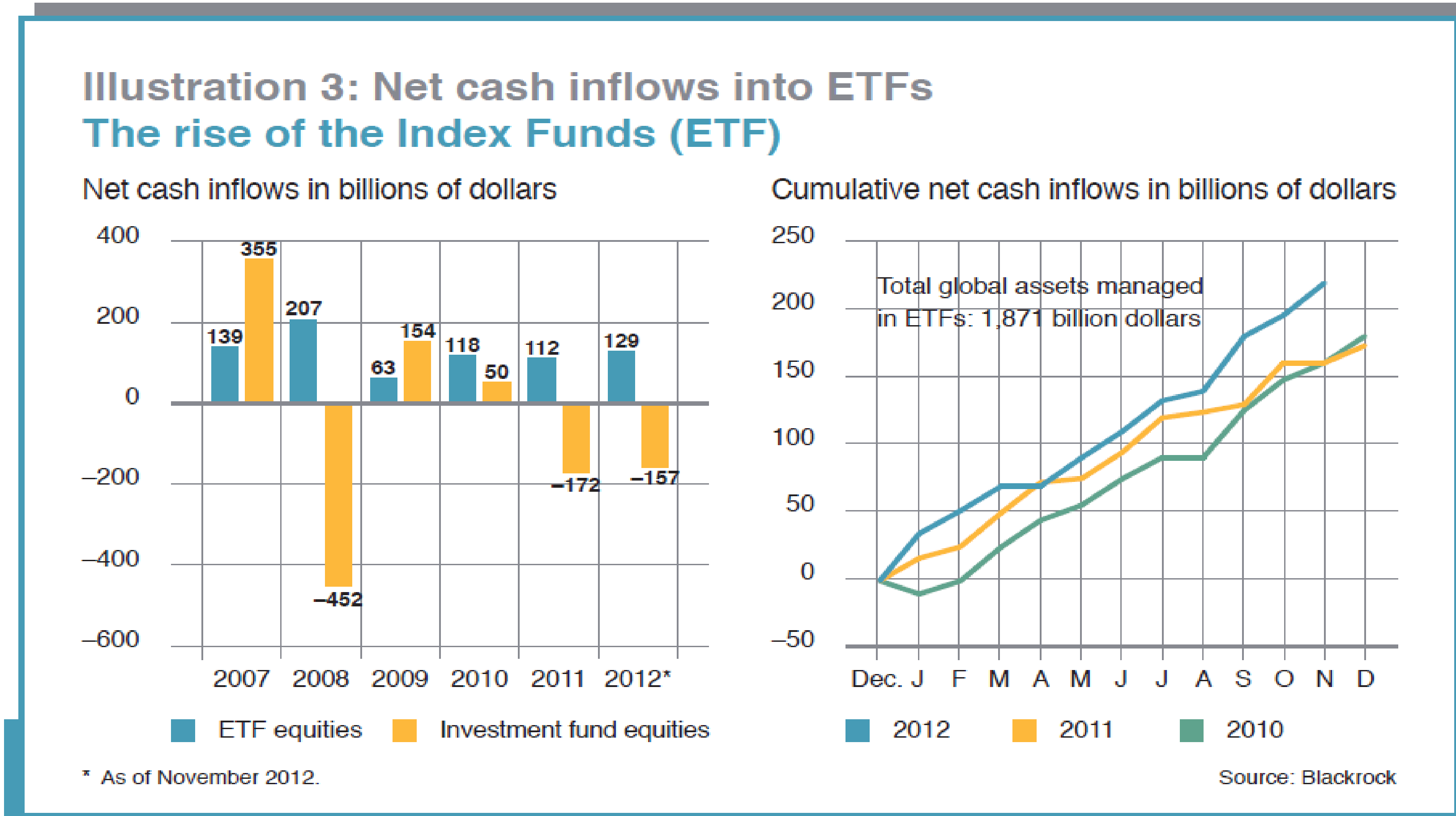
# Investment today: Headwinds for advisors

- Climate of mistrust against all actors in the financial sector
- Dissatisfaction with long-term returns
- Scepticism towards sales stories about superior investment managers
- Increasing cost-awareness among investors
- Increasing costs among advisors due to tighter regulation

# Investment today: Tailwinds for ETF investments




ETFs continue to attract substantial inflows
Since October 2013, an index fund is the largest investment fund in the world

# Common beliefs about passive investment

- Based on over-simplistic theoretical assumptions
- "De-mystifies" the investment advisor, destroying classical sales stories
- Destroys commission based sales
- Makes ongoing management activities superfluous

# An alternative view on passive investment

- Based on over-simplistic theoretical assumptions
- *Takes theory really seriously*

- “De-mystifies” the investment advisor, destroying classical sales stories
- *Re-constructs the investment manager as a neutral expert*

- Destroy commission based sales
- *Provides a justification for fee-based advisory*

- Make ongoing management activities superfluous
- *Requires modified investment processes*

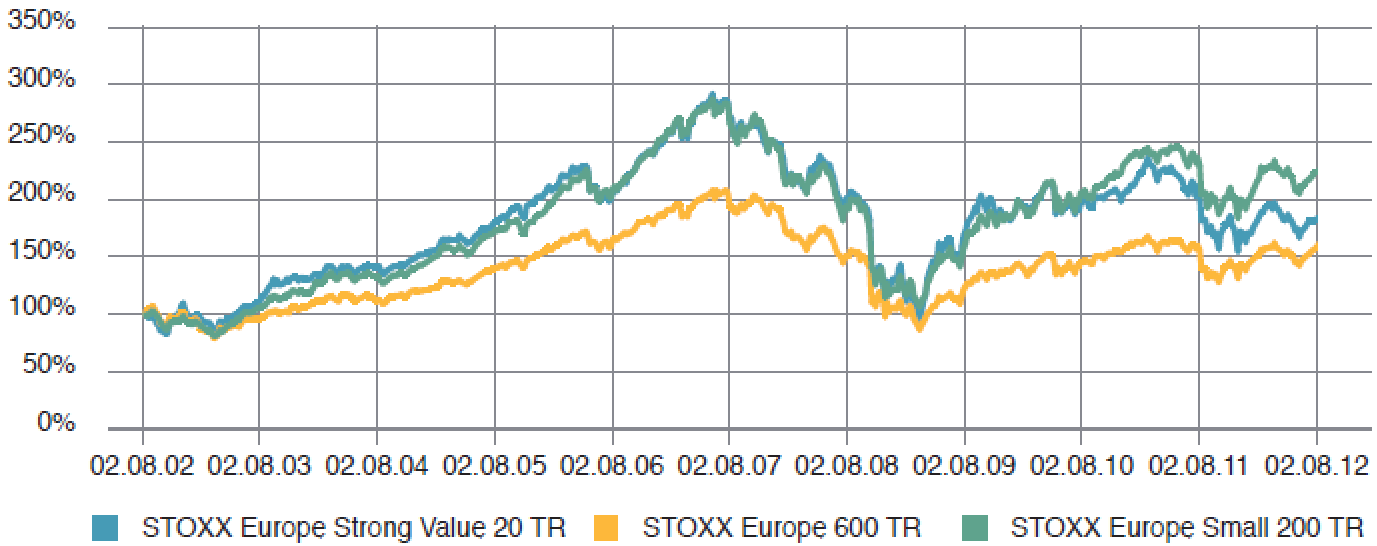
# Markowitz: Only one systematic risk factor

$$r_i = r_f + \beta_i(r_m - r_f) + \varepsilon_i$$

There is only one systematic risk factor: The total market itself.

# Fama & French: Challenging findings

**Illustration 5: STOXX® Europe 600 index compared to two of its sub-indices**




Source: STOXX Ltd.

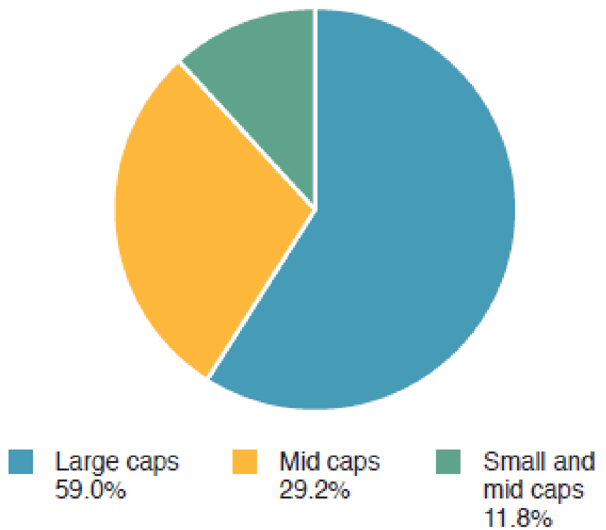
Stocks with a high book-to-market-ratio (“value stocks”) and stocks with low levels of market capitalization (“small caps”) generate a systematic long-term excess return on the total market.

# Not only of theoretical value

## Illustration 6: Average size allocation of the 30 most successful European equity funds (left) compared to the MSCI Europe index (right):

### Division of funds investigated according to market capitalisation

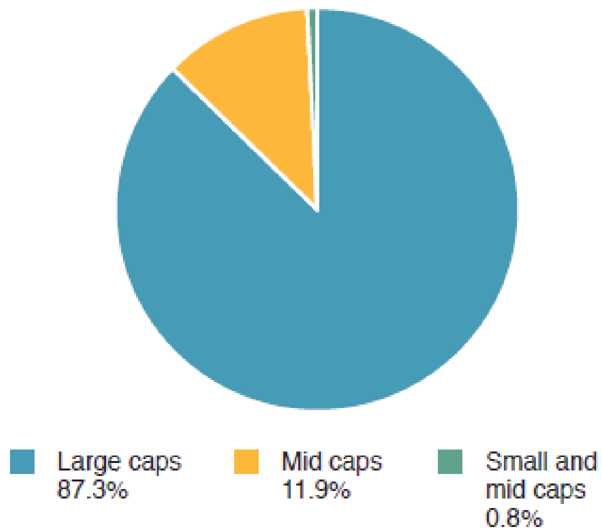
average division in percent




Source: Institut für Vermögensaufbau

### Division of benchmark ETF according to market capitalisation

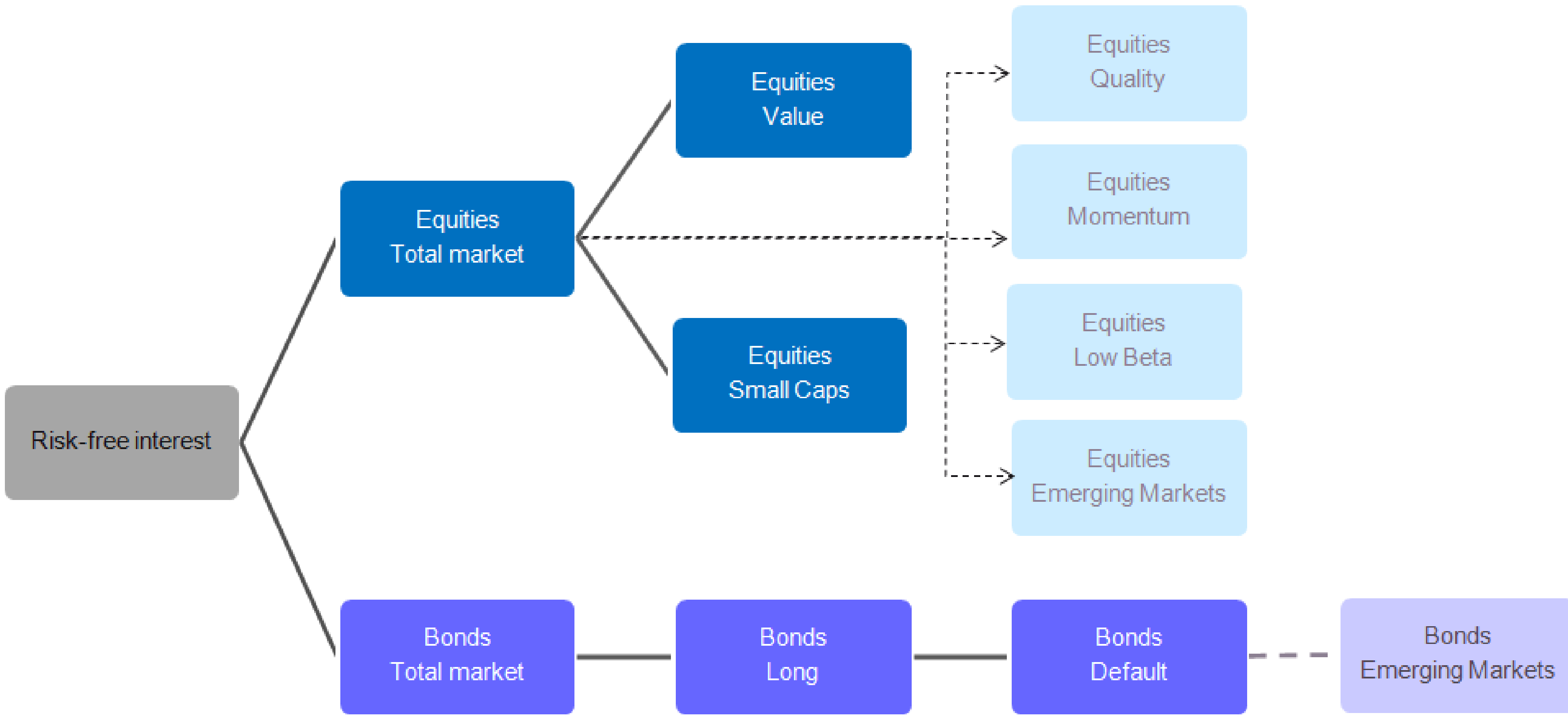
MSCI Europe ETF in percent



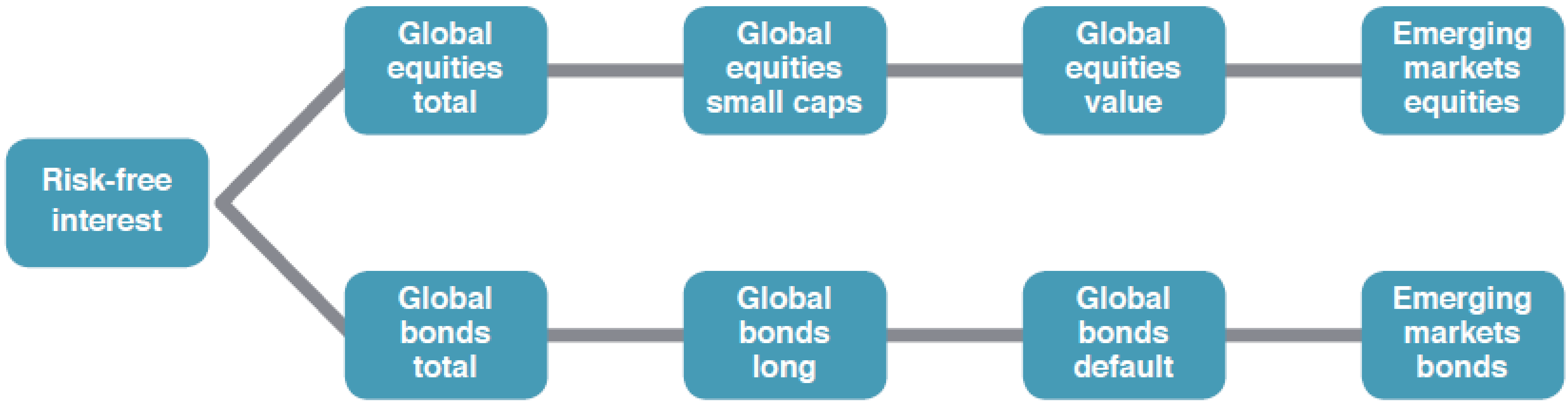

Source: Institut für Vermögensaufbau

Small caps heavily overweighted in most successful European equity funds.

# Today: Even more factors under discussion



# A simple global multi factor model




- Theoretically, no other global equity-bond-portfolio will have a higher probability to beat the total market than the one that overweighs these factors
- Note: It will undergo phases of underperformance relative to the total market
- Note: It will exhibit higher volatility than total market (no „free lunch“)
- However, in the long run, it will accumulate risk premia in the most systematic way

# Many non-trivial questions arise

- How do you define the “total market”: Globally or locally?
- Defining the market globally: How do you deal with the resulting FX-exposure?
- What is the best way to invest into a certain market?
- How do you weigh the factors for investors with differing investment horizons and risk tolerances?
- How do you deal with investors with a strictly limited risk budget?
- What about alternative investments?

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# Application of a global model, EUR-adjusted


Tracking “good” indices in terms of market representation
Controlling the FX-exposure on the bond side

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# Customer types: The crucial differences

| | Investment focus | |
| --- | --- | --- |
| **Investment horizon** | **Yield optimisation** | **Loss limitation** |
| **Short (up to 5 years)** | Customer type 0 | Customer type 2 |
| **Long ( > 5 years)** | Customer type 1 | Customer type 3 |

**Customer type 0:** not in the focus of investment advisors (speculation)
**Customer type 1:** long-term capital appreciation without specific constraints
**Customer type 2:** continuous risk budgeting
**Customer type 3:** long-term capital preservation

# Differences and similarities between the three customer types

| | Customer type 1<br>Asset building | Customer type 2<br>Continuous loss limitation | Customer type 3<br>Capital preservation at end of term |
|---|---|---|---|
| **Horizon** | Long | Short<br>(at least short-term risk budgeting) | Long |
| **Clear definition of term** | No | Yes | Yes |
| **Risk tolerance** | All variations | Low | All variations |
| **Risk-bearing capacity** | Medium to high | Low | Low to medium |
| **Investment focus** | Yield optimisation | Loss limitation | Loss limitation |
| **Range of bonds component** | Depends on risk tolerance:<br>Low 45-60%<br>Medium 35-50%<br>High 10-40% | Depends on short term risk budget, generally min. 45% | Depends on the holding period until end of term, for holding period > 25 years, to under 50% |
| **Range of equities component** | Depends on risk tolerance:<br>Low 20-30%<br>Medium 40-60%<br>High 60-80% | Depends on short term risk budget, generally min. 30% | Depends on the holding period until end of term, for holding period > 25 years, to over 50% |
| **Rebalancing** | Normally annually also mid-year during crisis | Normally monthly, no more rebalancing but restructuring once risk budget used up | No rebalancing, only restructuring if performance very successful |
| **Suitability of savings plan** | Yes | No | No |
| **Product range** | ETFs as core, active funds possible as satellites | ETFs only | ETFs only |
| **Process management** | Gradual risk reduction towards end of term | Continuous risk budgeting | Restructuring if performance very successful |
| **Typical investor needs** | Free investment assets to be used for an indefinite period of time to build assets | Specific short-term investment objectives or long-term withdrawal plan | Pensions or other long-term liquidity requirement at a specific time |

# Customer type 1

**Customer type 1**: Main target client for passive strategies

- ❖ Making clear that pursuing a passive strategy means accepting increased levels of volatility

- ❖ Making clear that pursuing a passive strategy requires strict rebalancing (buy “losers”, sell “winners”)

- ❖ Making clear that pursuing a passive strategy requires a high level of long-term investment discipline

➡ Increased <u>communicative</u> challenges, switching the focus of discussion from initial asset allocation to the evolution of the strategy over time

# Model portfolios for „Type 1" customers with differing risk appetite

| FACTOR | INDEX | RISK TOLERANCE | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | | Low | | | Medium | | | High | | |
| | | min. | strategic | max. | min. | strategic | max. | min. | strategic | max. |
| **SECURITY** | | **15%** | **25%** | **30%** | **5%** | **10%** | **25%** | **0%** | **0%** | **10%** |
| **BONDS** | | **45%** | **50%** | **60%** | **35%** | **40%** | **50%** | **10%** | **25%** | **40%** |
| Total | db Global Investment Grade Sovereign | 0% | | 15% | 0% | | 10% | 0% | | 5% |
| Term | iBoxx® € Sovereigns Eurozone 10-15 TR | 0% | | 15% | 0% | | 10% | 0% | | 5% |
| | iBoxx® € Sovereigns Eurozone 15+ TR | 0% | | 15% | 0% | | 10% | 0% | | 5% |
| Default | iBoxx® € Liquid Covered | 10% | | 20% | 5% | | 15% | 0% | | 5% |
| | iBoxx® € Liquid Corporate 100 | 10% | | 20% | 5% | | 15% | 5% | | 10% |
| | iBoxx® € Sov. Eurozone Yield Plus | 5% | | 10% | 5% | | 10% | 5% | | 10% |
| EM | db Emerging Markets Liq. Eurobond Euro | 5% | | 10% | 5% | | 10% | 5% | | 10% |
| **EQUITIES** | | **20%** | **25%** | **30%** | **40%** | **50%** | **60%** | **60%** | **75%** | **90%** |
| Total | MSCI World | 0% | | 5% | 0% | | 10% | 0% | | 25% |
| Small | MSCI Europe Small Cap | 5% | | 10% | 5% | | 15% | 10% | | 25% |
| | Russell 2000 | 0% | | 5% | 5% | | 10% | 10% | | 25% |
| Value | Stoxx® Global Select Div. 100 | 10% | | 15% | 10% | | 20% | 15% | | 25% |
| EM | MSCI TR Net Emerging Markets | 5% | | 10% | 10% | | 15% | 15% | | 25% |

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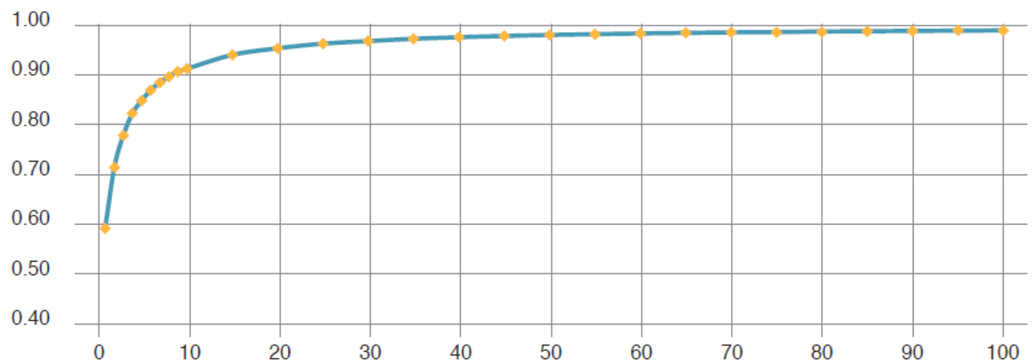
# Reconsidering alpha

- True alpha requires sufficient tracking error between portfolio and benchmark

- But: Tracking error decreases as the number of individual securities in the portfolio increases (“law of large numbers”) → Basic dilemma for active portfolio managers!

Illustration 16: Correlation between portfolio and benchmark vs. number of securities in portfolio



# Alternative Investments within a passive strategy

- Classical method: Try to collect the risk premia of markets that are not part of your benchmark

- Passive suggestion: Implement a core-satellite-strategy with a “passive core” and “active satellite”

- Two essential rules for picking the “active satellite”:
  1. Pick satellite with lowest correlation to the core
  2. Add only a few satellites

# Summary

- Trend towards passive investment can represent an opportunity for investment advisors
- To take advantage of it, it will not be enough to make increased use of ETFs
- Readjustment of existing investment processes is needed with respect to functional, commercial and communicative aspects
- Value proposition is more challenging in the beginning, but more sustainable in the long run
- Critical and cost-conscious customers will recognize that they are being offered a transparent, cost-effective and flexible strategy to achieve their investment objectives

# Further interest?

Please feel free to contact us if you are interested in the following services:

- Readjusting existing investment processes for the application of passive strategies
- Risk management of passive investment strategies

# Thank you for your attention

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