SO LONG AS IT IS BLACK

Lode Devlaminck, Managing Director, Equities

Disruption is a process, not an event. New technologies and scientific discoveries only turn into disruptive forces when there is a new business model or catalyst to put it within reach of a large audience. The Ford Model T debuted long ago in 1908. However, the disruption it brought to the transportation industry is remarkably similar to the upheaval we are seeing today within the investment industry.

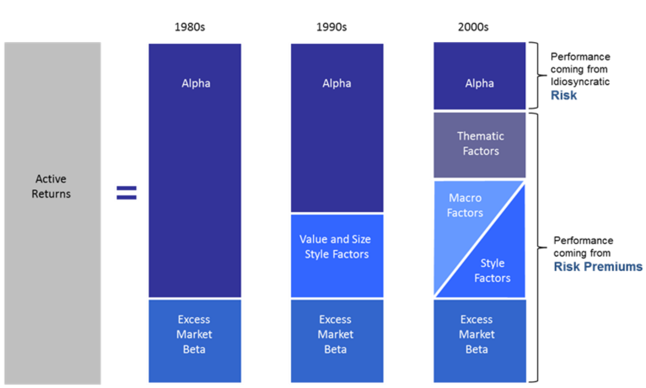
Automobiles had been around for thirty years prior to the Model T, but it took Henry Ford's "platform production" method (the enabler) and a growing middle class (the catalyst) for the automobile to radically change the transportation industry. Similarly, factor and index-based strategies have been around for several decades, but it took more advanced technology (the enabler) and a change in our approach to investing since the Great Financial Crisis (the catalyst) to turn these strategies into a disruptive force.

We are ushering in a new era of investing. An understanding of how and why institutional investors are changing the way they invest shows there is less need for the traditional, low-risk, diversified portfolio. We are instead moving toward a new ecosystem in which mass-produced factor and index strategies will find a natural market share adjacent to the more differentiated active manager.

HOW AND WHY

Over time, our understanding of active return has evolved. As shown in Figure 1, the decomposition of active return into the various sources of risk premium has greatly changed. What is most striking is how the "alpha" component has incrementally diminished as other systematic factors have been un-covered.

FIGURE 1: INVESTMENT STYLE RISK PREMIUMS



While active return was once viewed as just excess market beta and alpha, with alpha attributed to stock selection, more recent research has shown that alpha can be further subdivided into at least four distinct buckets. Macro factors (1) regroup stocks based on sensitivity to economic factors, such as interest rates or inflation. Style factors (2) regroup stocks using company or stock characteristics like valuation, profitability, or growth. Thematic factors (3) tend to be more qualitative in nature, and are used to assess a company's exposure to structural trends like cloud computing, aging demographics, or environmental regulation. Finally, alpha (4) remains a source of idiosyncratic risk from individual stock positions.

Why is this important? While factor investing is nothing new, a trifecta of conditions following the Great Financial Crisis (GFC) served to fundamentally alter the way the investment industry allocates assets. During the crisis, the correlations of traditional asset classes' characteristics, such as sectors and countries, converged to near one causing traditional methods of diversification to fail. As a result, institutional investors began to look for better ways to manage risk and gain a more thorough understanding of their performance.

An improved understanding of risk premiums, more advanced risk management software, and an abundant supply of cheap beta and factor exposure products (smart beta ETF's) allowed institutional investors to unbundle exposure to the various risk premiums. As a result, investors have gained more granular control over portfolio performance and risk.

The move to diversify across risk premiums as opposed to asset classes has had two implications. First, a growing number of large asset owners are shifting their allocation across specialist managers offering either beta exposure (market index funds), factor exposure (quant funds or factor ETF's), or idiosyncratic risk (specialist managers, concentrated portfolios, hedge funds, etc.). In doing so, they can better control risk and more effectively identify concentrated exposure to specific risk premiums. Second, management fees have come under pressure as low-cost solutions gain in popularity.

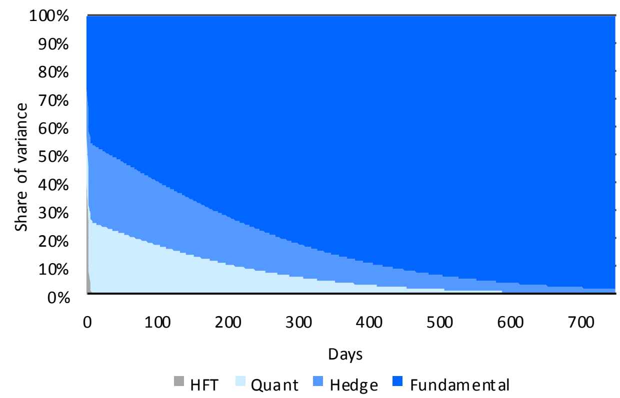
Where Does This Leave Fundamental Managers?

The continued growth of passive and factor based strategies coupled with the declining popularity of traditionally diversified products suggests a winner-takes-all outcome in the "Active versus Passive" debate. However, we believe the need for idiosyncratic risk will continue to support demand for active management. Specialist managers with an acute awareness of both how they generate their returns and the combination of active return groups they use to do so can survive, and perhaps thrive, within this environment.

In particular, recent research suggests that one of the most fertile grounds for fundamental active managers is Time Arbitrage. Professor Peter Kyle of the TABB group in conjunction with UBS Quant Research has shown that over a long-term investment horizon, fundamental managers have the largest impact on stock prices.[1] Over a three-year horizon, 98% of a company's price is driven by fundamental investors (both retail and institutional) pricing a company on both its underlying factors and idiosyncratic exposures. The impact of high frequency traders, quant managers, and hedge funds is much shorter lived (Figure 2).

Time Arbitrage is the one sustainable market inefficiency that can be exploited by adopting a true long-term investment horizon in combination with sustained exposure to factors, such as quality, valuation, and end markets, as well as idiosyncratic risk, including management and product quality.

Figure 2: Proportion of Variance Explained by Participant



Source: UBS, Quant Research

Conclusion

"Any customer can have a car painted any color that he wants so long as it is black." -Henry Ford

Built for the masses, passive and factor-based strategies continue to commoditize historic sources of return similar to how Ford commoditized the automobile. Today's institutional investor has less need for the low-risk, diversified strategy. Instead, there is a greater need for more differentiated products focused on long-term factor exposures and idiosyncratic returns. We expect portfolios with more outspoken styles or characteristics will be in greater demand moving forward despite the potential for higher risk relative to the benchmark, or a profile that does not neatly fit into a consultant box.

Lode J. Devlaminck, Managing Director, Equities, is the lead portfolio manager for the firm's EAFE and Global Equity strategies and a portfolio manager on the Emerging Markets Equity strategy. Mr. Devlaminck is a member of the DuPont Pension Trust Investment Committee and the DuPont Savings Plan Investment Oversight Committee. Prior to joining DuPont Capital in 2014, Mr. Devlaminck was a Senior Portfolio Manager and Sector Specialist of Global Equities at Hermes Fund Managers in Boston, Massachusetts. Mr. Devlaminck joined the investment industry in 1989. Mr. Devlaminck holds a Master's degree in Applied Economics from the University of Antwerp, in Antwerp, Belgium.

[1] "The Future of Active Management: How Do We Integrate Humans and Machines?" UBS Global Quantitative Research, May 15, 2018.