Investors Are Turning to Active Managers — Even if 'They Can't Predict the Future'

The current rocky markets are testing investors' faith in passive.

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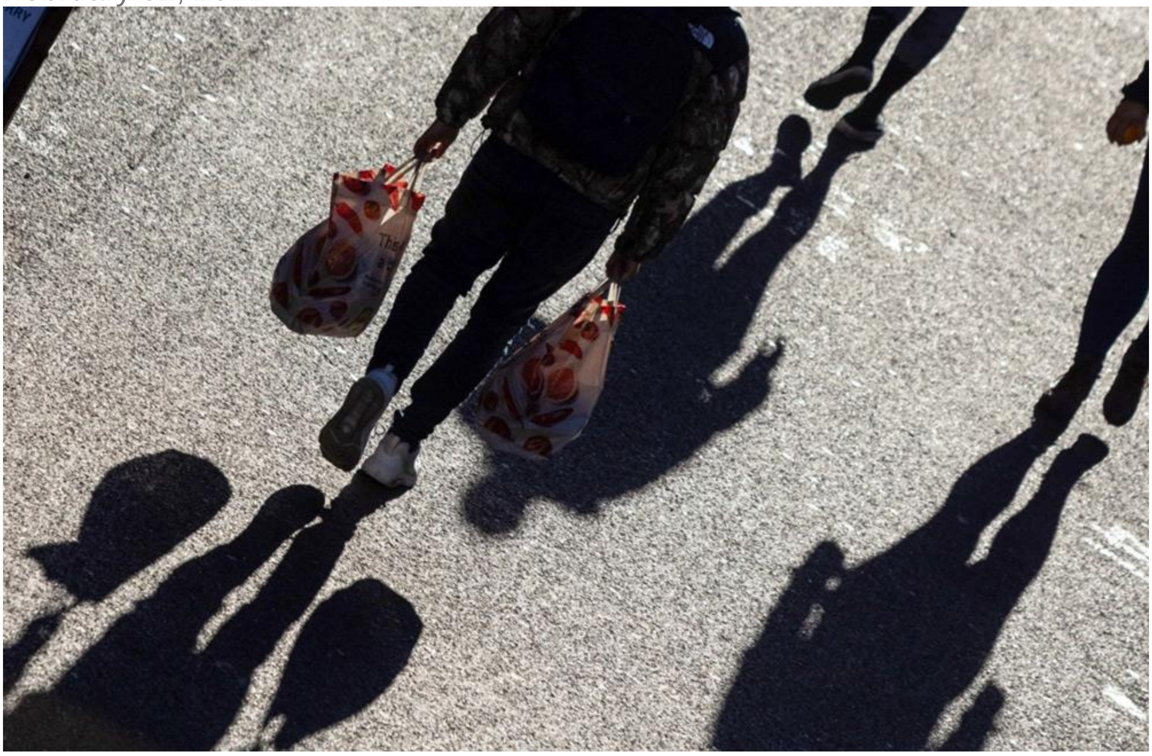

Chris Ratcliffe/Bloomberg

Amid inflation worries and market volatility, a growing number of institutional investors are beginning to hand over the portfolio reins to active managers.

The trend can be seen in the findings of a November CoreData Research survey of 378 global institutional investors. When institutional investors were asked what they considered to be the most important elements of portfolio construction in the current economic environment, 31 percent pointed to the need to hire skilled active managers. Thirty-seven percent of institutional investor respondents identified the importance of diversifying into uncorrelated assets.

Institutional investors indicated that they believe inflation will pose the biggest risk to their investment portfolios in the coming year. Other portfolio risks on their radar include central bank tapering (12 percent of respondents), a bursting tech-stock bubble (11 percent), and rising interest rates and their impact on bond markets (10 percent). Inflation concerns were concentrated among North American investors, with 40 percent of the region's respondents fearing its effect on their portfolios.

Daniel Celeghin, managing director of the asset management consulting firm Indefi North America, said that while the diversification of uncorrelated assets is an evergreen task, the inclination to work with more skilled active managers is a reaction to market instability. “With the environment we’re going into — and frankly, what we’ve been in — it feels very hard to predict or anticipate how different markets will perform,” Celeghin told *Institutional Investor*. “I’m not surprised that the conclusions you’re seeing from the survey basically point to a desire for expert guidance and help.”

Celeghin pointed to the market’s reaction to the onset of the Covid-19 pandemic: At the beginning of March 2020, share prices dropped to historically low levels. Seven months later, however, roughly half of the sectors had made a full recovery. As a result of such unpredictable market behavior, Celeghin said investors no longer feel comfortable “mapping [their] own destiny” through passive investing.

In fact, only 9 percent of CoreData survey respondents pointed to passive investing as a key consideration in portfolio construction. The accompanying report attributes this shift to the uncertainty of the current investment environment and, particularly, to factors like inflation. “The environment that we’re currently in and are likely to be in for the foreseeable future is one that favors active management,” Marina Gross, co-head of Natixis Investment Managers Solutions, told *II*. “Generally, an environment that is more uncertain, where there’s less visibility [and] more disruptive factors, can accrue to the benefit of active managers.”

Gross said that the collision between the material impacts of inflation on asset values and the fear and anticipation of rising rates spurs market volatility. “It becomes a difficult environment to navigate, but if you have the skill and experience, you can really steward capital in a highly successful way that we feel will be far better than a more mechanical, passive strategy,” Gross said.

She cautioned, however, that this doesn’t necessarily translate into performance, and Simon Hallett, vice chairman and partner at asset manager Harding Loevner, agreed. “Active management is not for everyone,” Hallett told *II*. He said that managers can’t predict the future, and while past performance is a fundamental part of manager selection, it requires a belief — on the part of investors — that the future will be something like the past.

Celeghin said that while investors tend to turn to active managers in moments of uncertainty, the most favorable environment for managers is when there’s heightened dispersion — in other words, when there’s a big difference between the performance of individual stocks or sectors. Hallett said that over the past 7 or 8 years, dispersion has been low because of the great liquidity available in the market, but when it does exist, active managers should be able to identify the underlying drivers, profit from the uncertainty, and outperform the indexes.

What's more, passive presents its own challenges. In a 2020 blog post, the Investment Adviser Association used previous data to estimate the success rate — or the ability of the fund to outperform the average — of passive and active funds. The IAA found that the success rate for passive funds was 25 percent, 10 percentage points lower than active funds' 35 percent.

Hallett said that there's more risk in passive investing than most investors realize — index funds have become a lot more concentrated, and the top companies have become increasingly expensive. Additionally, benchmarks work mostly as an indicator of momentum, not necessarily value. "I [worry] that people think they're buying relatively low-risk instruments, when, in fact, they're not," Hallett said. "Exposure to a cap-weighted benchmark means you're getting exposure to what's recently worked."

Whether or not the public equities environment is optimal for active managers, the increased demand for them means that there will be more competition in the space. According to Hallett, the core characteristics of a skilled active manager are that they have a high degree of equity exposure, manage a relatively small amount of assets, and have high exposure (i.e., "skin the game") to their own investment results. Above all, Hallett said, it's important for managers to be able to define their investment philosophy and explain exactly which factors are creating the market inefficiencies that they believe they can capture.

Celeghin said that the difference between the managers that succeed and those that fail depends significantly on the level of transparency they provide into their actual holdings, and he's noticed that in recent months, institutional investors have begun to pay more attention to the investment strategies that their managers are using. Until recently, large allocators were primarily focused on understanding the outcome of their managers' investments and less concerned with the minutiae, but over the last few months, that's changed.

"Large institutions — even senior people at the CIO level — want to get involved," Celeghin said. "If we're making an allocation and we're particularly concerned about inflation, let me understand exactly what this manager claims we should do to address this."