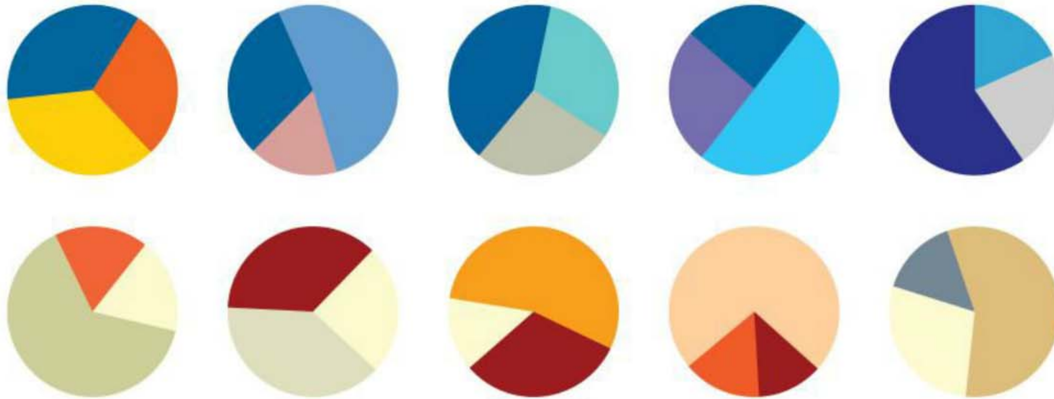
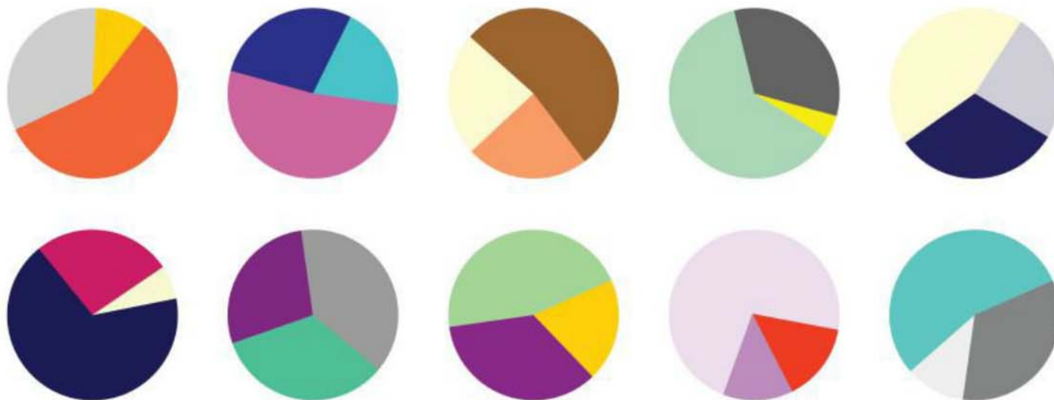


# The Different Faces of Active Management



## Exploring the varying definitions and strategic approaches

By Linda Ferentchak

In portfolio management, two basic but disparate theorems hold court.

The first is passive, or buy-and-hold, investing. Passive investing maintains that successful investing results from establishing a prudent asset allocation and maintaining that allocation regardless of market conditions.

The second, active management, as implied by the name, believes that investors are best served by an approach that can change with market conditions and is far more discretionary in the allocation of a portfolio.

With that said, "active" has evolved into two different meanings based on the approach to the market.

In the mutual fund industry, "active" has come to mean the selection of a stock for inclusion in a fund based on fundamental and technical analysis and a good fit with the fund's investment objectives. Until Vanguard founded the first publicly available index fund in 1975, all mutual funds were "actively managed." Investments were selected for the fund portfolio based on analysts actually making value judgments about the businesses.

Then index investing exploded. By 2014, the Financial Times anticipates that institutional indexing of U.S. equities could become 50% of the market. The growth of index investing led to the need for an easy term to differentiate between the newer index funds and traditional funds where the manager selects individual securities based on expectations for growth and return. The traditional approach is now referred to by many as "active" versus the index fund's passive use of whatever stocks make up a particular index.

However, within the sophisticated money management segment, "active management" had come to mean something far beyond actively managed mutual funds. Over the last quarter century, a far more opportunistic active management strategy has taken shape. This approach takes into account current market conditions to seek opportunities for profit as well as risk management across a much wider range of investment strategies and vehicles.

This opportunistic approach to active management sweeps away the restrictions of investment vehicles, style boxes, and narrowly defined investment suitability to ask, "Based on current market conditions, where are the perceived opportunities for profit, income and/or growth?" as well as, "Who are the best-performing managers? Which investment strategies are performing best given the investment climate?"

*continue on pg. 11*

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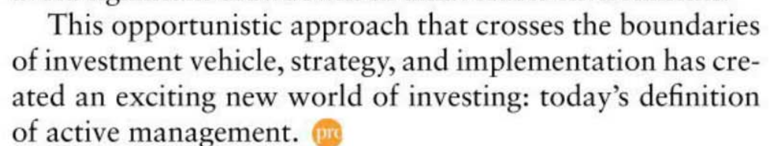
Analysis and selection of investments, strategies, and managers are typically based on quantitative factors. By focusing on the numbers and removing emotion from the decision process, investment approaches can be backtested against different market environments and replicated in the current environment. As market conditions change, portfolio allocations and strategies should also change.

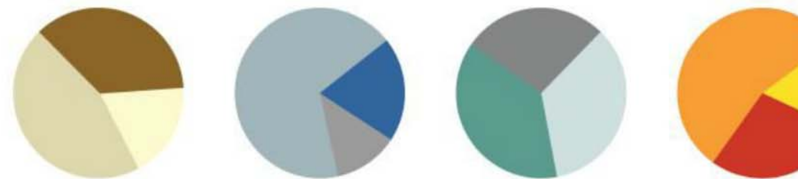
Initially, opportunistic active managers allocated funds primarily among "actively" managed equity, bond, and money market mutual funds. With the increase in sector and geographic funds, it became easier to target the growth potential of specific industries and countries. Then, the proliferation of index-based mutual funds and ETFs provided active managers with the ability to invest in very specific industry, market cap, and geographic segments of the markets, as well as "funds of funds," real estate, commodities and metals, currencies, and other alternative asset classes.

As active management matured and longer track records were established by active managers, it became evident that different investment strategies were better suited to handle changing market environments. A strategy might outperform at one point in the economic cycle only to falter later in the cycle. Rather than simply diversifying by asset class, active managers began to diversify client portfolios by strategy and manager as well. Hedging, derivatives, and inverse strategies became part of the active manager's options.

The opportunities for diversification among active management strategies can be found in the variety of approaches under the active management umbrella. These can include trend following, sector rotation, contrarian, political seasonality, hedging, long/short equity and bonds, short-term tactical, macro themes, pattern recognition, and even faith-based investment approaches. All share a common objective, however, of placing prime importance on risk management, seeking to avoid significant drawdowns in unfavorable environments.

This opportunistic approach that crosses the boundaries of investment vehicle, strategy, and implementation has created an exciting new world of investing: today's definition of active management.





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