Stop Being so Passive! Why Investors are Shifting Back to Active Management

The first half of 2018 in financial markets, for all its moving parts, has gone as many expected. Following a year of seemingly boundless growth in global equity markets, investors were left to face decisions about how to position their portfolios for what was to come next. The past decade of low interest rates, little to no inflation, and high investment returns against a backdrop of suppressed volatility surely could not last forever. As central banks around the world unwind their quantitative easing programs we have seen rates bounce off their sustained lows, inflation begin cropping up, volatility return to historical averages, and mild equity returns bolstered by the successes of a small handful of companies, investors are beginning to reposition accordingly.

These shifts in market dynamics signaling the latter stages of the current business cycle do not mean that investors are completely changing their stance to a defensive one. Investors still see the potential for global growth to continue but many are beginning to change their approach ahead of a potential downturn. 2018’s marketplace has brought higher volatility, wider dispersion of returns, geopolitical uncertainty, and potential asset bubbles to the equity markets. With these changes from 2017, the market is positioned for investors to consider strategies utilizing active managers.

INFLOWS TO PASSIVE INVESTMENTS IN THE FIRST HALF OF 2018 HAVE SLOWED

Since the global financial crisis in 2008, investors have enjoyed a nine-year bull run in equity markets. The most popular way to access the red-hot equity markets have been passive funds in the form of mutual funds and ETFs which track the performance of equity indices, for example the S&P 500 for U.S. stocks. Annual inflows to these strategies have risen steadily, culminating with a record $692 billion in passive strategies in 2017.¹

As the market environment has changed, investors’ insatiable appetite for passive vehicles has been curbed. In February 2018, passive US equity funds experienced their first net outflows since 2015. For the first six months of 2018, passive inflows were down 44%, compared with the same period in 2017.² Where is that money going instead? Professional investors have increased their allocation to active strategies.

INSTITUTIONS BELIEVE IN ACTIVE MANAGEMENT

Professional investors are showing a particular affinity for active strategies in 2018. A survey conducted by Natixis Investment Managers’ Center for Investor Insight of 500 institutional investors around the world who manage more than $19 trillion of assets revealed that more than three
quarters of professional investors believe the current market environment is favorable for active management. The survey also captured the rationale behind their increased allocations to actively managed investments since 2015 to just over two thirds of their overall portfolios in a time where money poured into passive indexed strategies: 74% of Institutional Investors believe that active management is better suited to provide exposure to non-correlated asset classes, which are in favor when concerns about equity downturns are present. 69% believe that active managers are better at delivering risk-adjusted returns – the ultimate goal for many investors.

A similar survey conducted by PPB Capital Partners echoed the sentiment, 93% of financial professionals surveyed said they would maintain or increase their allocation to alternative investments in 2018 with 73% of financial professionals responding that they will increase alternative investment exposure in client portfolios by up to 25%.

Markets will always be moving targets, going through constant changes over time. The stages are inevitable: first recovery, and then expansion — when that fails, leverage, default, downturn, write-offs, and recession at last. Although the market always trends upwards over the long term, active managers may be better positioned to navigate through volatility shocks and potentially take advantage of opportunities that arise from them. Equity markets are still showing modest growth with no signs of an immediate downturn but the best time to dig a well is before you are thirsty. As we go through the latter stages of the current business cycle, it may be time to stop being so passive when it comes to making asset allocation plans.

FINANCIAL PROFESSIONALS ARE REPLACING PASSIVE EQUITY WITH ALTERNATIVES

Institutions are not the only investors who see the merit in active strategies in the latter stages of the business cycle. Independent financial professionals, who have typically utilized passive strategies for their lower expense ratios compared to active, have shown a propensity to move away from passive equity strategies which can be vulnerable to volatile markets and investor anxiety over a potential downturn. One place in a portfolio that financial professionals expect to relocate some of their passive equity exposure this year is alternative investments. A survey conducted by BNY Mellon’s Pershing Advisor Solutions of financial professionals revealed that 77% of professionals believe alternative investments is the investment area likely to experience the largest increases in portfolio allocation in 2018.

1 2017 Morningstar Annual Fund Flow Report
3 Natixis Institutional Investor Outlook for 2018
4 BNY Mellon’s Pershing Advisor Solutions Survey – July 2018
5 PPB Capital Partners Survey of RIAs – November 2017

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