Need for active in passive!

As I was contemplating the topic for today's blog, I came across a research article published by Research Affiliates, which discusses performance chasing behaviour in ETFs (Research Affiliates, Chasing Performance with ETFs by Chris Brightman, Feifei Li, Xi Liu, November 2015). There was one particular chart, Figure 3, which caught my eye and I would like to share it with you in today's blog.

Please click the link below and look at 'Figure 3'.
https://www.researchaffiliates.com/en_us/publications/articles/470_chasing_performance_with_etfs.html

What the charts illustrate is the significant difference between the performance of ETFs before the launch of ETF and the performance after the launch. In a 3 year period before the launch, the same strategy has outperformed on average by 4.3% per annum, but looking at a period of 3 years following the launch of the ETF, the strategy on average remained flat relative to the broad market index. While I would expect some difference in the historical performance vs. live performance, the magnitude and the clarity of the data has been quite incredible.

Most of the ETFs will be designed to follow or replicate an investment index that will be either; a market capitalisation weighted portfolio of particular market (region, sector) or a systematic, rule based investment strategy that is attempting to capture specific investment factors, better known as Smart Beta indices. Of particular note when designing a new investment index is that the index provider do not need to include trading costs that would be required to rebalance the index, nor do they need a live track record. Given that, it is very easy for an investment bank or an index provider to create new systematic or passive index strategies with a very long history of data.
So what could be some of the reasons for such a big dispersion of pre and post launch performances? Below I have listed a few that come to my mind, but I am sure there must be others.

1. Data overfitting: we all know the issue with back-testing and I have yet to be shown a "bad looking back-test". Each of those so called smart beta strategies rely on number of predefined rules that are supposed to be based on some sort of fundamental reasoning. But when you look at them in greater detail, what you find is that there is a lot of randomness when it comes to defining the rules. Do you use the last 100 days to calculate the statistics or do you use the last 3 years? Do you use daily data or monthly data, is the portfolio equally weighted or factor weighted? Fundamentally speaking, they could all give you the same factor, but once you simulate the performance over a period of last 20 years, each of them might have drastically different performance. You might try to justify it, but most likely the only reason for the difference is randomness. Each systematic process would have tens of randomly defined variables and it is very tempting to use the ones that have historically performed best. Some of that might be done intentionally, but perhaps most of it is unintentional.

2. Underestimation of trading costs: Most back-tests claim to incorporate trading costs, but those can easily be underestimated. Also, as mentioned above, most market indices simply use the end of the day closing prices and therefore can rebalance at zero cost.

3. Underestimation of speed with which the new capital will erode the market inefficiencies that the strategy is trying to capture. Once the strategy becomes well known and large amount of capital start trading based on same rules, it can quite quickly push the prices of certain factors up and market inefficiencies get arbitraged away.

4. Launching ETFs are driven by sales force and it is much easier to sell something that has been popular for example due to recent outperformance. I assume that each ETF provider has tens of strategies primed whilst they wait for a period of strategy outperformance to bring them live.

So, when it comes to investing in a systematic, smart beta index strategy, you need to make sure that the historical outperformance is sustainable and not only a result of market timing or a dubious back-test.

Using passive rule based strategies can be extremely beneficial to the client portfolio, especially when it comes to accessing certain alpha opportunities on cost-effective basis. However, not every smart beta strategy will guarantee success, and when it comes to investing in semi-passive smart beta ETFs or Index Funds you still need to conduct proper investment and operational due-diligence. From my experience the smart beta strategies require just as much due-diligence as any other active strategy. At Momentum we review each step in the process and seek a fundamental rationale for each systematic rule; we would cross check the key assumptions in discussions with other active managers in the asset class, and we would seek to understand the turnover and trading cost assumptions. In short, even when it comes to investing in passive strategies you need to keep your active scrutiny in order to avoid unnecessary disappointments in client portfolios.

The Marketplace

- Angela Merkel wins German election
- Federal Reserve to begin balance sheet reduction in October
- US President Trump imposes fresh sanctions on North Korea
- China long-term sovereign credit rating downgraded by S&P
- Theresa May clarifies Brexit stance in Florence speech

Market Focus

US

- The US imposed fresh sanctions on North Korea after Donald Trump signed an executive order allowing him to take action against anyone financing or facilitating trade with North Korea.
- US President Donald Trump made a strong statement of intent towards North Korea in his debut speech at the UN general assembly, noting that if the US was forced to defend itself, it would 'totally destroy North Korea'.
- On Wednesday the Federal Reserve left interest rates unchanged, but suggested a rate rise was likely before the end of the year. The Federal Reserve also announced plans to start reducing its balance sheet in October, rolling off $10 billion initially.
- In the second quarter of 2017 the current account deficit was slightly larger than expected at US $123.1 billion, roughly 2.6% of GDP.
- US equities rose 0.1% whilst US Treasuries fell 0.3%.

UK

- Prime Minister Theresa May's Brexit focused speech on Friday was well received by both UK and EU officials with the speech indicating a move away from hard Brexit rhetoric. May clarified numerous medium term objectives, including a post-Brexit transitional deal to smooth the exit process.
- On Monday Bank of England Governor Mark Carney made a strong signal that interest rates were likely to rise soon, taking note of inflation being at 2.9% year-on-year, well above the 2% target.
- Moody's cut the UK's credit rating on Friday night from Aa1 to Aa2 citing the challenges of Brexit on public finances.
- Retail sales rose 1.0% month-on-month versus 0.2% expected, pushing the annual rate up to 2.8%.
- UK equities rose 1.3% during the week whilst Sterling fell 0.3% versus the US Dollar.

Europe

- On Sunday Angela Merkel won the German election, a result which was expected, although this was her worst election result as leader of the party. Merkel now has the tough task of forming a coalition government. Of particular note was the strong election result of the far-right Alternative for Germany party.
- Portuguese 10 year sovereign bond yields fell 37 basis points on Monday following a credit rating upgrade by the S&P to BBB-.
- Spanish police raided the offices of Catalan government officials and arrested at least 12 following the progressing independence movement in the Catalonia region.

Asia

- China's long-term sovereign credit rating was downgraded from AA- to A+ by S&P, citing its sustained period of strong credit growth increasing economic and financial risks.
- The Bank of Japan voted to hold interest rates at 0.1% and kept its yield target for 10 year Japanese bonds at 0.0%.

Source: Bloomberg. Returns in local currency unless otherwise stated.

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		Currency returns			
Asset class/region	Currency	Week ending 22 September	Month to date	YTD 2017	12 months
Developed markets equities					
United States	USD	0.1%	1.3%	12.9%	16.6%
United Kingdom	GBP	1.3%	-1.6%	5.6%	9.9%
Continental Europe	EUR	0.7%	2.5%	10.7%	16.0%
Japan	JPY	1.6%	2.9%	10.9%	25.8%
Asia Pacific (ex Japan)	USD	0.0%	1.3%	29.0%	21.4%
Australia	AUD	-0.2%	0.0%	3.9%	10.5%
Global	USD	0.4%	1.9%	15.6%	16.8%
Emerging markets equities					
Emerging Europe	USD	-0.6%	-0.5%	15.5%	22.6%
Emerging Asia	USD	0.1%	1.7%	34.1%	23.8%
Emerging Latin America	USD	-0.1%	3.9%	29.6%	25.9%
BRICs	USD	0.2%	2.9%	35.6%	27.1%
MENA countries	USD	-0.6%	0.4%	5.9%	16.6%
South Africa	USD	0.2%	-3.2%	16.0%	8.9%
India	USD	-2.3%	-0.8%	29.0%	16.9%
Global emerging markets	USD	0.0%	1.5%	30.2%	22.4%
Bonds					
US Treasuries	USD	-0.3%	-0.6%	2.7%	-1.3%
US Treasuries (inflation protected)	USD	-0.4%	-0.2%	2.3%	0.0%
US Corporate (investment grade)	USD	0.0%	-0.2%	5.1%	2.4%
US High Yield	USD	0.2%	0.6%	6.7%	9.1%
UK Gilts	GBP	-0.3%	-2.9%	-0.4%	-4.6%
UK Corporate (investment grade)	GBP	-0.1%	-2.1%	2.4%	-0.4%
Euro Government Bonds	EUR	0.0%	-0.5%	-0.4%	-3.3%
Euro Corporate (investment grade)	EUR	0.0%	-0.2%	1.7%	0.5%
Euro High Yield	EUR	0.2%	0.5%	5.9%	7.9%
Japanese Government	JPY	0.0%	0.0%	0.2%	-1.0%
Australian Government	AUD	-0.2%	-0.4%	2.1%	-1.2%
Global Government Bonds	USD	-0.3%	-0.4%	6.6%	-2.2%
Global Bonds	USD	-0.2%	-0.2%	7.0%	0.0%
Global Convertible Bonds	USD	-0.2%	0.8%	9.6%	7.1%
Emerging Market Bonds	USD	-0.5%	0.1%	8.8%	2.7%

Source: Bloomberg. Past performance is not indicative of future returns

Asset class/region	Currency	Currency returns			
		Week ending 22 September	Month to date	YTD 2017	12 months
Property					
US Property Securities	USD	-2.3%	-0.8%	2.1%	-3.0%
Australian Property Securities	AUD	-1.9%	-0.5%	-6.2%	-6.2%
Asia Property Securities	USD	0.0%	1.4%	23.7%	13.6%
Global Property Securities	USD	-1.0%	0.9%	12.4%	5.1%
Currencies					
Euro	USD	0.0%	0.5%	13.5%	6.6%
UK Pound Sterling	USD	-0.3%	4.9%	9.5%	3.5%
Japanese Yen	USD	-1.2%	-1.8%	4.4%	-10.1%
Australian Dollar	USD	-0.5%	0.4%	10.6%	4.2%
South African Rand	USD	-0.3%	-1.6%	3.5%	3.2%
Swiss Franc	USD	-1.0%	-0.8%	5.1%	-0.1%
Chinese Yuan	USD	-0.6%	0.3%	5.6%	1.3%
Commodities & Alternatives					
Commodities	USD	0.1%	1.5%	-1.4%	2.9%
Agricultural Commodities	USD	-0.1%	0.7%	-3.1%	-2.6%
Oil	USD	2.2%	8.6%	0.1%	19.3%
Gold	USD	-2.1%	-1.7%	12.4%	-3.2%
Hedge funds	USD	0.2%	0.5%	4.3%	5.7%

Source: Bloomberg. Past performance is not indicative of future returns

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