Principal Global Investors

Principal℠

The Wisdom of **Staying Active** in an Outcome-Oriented Investment World

Highlights:

Increasingly, investors are seeking managers that can help them achieve desired outcomes (not benchmarks) and investment solutions (not products). This paper explores which management solution — active or passive — is most beneficial in an outcome-oriented investment world.

Active Management

- Advocates of active management strongly believe that talented active asset managers can outperform market indices by leveraging informational advantages such as fundamental research and macroeconomic insights.
- Active managers that outperform over time tend to focus on: less efficient market segments, strong, sustainable investment processes, and an understanding of what drives active outperformance.

Passive Management

- Passive management starts from a belief that markets are largely efficient and that the potential returns from capturing any inefficiencies will be more than offset by costs and risks.
- For the investor focused on achieving a "real world" outcome, using entirely passive strategies that primarily concentrate on delivering beta won't necessarily get them to their goal.

We believe active investment not only pays for itself, but can make a material financial difference to the investor — making it an essential tool than can help investors better navigate the outcome-oriented investment world.

As the demographic profile of the U.S. and other developed countries continues to gray, we hear much about the importance and benefits of "staying active" — both physically and mentally.

Of course, the term "active" has quite a different meaning in investing, but it has the potential to be every bit as important to an investor's long-term financial well-being as "staying active" can be to their physical and mental welfare.

In the last decade or so, however, we've seen a growing market for passive investing. Much of that growth has been fueled by a focus on two key variables:

Relative performance: in particular, can an active manager consistently beat the benchmark index, and

Cost: if an active manager cannot consistently beat the index, then why pay active fees for, at best, index-level returns? It would be more cost effective to passively manage the asset exposure through some form of indexed investment.

Matching the management strategy to outcome-based goals

Characteristic	Passive Management	Active Management
Expected return	› In line with benchmark performance	› Above-market returns
Upside potential	› Limited; returns are tied to the index	› Potential to outperform the benchmark/index
Downside protection	› No downside protection	› Potential downside protection
Investment approach	› Mirrors the market benchmark	› Manager expertise seeks to generate above-index returns
Tax efficiency	› Typically efficient	› Typically efficient
Management style	› Tactical	› Strategic
Management fees	› Generally lower fees	› Generally higher fees
Investment decisions	› Index-based	› Research-informed
Portfolio diversification	› Typically invests in a single asset class	› May invest in variety of asset classes
Risk	› More market-driven	› More manager-driven

While tax efficiency may also play a role in an investor's active/passive decisions, many investors have increasingly come to recognize in recent years that they need to frame their investment decisions in a much broader context. That doesn't mean that achieving the best performance they can is no longer important. It is — but they have come to recognize that a strategy that focuses on maximizing their portfolio's return at all times may come up short in helping them to achieve other goals. Likewise, an investment strategy with the lowest fee may not be worth the cost savings if it impinges on meeting an important goal.

A change in the investor's mindset: outcome-oriented investing

More and more of the investors we work with are not seeking a single manager to fill an open slot in their portfolios. Rather, they want their investment portfolio to achieve a particular outcome (or set of outcomes) and are seeking managers who can help them attain that outcome(s). This change in investor mindset has come about because of a lesson learned from the global financial crisis; namely, that achieving personally defined outcomes matters more than meeting a market benchmark. One impact of institutional, retirement, and retail investors all increasingly "thinking beyond the benchmark" is a pronounced shift from individual products to holistic solutions. Among retirement and retail investors that shift is evident in the continued and growing popularity of "advice-embedded" products such as target date and target risk funds.

It is fair to say then that investors are thinking in a more multi-dimensional way about the objectives they set for their portfolios. But what does that mean in practical terms? What kind of outcomes are increasingly on their radar? What market benchmarks are they using, if any? The following are some of the more obvious trends we are seeing.

Sample outcomes

Searching for yield:

As the Baby Boomer generation in the U.S. and other developed countries has begun to retire, their investment focus has shifted from wealth accumulation to income generation. Historically, U.S. retirees have often used Treasurys and/or municipal bonds to help generate the retirement income they needed, but that tradition has been challenged by the low rate environment that has persisted since the global financial crisis. To put the nature of the challenge in context — someone retiring in 1996 could have earned a yield of 6.80% on a 10-year Treasury. Today, that same 10-year Treasury is yielding just 1.46%.

Against that background, it's not surprising that the search for elevated yield has become a priority outcome for many investors. However, to get that yield, investors have to make some hard decisions. In particular, are they willing to go out of their risk comfort zone to get the yield they need — or will they dip into their capital to supplement the income generated by their portfolio and run the risk, in the long term, of outliving their retirement assets?

Downside protection:

The global financial crisis seared into investors' minds the importance of this portfolio outcome. In the stressed market conditions that prevailed from 2007-2009, asset classes with historically low correlations became highly correlated, exacerbating the downward trajectory of markets and investors' portfolios. That financial pain expressed itself in different ways across the investor spectrum.

- **The soon-to-retire DC plan member** who had to defer retiring, maybe five to ten years, because of the impact on their portfolio's value.
- **The just-retired DC plan member** facing a much depleted retirement fund and a shortfall in their expected income.
- **The plan sponsor** required to make an unexpected and significant contribution to its DB plan to bolster its funding status.
- The **college endowment**, faced with elevated illiquidity within its portfolio, and concerned about implications it could have for the operating budget of its parent institution.

While markets have recovered from the lows of 2009, the fact remains that at that moment in time each investor had obligations they needed to meet and hard decisions to make as to how they were going to meet them. Many realized they did not want to find themselves in that kind of situation ever again, if they could avoid it, making downside protection a key portfolio outcome for them going forward.

Absolute (not relative) return:

As investors think more and more about their portfolios in terms of outcomes, it may not be possible — or make absolutely no sense — to manage their portfolio against any of the available or typical benchmarks. Indeed, the comparison to a traditional benchmark runs the risk of being completely spurious. In this context, it's not surprising to see investors being drawn to "benchmark agnostic" strategies, where the goal is typically to earn an "absolute" return, independent of what markets are doing.

Target return strategies are a good example of the shift toward absolute return. They aim to deliver a specific positive rate of return, regardless of what's going on in the markets, with performance assessed over a clearly defined period (e.g., five years or rolling three-year periods). Another good example of benchmark agnosticism is the growing demand for target income products. For most retired investors, or those on the cusp of retiring, income is king, and target income strategies provide them with a focused solution — one designed to deliver a steady stream of income during their retirement years.

It's not surprising that the search for elevated yield has become a priority outcome for many investors.

This is just a small sample of the most common outcomes investors are focusing on, but there are others, driven by each investor's unique circumstances — including capital preservation/inflation hedging, minimizing funded status volatility, and liquidity management.

What's the solution? active or passive?

With today's investors trending toward investment outcomes (not benchmarks) and investment solutions (not products), how might they go about choosing between active and passive management? Academic arguments on the relative value of each management style may still be of value, but what will really matter is the extent to which a set of strategies can help a client reach their investment and lifestyle goals (their outcomes). Since those outcomes are unique to the individual or organization involved, it is impossible to make a single, broad statement that will apply equally to every investor. What we believe we can say, however, is that for the investor focused on achieving a "real world" outcome, using entirely passive strategies that primarily concentrate on delivering beta won't necessarily get them where they need to go. The best way to show the challenges such an approach might pose, versus an active alternative, is to examine them in the context of some of the sample outcomes we've just discussed.

Elevated yield: the yield on an index is what it is — but an active equity manager is capable of generating portfolio dividend yields above those of the index. Better yet, skilled active managers are able to find the right mix of holdings, to maximize dividend yield per unit of portfolio risk.

Downside protection: some investors may prefer to have downside protection against the benchmark, even if it means they have to give up a bit of upside participation. Indeed the whole idea of risk management is central to active management, aligning the interest of managers and investors to preserve capital in difficult markets. In contrast, passive strategies are built to participate in market movements, regardless of direction — which means, in a down market, following the index all the way down until it eventually stops!

In the context of downside protection, it's also worth noting the role that active and passive management can play in addressing broader market volatility. Since the global financial crisis, market volatility has increased in general, and so too has the frequency of market shocks (however temporary). For those investors looking for the comfort of a smoother ride, investing in an active strategy that focuses on stocks with lower volatility than the market can provide solid long-term growth potential while evening out the journey. The ride can also be made smoother by the selectivity an active manager can exercise in deciding which low-volatility stocks to invest in — because sometimes what's left out of a portfolio can be as important as what goes in when it comes to performance and managing volatility. That level of selectivity may not be available through a passive investment linked to a standard industry index — even if it is a low volatility index.

Bottom line, given the challenging market and return environment investors face today, they need as many options in their investment toolkit as possible. For most investors that means thinking in terms of using active AND passive strategies, rather than one or the other in isolation. The lower fees associated with passive investing aren't enough of a reason to abandon active investing, when it can mean leaving additional alpha potential on the table. But more on that in the following pages.

The wisdom of staying active

Think beyond the average manager

Advocates of active management fundamentally believe that talented active asset managers can outperform market indices by leveraging fundamental research, macroeconomic insights, and/or other means of gaining an informational advantage. We share this fundamental belief. That being said, there is established research that shows that the average active manager consistently fails to outperform an indexed investment for the same asset class. While that is obviously not good news for the investor with the average manager, the reality is that most investors do not select the average manager and their fund; for a given asset class or style, most investors gravitate towards a few managers' funds.[1] Investors are not evenly distributed across the universe of available managers.

The clear fact is that some managers do outperform their benchmarks, so the more appropriate question is, "is this outperformance sustainable?" Judging whether a manager can produce sustained outperformance over a full cycle is the most important element of any active/passive decision. And managers that outperform their benchmarks over time tend to possess a similar set of characteristics.

They focus on less efficient market segments

The claims that the average manager "fails to beat the index" are often centered on what would be considered core asset strategies, such as U.S. large-cap funds, and are reflective of mutual funds with high expense ratios. For example, the average large-blend fund carries an expense ratio of 1.04%[2], which is a relatively high hurdle to clear in the super-efficient U.S. large-cap market. (But for those funds that keep expenses below the industry averages, the probability of success rises in lockstep.) The average manager in asset classes that are listed as "efficient" — such as large-cap core — will find it challenging to beat the index… while those in asset classes defined as "inefficient" — such as international equities and international small-cap — will face a little less challenge. **The sweet spots for alpha potential are the "inefficient" asset classes.** These asset classes, which are more specialist than core, are where talented active managers would be expected to find greater opportunities to produce excess performance over the benchmark. For that reason, they are the asset classes in which investors should focus their active investing endeavors.

> Judging whether a manager can produce sustained outperformance over a full cycle is the most important element of any active/passive decision.

But just how much excess return might a talented active manager be able to generate in these "inefficient" (or at least less efficient) asset classes? In **Exhibit 1**, each chart highlights the distribution of returns, by quartile, among a sample of active strategies, on the basis of gross (pre-fee) returns. **In each instance, the popular passive market index (also quoted on a gross basis) lags the median active manager by a fairly wide margin.**

[1] "Fund Managers Might be Smarter than We Thought" (Merryn Somerset Web), *Ft.com*, February 1, 2013.
[2] Source: Morningstar

These averages indicate that the opportunities for incremental alpha are relatively abundant in some of the "less traveled" corners of the investment markets. The comparisons are particularly compelling for the upper-tier of managers, where top-quartile results more than overcome fee levels, even among the more expensive mutual fund industry averages. The value to large institutional investors is further enhanced by their buying power and lower expense burdens as a percent of assets.

They have strong, sustainable investment processes

When the goal is to find managers that can be expected to outperform over time, the importance of thorough manager due diligence by advisors and investors cannot be overstated. More specifically, it is important to have a bias toward active managers who are truly active. In simple terms, that means managers that don't hug the benchmark, but are skilled at making diversified stock picks and confident in building portfolios. There are two key metrics that can be used to compare managers in this regard:

- **Active share:** the percentage of the portfolio that is different from the benchmark.
- **Tracking error:** a measurement of the volatility of returns, relative to the benchmark, over time.

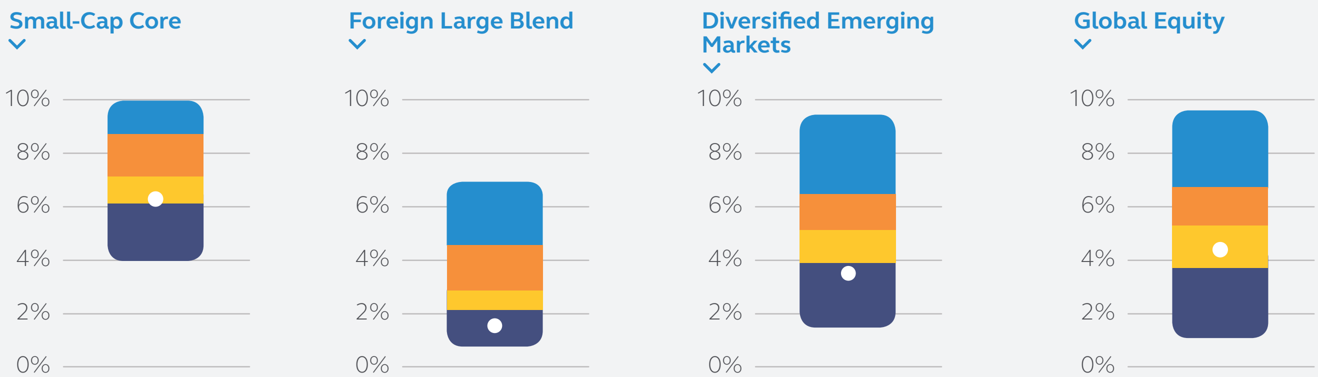
Put simply, managers who design portfolios with high active share and low-to-moderate tracking error have been shown to outperform over time.[3]

They charge reasonable fees

Managers who charge very high fees and generate high expenses (through cost overhead or excessive trading) are relatively unlikely to outperform, unless those fees and expenses provide the means for truly superior returns.

Exhibit 1: Choosing Active vs. Passive

Peer rankings and expense comparisons • Annualized Returns, 10 years ending June 30, 2016



	Small-Cap Core	Foreign Large Blend	Diversified Emerging Markets	Global Equity
Index Return	6.20%	1.58%	3.54%	4.43%
Index Rank vs. Category	73rd Percentile	85th Percentile	79th Percentile	69th Percentile
Index Name	Russell 2000	MSCI EAFE	MSCI Emerg Mkts	MSCI World
Median Instituional Fee	0.80%	0.70%	0.90%	0.75%
Median vs. Index	+1.11%	+1.34%	+1.61%	+0.89%
Top 25% vs. Index	+2.50%	+2.94%	+2.89%	+2.22%
Category Ave Net Exp Active MF Managers	**1.31%**	**1.26%**	**1.54%**	**1.33%**

○ Index return ■ 5th percentile ■ 25th percentile ■ 75th percentile ■ 95th percentile

Index performance information reflects no deduction for fees, expenses, or taxes. Indices are unmanaged and individuals cannot invest directly in an index.

Source: eVestment; Morningstar.

[3] For more on active share and related concepts, see "Alpha Dynamics: Evaluating the Activeness of Equity Portfolios" (Mustafa Sagun and Scott Leiberton, Principal Global Equities whitepaper, 2012). See also "How Active is your Fund Manager: A New Measure that Predicts Performance" (K.J. Martijn Cremers and Antti Petajisto, Yale School of Management working paper, March 31, 2009).

Understand what drives active outperformance

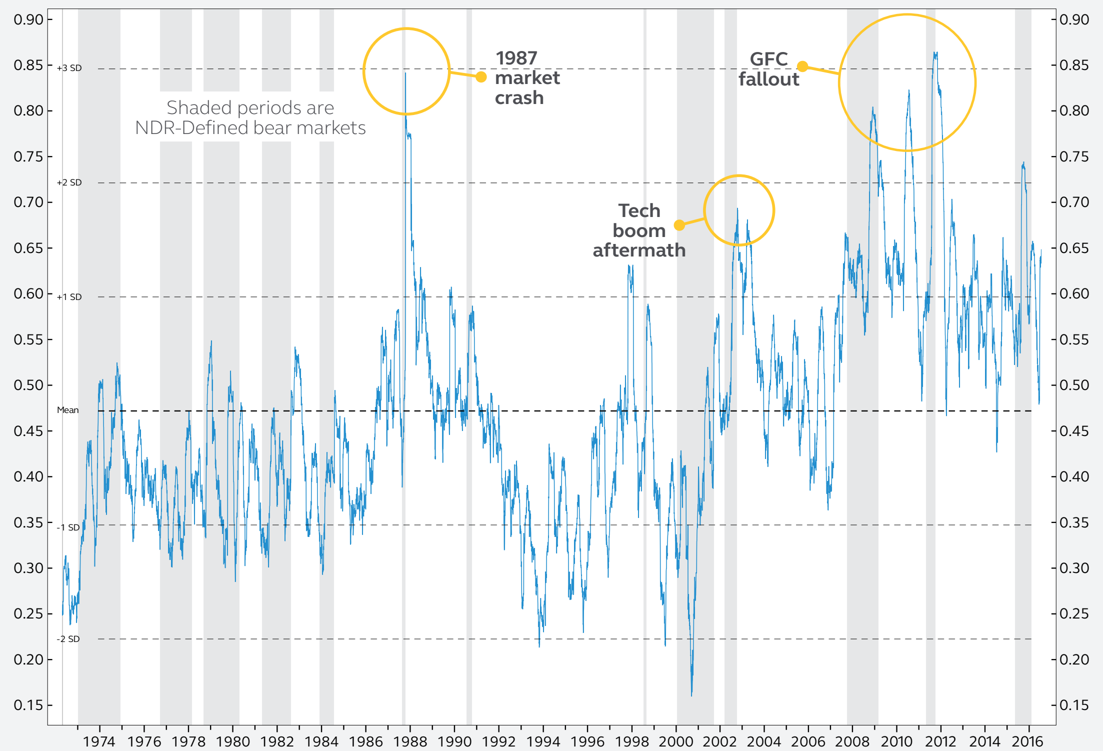
To expect that an active manager will be able to outperform over every time period — no matter how short the timeframe or without regard to prevailing market conditions — is unrealistic. That's why we believe it is essential that we set reasonable expectations with our clients, so that they will be willing to give an active strategy sufficient time to pay off.

In setting appropriate expectations, one of the most important things for a client to grasp is that, **generally speaking, active management performs well when valuations are driven by underlying sector and company fundamentals, rather than by political issues and/ or macroeconomic events.** During periods of extreme risk aversion, correlations both within asset classes and between asset classes tend to rise toward 1.00 — in other words everything moves up or down together. For example: correlations among the S&P 500 constituents tend to average just below 50%, but at times of particular macro stress often spike above 70%. Such a spike was seen most recently, on numerous occasions, during and following the global financial crisis, when there was a relatively indiscriminate exodus from equity markets by a broad range of investors **(Exhibit 2)**.

In such a market environment, the opportunity to achieve excess return becomes biased toward broad market timing, making it quite difficult to outperform benchmarks through fundamental analysis and security selection (the foundations of active management). However, when correlations recede, the opportunity shifts back in favor of fundamentals and active management.

It is worth noting, however, that not every economic downturn is necessarily bad news for active management. Academic studies have shown that, at least prior to the 2007-2009 global financial crisis, active management outperformed during recessions. These studies indicate that it is not an active manager's move to cash that leads to better performance in recessions. Instead, active managers do better in down markets because they are able to exploit superior information in a time of market uncertainty and higher volatility.[4]

Exhibit 2: Correlation Among U.S. stocks • (63-day rolling average pairwise correlation)



Daily Data 04-20-1972 to 07-22-2016

Source: Ned Davis Research

[4] "Active Management in Mostly Efficient Markets" (Robert C. Jones and Russ Wermers, Financial Analysts Journal, 67(6), November/ December 2011).

Understand how passive strategies behave

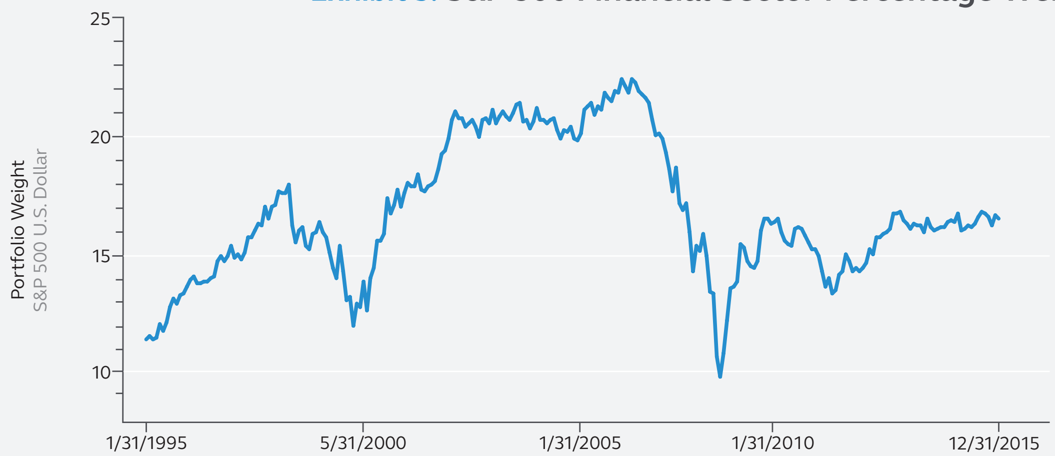
A key to understanding how passive strategies behave is to recognize that by continually seeking to hold a portfolio that replicates a particular index, a passive manager is intentionally "looking in their rear view mirror." As a result, passive strategies *can* disappoint, especially when circumstances change and even more so when those changes are quick and/or dramatic — something we have seen with increased regularity in global markets in the last decade. There are three reasons for this risk.

1. Many, if not most, passive indices are market-cap weighted, meaning that the investor is **more exposed to the movement of a few large companies** than he or she may think. In addition to this large-cap bias, these strategies tend to overweight certain markets and thus have a "large-market bias."

2. Passive indices may be subject to sometimes significant **momentum bias** and **may not be able to adapt quickly** when events in the real world impact a sector or company. In other words, the strategy works as intended as long as the winners keep winning, but when the winners stumble, the strategy is overexposed. By contrast, while an active manager might take profits as the prices of particular securities rise strongly, a passive index — by its very nature — just gets more and more concentrated in successful securities.

Exhibits 3 and 4 illustrate how the momentum bias inherent in index funds can be seen in sector allocation over time. The two exhibits highlight, respectively, the proportion of the S&P 500 represented by financial services companies and technology companies over the past 20 years.

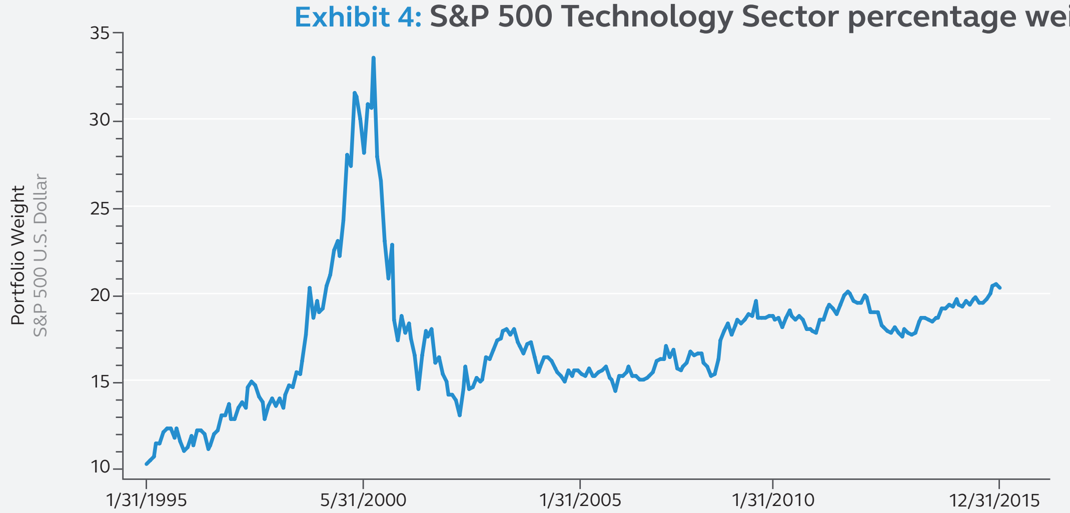
Exhibit 3: S&P 500 Financial Sector Percentage Weight



Note that the peak level of financials exposure corresponded directly with the housing boom and mortgage financing bubble of the mid-2000s, exacerbating the steep losses incurred during the global financial crisis.

Source: Factset

Exhibit 4: S&P 500 Technology Sector percentage weight



Similarly note the particularly profound rise and fall of the technology weight during and following the notorious "dot com" bubble of the late 90s and early 2000s.

Source: Factset

3 Passive strategies are not totally passive — nor are they automated investments. The passive investor still has to make decisions around which index to mimic and which asset classes should be active or passive — and when target date funds are involved, decisions have to be made around asset class allocations. Passive strategies also need to engage in some trading and incur the related costs, which are naturally a drag on benchmark-relative performance. And it would be wrong to assume that all passive strategies are low cost — as in 15-20 basis points. **Exhibit 5** shows that the median expense ratio in some fund categories can come in around 35-45 basis points.

Exhibit 5: Median Net Expense Ratios By Category (%)

US Large Blend	0.37%
US Small Blend	0.45%
Foreign Large Blend	0.35%
Diversified Emerging Markets	0.31%
World Stock	0.20%

Source: Morningstar Direct as of 06/30/16.

Get strategic?

Maybe... but understand the limitations

While traditional index funds and ETFs make up the vast majority of passive investments currently, this discussion of active and passive investing would be incomplete without the inclusion of strategic beta. Strategic beta is an investment strategy that emphasizes capturing investment factors or market inefficiencies in a structured and transparent way, which seek to deliver a better risk and return trade-off than conventional market cap-weighted indices. While passive investing is generally seen as the antithesis of active investing, strategic beta is viewed by many as a hybrid between active and passive approaches. Therefore, it can be viewed as a "mechanical" and cheaper alternative to traditional stock picking.

It's important to recognize that for a certain type of investor, smart beta may be an appropriate investment choice, just as traditional passive investing might be for another. To make that decision, however, investors need to fully understand the associated risks and costs involved.

Understanding the risks:

As noted earlier, the market cap weight indices that typically form the foundation of many index investments result in these strategies having a large-cap (and often large-market) bias. Since strategic beta allows the investor to build their index around an array of other metrics, it is possibly to eliminate such bias — but doing so may introduce other biases or risks.

For example, a popular strategic beta strategy is to equally weight the components of an index like the S&P 500. Doing so, however, results in investors having more exposure to smaller companies than large ones. While small-cap stocks have historically outperformed large-cap stocks, over the long term they also tend to have higher volatility. That risk needs to be acknowledged and accepted by an investor.

Strategic doesn't necessarily mean less expensive:

Given the customized factor-based index that underlies strategic beta strategies, the fees on many strategic beta ETFs are, on average, higher than those on traditional index strategies It is also not unusual for turnover rates to be more than double those of traditional index strategies, especially those that are equally weighted. High turnover creates additional trading costs, which may require that the strategic beta strategy take on more risk in an effort to beat the broader market.

For the active investor, this high turnover in strategic beta ETFs can be a silver lining. ETFs are, by nature, liquidity-driven; they buy and sell securities based on flows in or out of their funds rather than assessing relative value. This can result in market dislocations in securities owned by ETFs and can create opportunities for active investors. Strategic beta strategies may also generate additional opportunities for active investors by creating a pool of underpriced assets that are excluded from their indices.

Lack of a proven track record:
Strategic beta strategies have short track records that are largely based on back-testing. Though they can show hypothetical outperformance over long time periods, there can be prolonged stretches of underperformance. For example, an MSCI study of over 20 years of performance history found that:

- Investing toward small caps lagged the broader market for as much as six straight years.
- Value investing underperformed for a three-year stretch
- Low volatility stocks did the same for two years.

The wisdom of staying active — passive positives aside

Even if the market for a specific asset class is deemed efficient, and passive management would seem the obvious solution, there still may be good reasons to stay active. Such a decision could potentially make sense when:

- The availability of passive strategies that best meet the client's needs is limited.
- The allocation to the asset class is small and unlikely to impact overall portfolio costs to a great degree.
- Analysis conducted by the investor or their advisor determines that the active manager is a specialist within the asset class.

Investors who consider strategic beta strategies would do well to enter into them with a comprehensive view of the relationship between their value and cost, risk, and limitations. Seen by investors as a less expensive alternative to traditional stock picking, investors who choose a strategic beta strategies should align the choice with their investment outcome objectives.

At the end of the day, it's important to remember that passive management starts from a belief that markets are largely efficient and that the potential returns from capturing what inefficiencies do exist will be more than offset by costs and risks.

There are a number of asset classes that would be considered inefficient. In those asset classes, **not only can the median manager add significant value, but the outperformance of the top quartile of managers could safely cover any management fee two or three times over (Exhibit 1).** Empirical evidence such as this confirms our conviction that, in the hands of the right manager, active investment not only pays for itself, but can make a material financial difference to the investor — making it an essential tool than can help investors better navigate the outcome-oriented investment world that is increasingly their choice today.

Watch for the next paper in this series for a discussion about maximizing investor outcomes through efficient portfolio construction.

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