Morphic
Perspectives Series

August 2016

ADAPT OR PERISH PART II

Identifying winners from the shift to passive investments among the surviving active strategies.

Change Creates Opportunity

Morphic
Asset Management

INTRODUCTION

Part I of this Perspectives Series painted a bleak picture for the active funds management industry: a landscape of reduced fees and competing products.

In this piece we will argue that passive strategies have had, up to now, something of a "free ride": markets were efficient due to the predominance of active managers which made passive the cheapest after fee option. However, we believe that at some point passive managers will occupy so much of the landscape that markets will become inefficient and passive investors will end up having to "pay" for price discovery.

We will also nominate a list of active management strategies which we believe stand to benefit most from industry changes.

Lastly, we will argue that passive and active will – and should - co-exist. Different mixes will be appropriate for different investors and at different points in the investment cycle. If every fund holding is passive, the problem of asset allocation – when to hold equities and in which countries or sectors – won't have gone away. Instead, it will be in the hands of consultants and financial planners that probably don't have the expertise or desire to handle these decisions.

THE CASE AGAINST PASSIVE?

For those readers who are already enamored with passive investment strategies, unfortunately the outlook is not as straightforwardly in favor of passive as they would hope.

If we look at this problem from first principles, active is a necessary part of the passive ecosystem. Passive strategies are like gut bacteria that live within their host (although some have argued the hosts just live for the bacteria!); they need active management for their survival as well.

"A major raison d'être for equity markets is to provide price discovery in capital pricing."

Consider for a moment a world with over 90% passive investment strategies. A new stock, say Uber, is being priced for an Initial Public Offering. Since it is not part of any index, passive strategies have no demand for the stock. How is it priced with little or no active managers to bid for the stock? With great difficulty and imprecision, we would suggest. This is good neither for investors nor the economy. A major *raison d'être* for equity markets is to provide price discovery in capital pricing. This function is dramatically impaired under this scenario.

There are other examples of the impairment of the price discovery function as well[1], so clearly there is a role for active management, and passive strategies need to "pay" active managers to perform this function. Payment is in the form of the "alpha" or above index performance enjoyed by those brave enough to keep some capital with active managers and smart enough to analyze what kind of active managers will do well in this new environment.

1. These can include pricing up placements; liquidity provider roles to enable smaller bid-ask spreads, as a large bid-ask spread (say 30bps) can wipe out any gains from cheaper strategies, at the extreme 2-3 years of savings (30 bps divide by the 7bps (to run the SPY tracker) so liquidity provision is valuable to passive investors.

NAMING THE WINNERS

Lipper, an international fund management data collection company, has put together the **Figure 1** below that looks at flow trends across the industry in a more nuanced way more than simply between "active" and "passive".

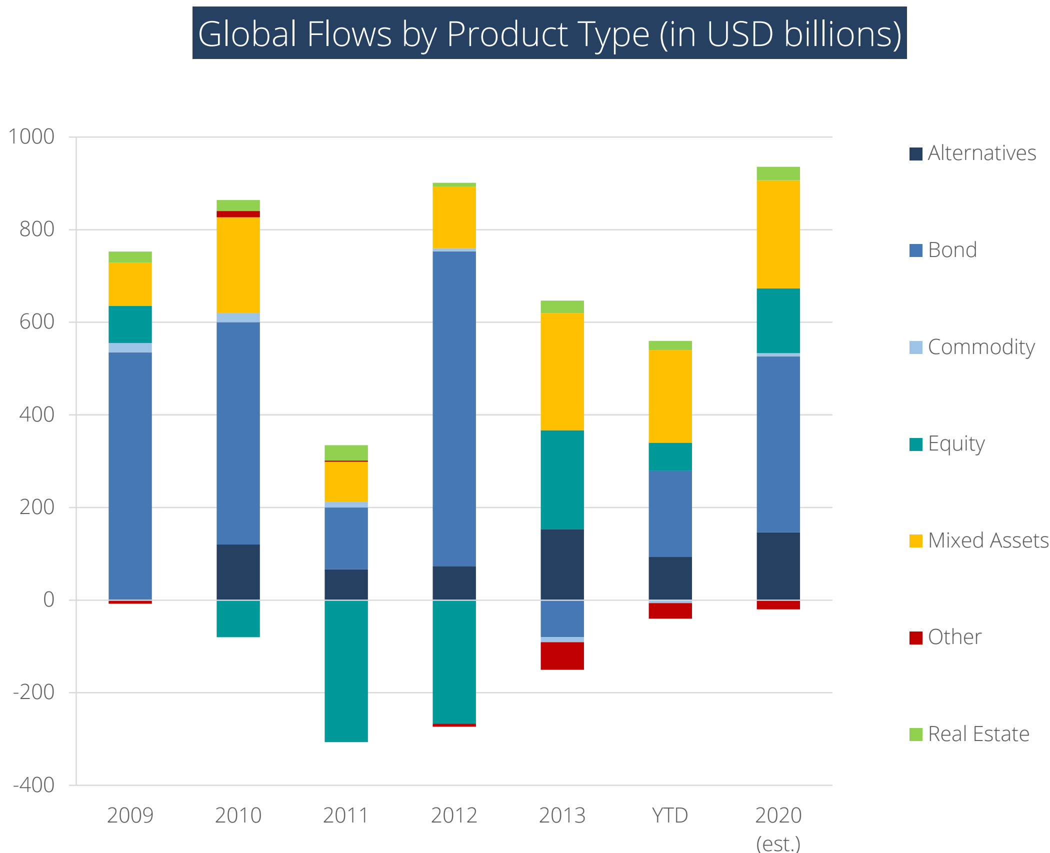
What can be seen is that there are actually good flows into a number of asset classes outside of equities, so at the margin, investors already recognize these changes. Lipper nominates active winners as likely to include some hedge funds; liquid alts (a version of hedge funds more suitable to retail investors); multi strategy funds or what they call mixed assets[2] ; alternate income products for an aging population; and in a world of climate change, Socially Responsible Investing (SRI)[3].

1) (Not so) alternative: equities become hedge funds; hedge funds become equity funds.

At a time when the Hedge Fund industry as a whole has had one of its worst year to date performances, and following quite a lean few years, it seems odd to outline this sub-sector as one that stands to benefit from moves to more passive strategies!

The issue for the Hedge Fund industry (and the long/short community in particular) is that "institutionalization" of the industry has not been good for them. Many managers' marketing pitch of being absolute return focused has created a dogma that owns them – they are supposed to "always make money". The problem is that if you never risk anything, you can't make anything,

Figure 1 - Flows by category

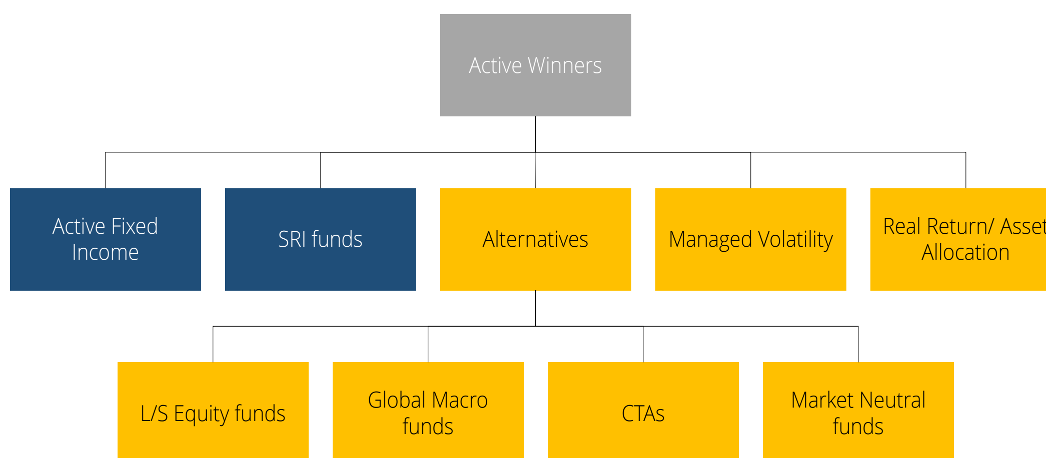


Source: Lipper

2. So asset allocation is incorporated in a structured way into the product..

3. Benchmarking and passive is difficult to achieve and clients often have desired targets not related to pure investment outcomes.

Figure 2 - Winning strategies among actively managed funds



Yellow = hedge fund related strategies; Blue = variations on mainstream funds
Source: Lipper, Morphic Team

so managing monthly returns results in sub-optimal long run returns.

This is a shame, as a lot of what will be used going forward in the investing world is part of this sector: a deep and broad understanding of risk; the ability to short; the ability to use leverage; and the ability to invest across asset classes. These tools will likely move into equity investments in the form of "liquid alternatives" where investors can get access to daily or weekly redemptions.

Constructing "short indices" and running pairs of long and short stocks isn't part of the traditional long only equity investor community's mindset. Nor are these things that can be easily (if at all) replicated in ETFs. The main sub-categories of Alternatives that we would expect to do well are:

i) *Long/Short (L/S) Funds:* For the reasons discussed above, L/S managers should do well, though we suspect not in their current guise. Running a net exposure level of 50% (versus 100% for long only equity funds) and through the cycle generating 50% of the S&P500 returns but charging fees over a cash benchmark, is another part of the ecosystem that has to "adapt or perish".[4]

We also expect investors to demand such managers adopt fairer and more "equity like" benchmarks for performance fees, which should pressure these managers to either carry higher net exposure levels or short more stocks to earn their keep.

ii) *Global Macro Hedge Funds:* Another area of perennial disappointment for hedge fund investors. Whilst the returns from the sub-class have been sub-optimal, they have generally been uncorrelated with equity markets. This makes this a good strategy to add to core ETF holdings.[5] The problem has been the "fetishization of losses" alluded to above. This piece does a nice walk through. Our advice is to find a global macro fund

4. Investors can replicate the 50% net exposure level by putting 50% of their funds into cash and the rest into an ETF - there is no need to pay for this lower volatility. To get to the same return as equities but still only be 50% invested, a manager can generate a return by investing money in a long idea and shorting a stock or index against. it, creating a 'pair'. If the average long idea generates 3-5% better than the index, a L/S manager will need a Gross book of 200% (100% long and 100% short) to generate 4% extra. With equity markets going up on average 8% a year, they can hit the 8% by then being at 50% invested (0.5 x 8%) plus the Gross book (100% x 4%). But L/S managers have generally not run their gross books (longs plus shorts) high enough to hit this, preferring it would seem to milk the fees of picking up the spread over cash hurdles.

5. For the more geeky readers, this blog does a nice run through of the benefits of global macro in a portfolio.

willing to say they will periodically lose money with the aim of making some over the long term!

iii) *CTAs:* CTAs or their original name "Commodity Trading Advisors" are also uncorrelated returns that are not (as easy) to replicate in ETFs. These are trend following computer models. Of late they have become more popular, but are still under-represented in most people's portfolios.

iv) *Market Neutral Funds:* These funds take the market exposure out by running shorts against all their long positons. Because they are solely focused on stock specific investing, their returns have tended to be uncorrelated as well. They are also not suited for ETF replication. The issue has been the low returns. In a world of cheap money and bonds rising a lot in the last few years, getting 3-6% returns just hasn't been sexy.[6] If returns are lower or negative, adding some of these strategies to cheap ETFs is going to be a nice diversifier to alpha and returns.

"...many of these strategies are not scalable, particularly market neutral or L/S."

One thing we would like to emphasize is that many of these strategies are not scalable, particularly market neutral or L/S. Running a $40bn long only fund is relatively common, but finding enough stock to borrow to short $40bn is a much more difficult task, bordering on impossible. As capacity is limited for any individual manager, we don't expect the categories to be under as much pressure as for traditional managers.

2) Fixed income:

In a world with an aging population and low or negative rates, the hunt for yield has driven investors out of the risk curve into high yield and emerging markets debt. There are some ETFs in this space, but they are not as large as those in equities. The other interesting thing is that most active bond managers have outperformed ETFs. Both should continue to do well.

3) Managed Volatility:

Whilst there are ETFs in this space, active management can and will continue to play a large role, simply because each client's risk preferences are very different and working volatility managers are likely to be the best way forward for some time. Specialist volatility funds, where managers use the volatility curve to generate income or downside protection, are likely to become more popular in portfolio construction.

4) Sustainable Investments:

Clients, both at the institutional and retail space have increasingly demanded their managers comply with ethical standards. Bodies such as religious institutions have very specific requirements as to what types of investments are included in their portfolios so that active managers who specialize in this ethical space, or in "Clean energy" or other non-traditional products are likely to see a growth of flows.

5) Real Return / Asset Allocation:

The last area that active management will likely grow is within the realm of Strategic Asset Allocation (SAA) or Tactical Asset Allocation (TAA). These are terms used to describe the decision of which asset class to allocate funds to and in what size.

6. Footnote 4 discussed the nature of running a Gross book. For a market neutral investment to generate 6%, it will need to have 200% longs and 200% shorts, if the longs make 3% and the shorts lose nothing. It's generally accepted that outperforming the index by 3-5% on the long side is a rough rule of thumb for what is achievable. Clearly there can be higher outcomes, but with leverage the risk of an error is amplified.

We are seeing the emergence of some of these funds. Former "bond king" Bill Gross runs one at Janus which is unconstrained and Schroders has a "real return fund". We are not convinced the Schroders one is set-up right yet (too much in vanilla assets that are correlated), but it's a step in the right direction. Variations of absolute return funds with the right risk controls and liquidity measures are probably best placed to offer up a dynamic mixture of assets according to the future needs of retirees.

WHERE DOES MORPHIC FIT IN?

When Part I of this series came out we were asked by many people why on earth an active manager would chose to write something that attacks active management. Our answer has been that just because we are part of an industry, doesn't mean it is worth defending in its entirety.

When we started Morphic more than four years ago, we asked ourselves a lot of hard questions about what our industry would look like in 10 or 20 years.

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We did a number of things that we believe separated our product from the incumbents and we believe will help us survive these changes:

a) Variable Net Exposure (or often called variable beta): The consultants hate it,[7] but we believe it's a valuable thing to have for our clients, many of whom are SMSF investors. They know that if we judge it appropriate, we can sell out of equities and go to cash. They use us for equity exposure and we are measured against the equity market, but we can raise up to 50% cash if needed. This saves our clients from thinking about it – and many of them have made the decision it is better to pay us to stay up all night on those regular occasions when we have to!

Mindful that other managers have a poor track record in this area (tending to carry too much cash on average), we built a process that separates this decision from the stock choices and defaults to being fully invested unless we believe we are seeing a major market break.

b) Use of other assets to enhance returns: Like the total return funds mentioned earlier, we can invest in other assets if we believe that they can help out our investors' returns. The parts of the team in charge of this are not the same who do stock selection.

c) Ability to short stocks: We use the insights from the L/S community to leverage stock ideas by shorting when we think there is money to be made there and we use the L/S risk management tools.

d) Use of ETFs: The firm openly embraced ETFs as a new tool to be added to the active managers' arsenal. We use ETFs to gain exposure where we want some, be it country or sector, and alternatively we use them to short out exposure where we don't want it. We have described ETFs as *"both the biggest threat and one the most useful tools available to our industry"*.[8]

Together these have created a product that, we have been told by our counterparties who see a lot of products, is like no other

7. One consultant actually said "you don't do that, that's my job to decide that!"

8. They are an opportunity because if you wanted to short a sector before you need to select a basket and trade a group. Equal weighted ETFs are cheaper and easier to implement.

being offered out there. Have we got all the parts right? Will it totally succeed in adapting? Only time will tell. Thus far it's performed well since we launched.

It's no coincidence we chose Morphic as a name - we are not sitting on our laurels waiting for the end to come.

ABOUT THE AUTHOR

CHAD SLATER, CFA

Joint CIO, Morphic Asset Management

Chad co-founded Morphic Asset Management in 2012. He was previously a Portfolio Manager and Head of Currency and Macroeconomics at Hunter Hall for five years. He has worked at BT Investment Management, Putnam and the Federal Treasury over his 15 year career.

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