Anything but passive:
A strategic approach to investing in equities

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Comprehensive investment solutions for the DC market: an alternative to passive investing

The risk appetite of a DC investor varies over their lifetime. Younger scheme members should logically prefer higher return, and potentially higher risk, investments, with the desire for risk naturally diminishing as retirement approaches. History would suggest that there are good opportunities for scheme members to maximise return growth in 'real terms' by investing in equities, over their lifetime. However, seeking higher returns can be associated with greater risk, and amid the scramble for growth, the importance of managing and diversifying this risk should not be underestimated.

When considering how best to allocate funds for any given DC scheme, we do not believe that scheme trustees must necessarily have to choose between diversified passive or concentrated active approaches. Rather, we believe that it is possible to be both **'diversified'** and **'active'**– maximising the potential return opportunity without taking undue stock-specific risk, while also avoiding the pitfalls of allocating to stocks simply to satisfy index constraints.

Schroders QEP team offers a suite of complementary strategies that can each hold over 400 stocks at any one time. This level of stock diversification could lead to the assumption that these are effectively 'passive' strategies - in fact, they are anything but. Indeed, the number of stocks in these strategies belies the 'active' nature of the portfolios which target returns in excess of the index while also limiting potential risk exposure. Here, we attempt to explain how the QEP approach differs from traditional strategies and we propose a number of attractive investment solutions for the DC market.

Significant opportunities exist outside of the index
Indices can restrict your investment universe

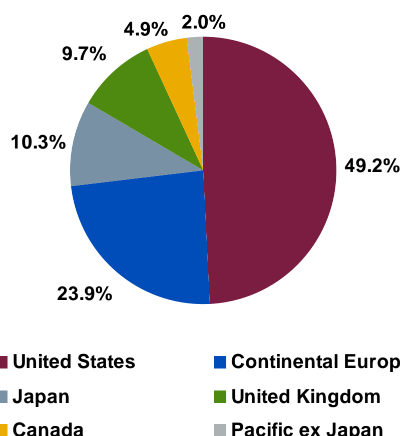
For passive investors, market cap-weighted tracker funds can provide a cost effective investment option which employs a systematic, repeatable and transparent process and offers a level of diversification. However, this notwithstanding, we would argue that adhering to index constraints may limit the potential return opportunity for investors and can lead to the inefficient allocation of funds to satisfy index constraints. Which begs the question, 'is passive investing the only option for investors seeking a tried and tested, systematic approach or could there be an alternative that offers a similar level of transparency but with higher repeatable returns, while still limiting risk exposure?'

Typical indices, such as the MSCI World Index, predominantly cover large cap stocks from developed markets. By adhering to index constraints, investors forgo significant opportunities to invest in attractive stocks within the emerging markets, and among small- and mid-cap names. To put this into perspective, we believe there is a global investible universe of up to 15,000 stocks compared with only 1,646 stocks[1] in MSCI World Index.

[1] Source: Schroders, Factset. MSCI World Index constituents at 16 April 2010

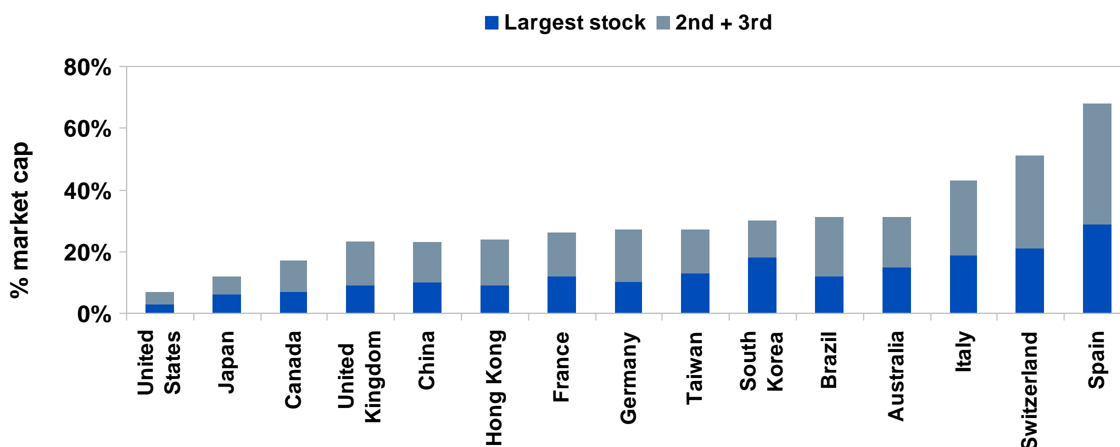
There is also little diversification at a regional level. Investment opportunities are limited to those stocks listed within the 23 developed countries that constitute the index. What is more, almost half of the total regional exposure lies in US equities, dramatically overstating the importance of the US market compared with the rest of the world.

In addition, stock weightings in market cap-weighted indices are a function of the company's past success, with index weightings being skewed towards current market leaders. That is to say, a handful of so called 'mega-cap' stocks with larger market capitalisations command a greater proportion of the index in percentage terms.



Source: Schroders, Factset. MSCI World Index constituents at 16 April 2010

For market cap-weighted tracker funds, these stocks crowd out other investment opportunities as too much of the portfolio gets allocated to them by virtue of their size. If we take the UK market, for example, the largest stock constitutes around 9% of the index and the top three stocks by market cap amount to over 20% of the index total, as illustrated below:



Source: Schroders, Factset. MSCI All Country World Index constituents as at 31 December 2009

We have all too recently seen the consequences of this 'concentration risk' in practice. Remember the 'tech bubble' of 1999/2000, where 36% of the MSCI World Index was comprised of TMT (telecom, media and technology) stocks; or the Japanese stock market bubble of the late 1980s. Japan's weighting in the MSCI World Index reached an astonishing 44% in 1988. Astonishingly, in hindsight, Japan was at that time only a 15% share of the GDP of the MSCI World constituent[2]. When this bubble deflated it was at enormous cost to most global funds, since even those managers who had a negative view on Japan could not avoid a substantial weighting. The unwinding of this overvaluation took 15 years and cost managers 2.6% per year[3].

[2] PPP (purchasing power parity) adjusted weight sourced from IMF

[3] The annualised difference between the MSCI World and the MSCI Kokusai from1988 to 2006 was 2.58% p.a.

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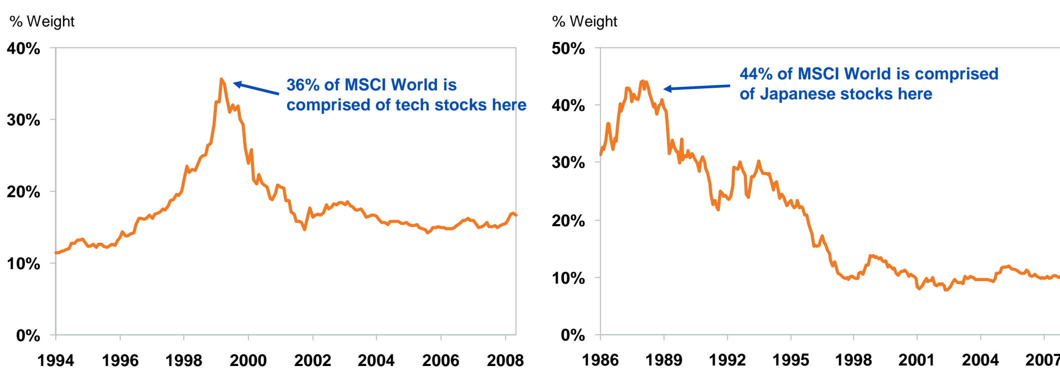
Fig. 1 Technology/telecoms bubble of 1999 / 2000 **Fig. 2 Japanese stock market bubble of the late 80s**



Source: Schroders, MSCI

Market cap weighting follows momentum, encouraging investors to buy high and sell low – effectively backing the 'winners' of yesterday and the 'losers' of tomorrow. Put simply, we believe these index-relative constraints can cost investors return. Removing constraints can greatly increase the chance of benefiting from the skill of a manager through greater breadth of investment opportunity. By introducing a rebalancing mechanism and trading against these inefficiency drivers, investors can reduce this 'mega-cap' drag. The rebalancing 'anchor' can be anything measurable that is **not** price sensitive, such as equal weighting, but is most likely better if linked to a return driver like Value or Quality.

Can active managers add value?

Market breadth helps to determine the opportunity

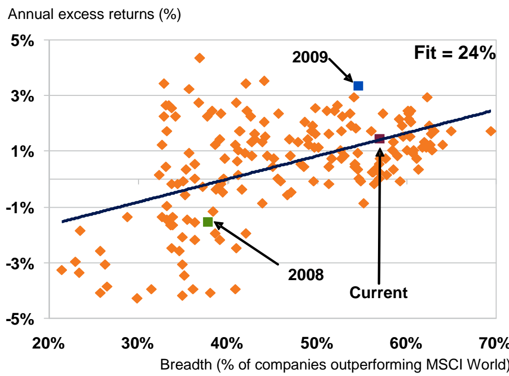
Global equity markets offer more opportunities for active managers in some years than others. We believe that the so-called breadth of opportunity, measured simply by the percentage of stocks outperforming the market index, is related to the ability of an active manager to deliver outperformance in any particular period.

Percentage of stocks outperforming the index

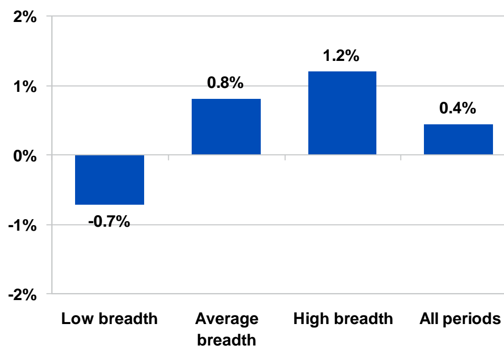
Source: Schroders as at January 2010. The proportion of global stocks outperforming the World MSCI All Country Index using the QEP Mega to Mid universe over six month periods through time.

Volatility in markets can be an attractive aspect for active managers, providing a wealth of opportunities to add value and increase returns through different market environments. The lower percentage of stocks outperforming the wider market in 2008 limited the opportunity set for active managers. However, as the breadth of outperforming stocks widened in 2009, active managers were poised to take advantage of this growing pool of strong performers. Analysis suggests that median performance by active global managers hit 1.2% versus the negative returns sustained when less than 40% of global stocks were outperforming (see graphs below).

Market breadth and active performance



Market breadth and median active performance



Source: Schroders, Mercer MPA database. All Global managers with equity funds domiciled in Australia (1995-2009). Performance is measured as the annual excess return relative to MSCI World ex Australia (before fees). Breadth is calculated as the proportion of global stocks outperforming the World MSCI All Country Index using the QEP Global universe ex Small Caps over twelve month periods through time.

Can active managers justify the fees?
Compounding of returns adds value for the long-term investor

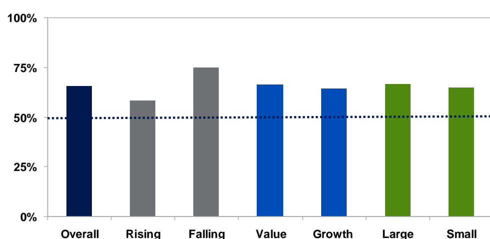
Not only does the risk/return profile for any investment need to be thoughtfully managed by DC scheme trustees and aligned to clients needs, but the burden of cost must also be carefully considered. Passive investing generally attracts a smaller fee from investors, but maybe a more relevant question should be 'does the return justify the fee?'

We know that compounding returns adds value. In our view, the most consistent way to accumulate returns through time is by investing in a strategy that offers **repeatable performance** and can **work across different market environments**.

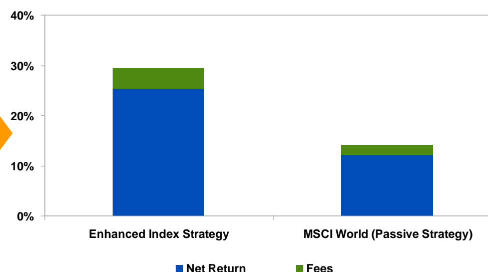
As an example, let us consider the enhanced-index approach below. The strategy targets modest outperformance against the MSCI World Index (+1% p.a.). Multiple investment strategies are spread across a large number of small stock positions to capture broad themes and limit stock-specific risk, and portfolios are constructed with the aim of outperforming the benchmark across all major market environments.

The key strength of this investment approach is the proven ability to produce consistent, repeatable performance while taking limited index-relative risk[4]. Generating small, incremental returns which compound significantly over time has seen the strategy outperform the MSCI World Index by a good margin since inception.

Repeatable performance across different market environments



Cumulative performance since inception (%)



Source: Schroders. Schroder QEP Global Core composite compared with MSCI World NDR, since inception of the QEP Global Core composite 31 January 2000 to 28 February 2010. Market environment (rising, falling, value, growth, large and small) defined using MSCI indices. Past performance is no guarantee of future results.

Source: Schroders. Schroder QEP Global Composite compared with MSCI World NDR in GBP from 31 January 2000 to 31 March 2010. Active management fees 0.35%; passive management fee assumed 0.15% and other expenses assumed 0.04% (for both strategies)

[4] The product has typically beaten the index in two out of every three months with a win rate of over 50% in all major market environments

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It is important to remember that no investment is free and we believe that the expense incurred should be commensurate with the expected return. If an active manager can put DC clients' money to good use – consistently and efficiently outperforming global equity indices while also minimising risk – the resulting compound returns may very well justify the cost of supporting such an investment.

Alternatives to passive investing

We would advocate a more 'unconstrained' approach to deliver higher returns, while still minimising risk exposure. A diversified, unconstrained strategy affords the freedom to invest in the best opportunities – wherever they are found – and not be forced to invest in a region, sector or stock simply because it forms part of an index. Unconstrained investment does not imply a disregard for risk, but instead recognises that constraints are a very costly way of managing risk. We believe risk should be managed more strategically at the overall fund level rather than micro managed by over-constraining individual components of the portfolio.

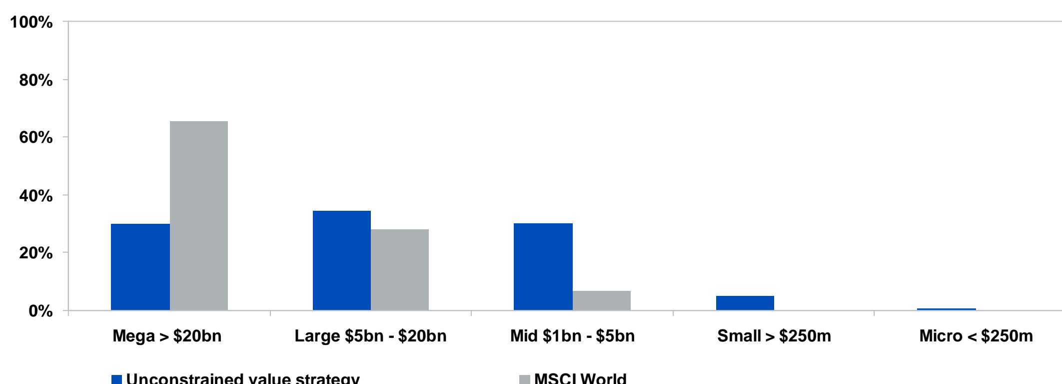
Most people would agree with the benefits of diversification, but few realise that it can also be a way to generate high returns through unconstrained investing. At any given time, there is a wealth of investment themes to exploit around the world, but many of these stocks fall outside mainstream indices. Therefore, in order to capture these, you may need to widen the investment scope, drop index-relative constraints, and invest in a greater number of stocks than a more conventional portfolio is able to invest in.

Maximising the breadth of opportunity

All cap investing

As we move away from the restrictions of market cap-weighted indices, the breadth of investment opportunities across the market cap spectrum becomes that much greater. The chart below effectively illustrates the dominance of the large 'mega-cap' names in the MSCI World Index, constituting 65%. The allocation to large cap stocks may not be too dissimilar, and obviously liquidity issues must be considered when allocating to small- and micro-cap stocks. However, the mid-cap space offers some of the greatest opportunities for stocks to deliver growth while, at the same time, offering ample liquidity.

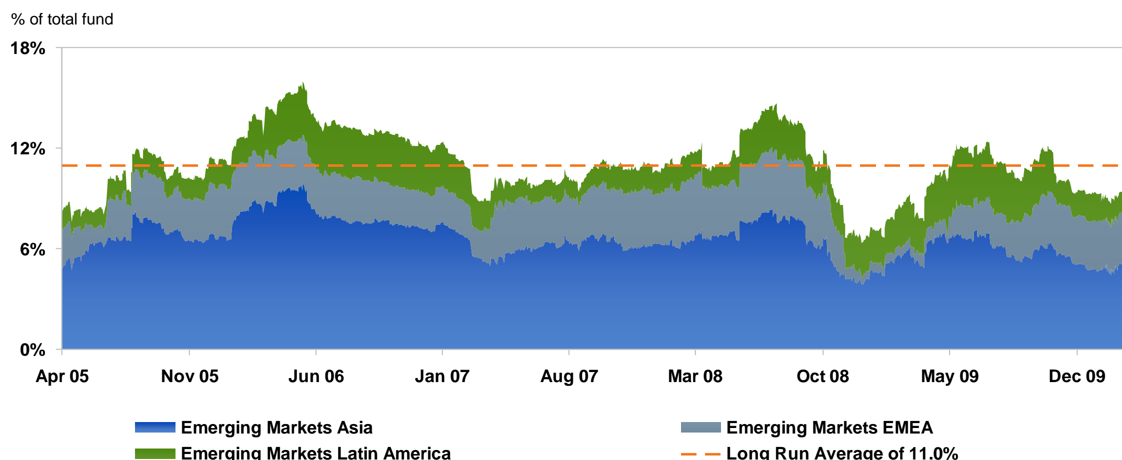
The QEP unconstrained approach is to weight stocks based upon their fundamentals and liquidity. We believe this is more balanced and, again, reduces the problem of the 'mega-cap' drag. The building blocks of our approach are 'Value' and 'Quality'.



Source: Schroder QEP Global Active Value Fund (Representative) at 31 March 2010

Bottom-up emerging market allocation

On a regional basis, an unconstrained approach can also take advantage of off-benchmark investments like emerging markets opportunities, which can offer significant growth potential beyond the scope of developed market investments. Having the ability to dip into emerging markets when they offer value and to avoid them when expensive is preferable to simply including these markets in the benchmark, where the investor is effectively forced to own them regardless of price. This 'self-managing' process within a systematic, unconstrained approach is an excellent way to take advantage of a huge breadth of potential return opportunities.



Source: Schroders. Source: Schroder Global Value (Representative) Fund from 01 April 2005 to 04 March 2010. Regions shown for illustrative purposes only and should not be viewed as a recommendation to buy/sell.

Conclusion: the DC proposition
Review of an alternative approach versus passive

We believe that DC trustees should consider diversified, unconstrained equity strategies as a means to enhance returns and reduce risk. In short, we advocate that investors seek out managers who employ a strong breadth of application with portfolios that are well diversified and, if efficiently implemented, exhibit low concentration, while still offering all the benefits of a high conviction strategy.

As an alternative solution to passive investing, an unconstrained, bottom up, systematic and pragmatic approach can ensure that portfolios are well-diversified and avoid the pitfalls associated with excessive stock or market cap concentration. Schroders QEP investment decisions are based on hard evidence and our process is completely transparent. By broadening our global opportunity set and deviating from market cap-weighted approaches, we avoid allocating 'dead money' to expensive stocks to satisfy index constraints, and are able to really maximise the potential return opportunity for our clients.

	Passive Index	Alternative Solution
– Diversification	✓	✓
– Systematic & transparent process	✓	✓
– Low management fees	✓	✓ Commensurate fee
– Combats stock/ market cap concentration	✗	✓
– Extends breadth of opportunity	✗	✓
– Employs return drivers	✗	✓

No single investment solution can suit all DC scheme clients, and we understand that scheme trustees require the flexibility to tailor investment solutions to specific clients needs. Ultimately, trustees are tasked with adopting an appropriate risk-return profile for any given scheme based, largely, on the amount of contributions and the length of time the funds are to be invested. We believe our comprehensive range of complementary investment solutions offer a compelling option for DC scheme trustees looking to generate higher return growth for DC clients without taking on undue index-relative or stock-specific risk.

Schroders QEP Global Equity Strategies

The below table highlights a selection of QEP Global Equity investment strategies that we believe offer an attractive alternative to passive investing for different types of DC clients.

Investment strategy	Suitability	Application
QEP Global Core (Enhanced-Index)	Highly fee sensitive clients with a preference for the index and increased stability and security.	Aims to achieve incremental, repeatable returns that significantly compound over time.
QEP Global Value (Unconstrained) or **QEP Global Blend** (Unconstrained)	Investors with a longer time horizon who are looking to harvest the equity risk premium, but still take advantage of the same pragmatic investment approach.	Unconstrained Value and Quality strategies target higher relative returns for clients who are willing to step away from the benchmark index.
QEP Global Quality (Unconstrained)	More risk-adverse investors with a shorter investment horizon.	Quality strategies work well in distressed markets, which is often when pension fund investors are most interested in their investments.

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Important information

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