How an investment strategy can blend the best of active and passive

From the Field
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Key Insights

- Clients worried about overly relying on the market's continued strength may want to consider a strategy that aims to blend the best of active and passive investing.
- A strategy that seeks a market-plus return with market-like risk could add value as an alternative or as a complement to typical passive or active solutions.
- An analyst-driven approach, when it's well executed, has the potential to generate strong, risk-efficient returns through the market's ups and downs.

The appeal of passive investment strategies offering exposure to broad equity indexes is easy to understand. Low fees and a strong stock market have made for a compelling proposition.

For clients concerned about relying too much on the broader market's continued strength to meet their longer-term objectives, a middle path that combines the advantages of active and passive could be appealing.

Seeking the best of both worlds

Passive investment strategies that track indexes such as the S&P 500 or the MSCI All Country World are common portfolio building blocks.

The popular core/satellite approach typically uses the market-like returns that these passive solutions offer to balance other investments that take more active risk in the pursuit of stronger outperformance.

Shifting to traditional actively managed strategies isn't necessarily an option for clients seeking to diversify their portfolio's core. That's especially true if they have a strict risk budget.

- By design, active strategies tend to exhibit higher levels of tracking error, or variability in their performance relative to the benchmark.
- Strategies with higher tracking error can outperform, but the dispersion in results historically has been wider in this group (Figure 1). Picking the right manager is critical.

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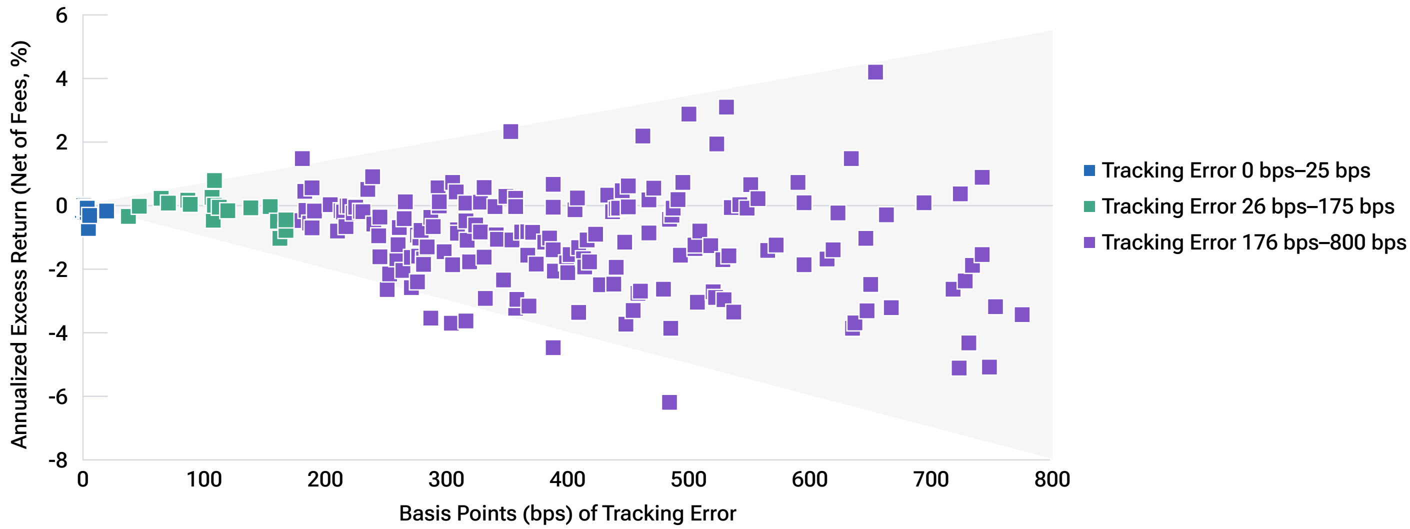
Wider dispersion in outcomes for U.S. large-cap equity strategies with higher tracking error

(Fig. 1) Average annualized excess returns, after fees, and tracking error vs. the S&P 500 Index



March 31, 2014, to March 31, 2024.
Past performance is not a reliable indicator of future performance.
Source: eVestment Alliance, LLC. Data analysis by T. Rowe Price. See Additional Disclosures.
Index performance is for illustrative purposes only and is not indicative of any specific investment. Investors cannot invest directly in an index.
The exhibit comprises U.S. large-cap equity strategies that had at least USD 250 million in assets under management as of March 31, 2024, and use the S&P 500 Index as their primary benchmark. The eVestment categories that define this universe are Large Cap, Passive US Equity S&P 500 Index, and Enhanced Large Equity S&P 500. The exhibit omits a small number of outlier data points with tracking errors higher than the top range. Here, tracking error measures, in basis points, the volatility in a strategy's returns relative to its benchmark, the S&P 500. One basis point is 0.01 percentage point. Strategies with higher levels of tracking error have exhibited higher levels of variability in their performance relative to the benchmark; strategies with lower levels of tracking error have exhibited less divergence in performance versus the benchmark. Excess return is the difference between a strategy's total return and the total return generated by the S&P 500 Index (including gross dividends reinvested). The strategies' returns shown are net of fees. They reflect the deduction of the highest applicable management fee that would be charged based on the fee schedule, without the benefit of breakpoints.

– Capacity constraints may also prevent pension funds and other large investors from allocating as much capital as they might like to traditional actively managed strategies. These solutions are often less diversified and may have larger allocations to small-cap stocks and off-benchmark securities.

An active-enhanced index strategy could add meaningful value as an alternative or as a complement to typical passive or active solutions.

The value proposition is simple: the prospect of a market-plus return with market-like risk. However, consistently delivering on these goals has been difficult for the asset management industry.

We believe that an analyst-driven strategy, when it's thoughtfully designed and well executed, has the potential to generate strong, risk-efficient returns through the market's ups and downs.

Fundamental research as a source of potential edge

The design and implementation of active-enhanced index strategies vary. Some rely on risk controls and stock picking. Others look to enhance returns through derivatives or by bundling fixed income strategies on top of exposure to the broader equity market.

Regardless of the approach, two principles are usually in play:

1. Identifying a source of edge that creates the potential for excess returns across different market environments; and
2. Isolating this competitive advantage by implementing strict portfolio construction rules that aim to approximate the risk exposures of the broader market.

Of course, markets are dynamic and highly competitive. Many sources of investment edge erode, unless they, too, change and adjust.

The potential advantages that come from rigorous fundamental research could be more durable because analysts focus on how a company's prospects and risk/reward profile may evolve over time.

For this reason, a risk-controlled strategy that seeks to isolate the power of individual analysts' stock-picking skills may have the ability to outperform in a variety of environments.

A large active manager may have a leg up because it can support a global team of experienced research analysts to offer both breadth of coverage and depth of knowledge.

With the resources to pursue their curiosity and creativity, these experts should be well positioned to develop differentiated investment insights.

Building an analyst-driven strategy in pursuit of risk-efficient returns

Here's one way a strategy can offer the potential benefits of active stock picking while maintaining a similar look and feel to popular market benchmarks.

1. **Analyst-driven stock picking:** Capital is spread across an extensive team of seasoned analysts. Each receives an allocation in proportion to the weighting of his or her coverage universe in the benchmark. They do not need to own every company in the index. Instead, each analyst seeks to allocate more capital to the stocks whose business fundamentals look attractive and to underweight or avoid names whose prospects appear less favorable. The portfolio also has the flexibility to hold a small proportion of stocks outside the index.

2. **Risk controls:** Deviations from the benchmark are governed by strict constraints on active weightings at the sector, industry, and holding levels. An oversight team tracks a battery of factor exposures—for example, momentum, business quality, growth, or value—and works with the analysts to rebalance the portfolio regularly. These efforts seek to ensure that the strategy isn't taking any unforeseen risks relative to its benchmark.

Taking a multi-contributor approach captures a diversity of viewpoints and investing styles while limiting the key-man risk associated with single-manager strategies. Relying on analysts to select stocks in the sectors and industries they know so well also provides a layer of risk management.

When implemented effectively, this process should result in a risk-controlled portfolio that creates a stage for the analysts' stock selections to drive relative performance.

Combining the advantages of active and passive investing

Popular indexes such as the S&P 500 and the MSCI All Country World were created to measure the performance of the broader market. Despite their strong performance over the past 10 years, they were not designed as investment portfolios.

Putting seasoned analysts directly in charge of stock selection for their area of expertise offers exposure to the potentially return-enhancing benefits of active management:

- **Exploiting dislocations:** Whether it's a possible peak or trough in the market, a sector, or a stock, a deep understanding of individual companies and their growth prospects can give analysts the courage of conviction to trim or add to a position when uncertainty is high.

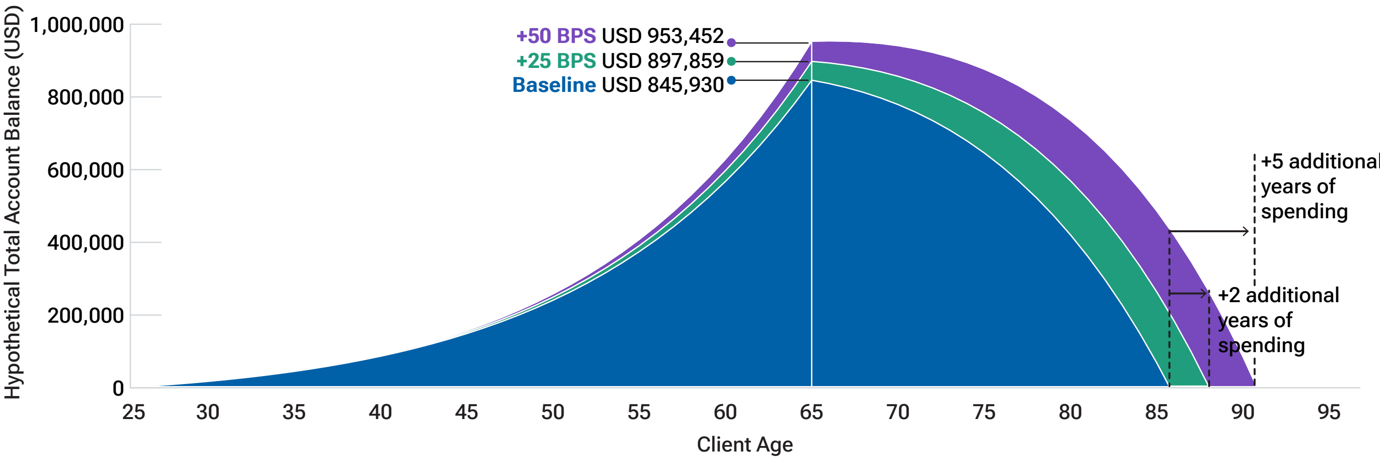
- **Taking advantage of heightened dispersion:** Focusing on fundamentals can also help when the differences in stock performance are especially high in a sector or industry. Consider, for example, the divergence in returns generated by companies that are perceived as benefiting from investments in advanced artificial intelligence.

- **Looking forward, not backward:** Analysts may be able to start a position before the company joins the benchmark or avoid names that are at risk of being removed. In these instances, the resulting investment inflows or outflows may boost or inhibit a stock's near-term performance.

> “...a risk-controlled portfolio...creates a stage for the analysts' stock selections to drive relative performance.

Even modestly higher returns potentially can improve retirement outcomes

(Fig. 2) Hypothetical impact of potential excess returns on portfolio growth



Demographic Assumptions	
Starting Balance	USD 0
Starting Age	25
Starting Salary	USD 30,000
Annual Salary Growth Rate	3%
Annual Contribution Rate	9%
Retirement Age	65
Ending Salary	USD 97,861

Scenario Assumptions	Baseline	+25 BPS	+50 BPS
Returns Before 65	7.00%	7.25%	7.50%
Returns After 65	5.00%	5.25%	5.50%
Account Balance at 65	USD 845,930	USD 897,859	USD 953,452
Withdrawal (% of Ending Salary)	50%	50%	50%
Annual Withdrawal Amount	USD 48,931	USD 48,931	USD 48,931
Withdrawal Increase	3%	3%	3%

The results shown above are hypothetical, do not reflect actual investment results, and are not a guarantee of future results. Hypothetical results were developed with the benefit of hindsight and have inherent limitations. Hypothetical results do not reflect actual trading or the effect of material economic and market factors on the decision-making process. Results do not include the impact of fees, expenses, or taxes. Results have been adjusted to reflect the reinvestment of dividend and capital gains. Actual returns may differ significantly from the results shown. The demographic assumptions, returns, and ending balances are shown for illustrative purposes only and are not intended to provide any assurance or promise of actual returns and outcomes.
Source: T. Rowe Price.

At the same time, appropriate controls mean that an actively managed strategy that's designed in this way can offer a similar risk profile to passive portfolios that track a broader market index:

- Diversification across sectors, industries, and individual companies is part of the appeal and can help to offer significant capacity for institutional clients.
- Market-like regional and sector weights, as well as factor exposures such as momentum or style (growth versus value), can help to blunt the risk posed by sharp shifts in market leadership.
- This approach should yield a neutral portfolio that doesn't rely on a particular subsection of the market to generate excess returns. In other words, the potential for outperformance is spread across a diversity of sectors, industries, and individual companies.

These qualities may strike clients as compelling after the roller coaster ride of the past several years and the extraordinarily narrow market of 2023, when a handful of mega-caps drove the bulk of the upside.

A little bit can go a long way

Aiming to approximate the risk characteristics of an index might limit the magnitude of a strategy's potential excess returns over shorter time frames.

However, these controls also reduce the risk that it will underperform the benchmark by a wide margin.

In a more subdued long-term environment for equity returns, even a modest excess return from active management could make a meaningful difference in retirement outcomes (Figure 2).

Our analysis, for example, suggests that an additional 25 basis points in excess return over 40 years of savings could result in an additional two years of retirement spending. Increasing the excess return to 50 basis points could add five additional years of spending.

Bottom line: An analyst-driven strategy that combines the best of active and passive investing has the potential to make a real difference for clients over the long term. Evaluating the people and process is critical to identifying strategies with the potential to deliver above-market returns with market-like risk.

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