Building portfolios with active, passive, and smart beta strategies

Investors increasingly recognize that both active and passive strategies can be useful when building a portfolio. We'll take a look at these strategies and explain how investors can benefit by combining both to achieve their financial goals.

What is **passive** investing?

At its core, passive investing is simply buying an investment and holding it for a long period of time. Perhaps the most common type of passive investing is index investing, where you invest in a fund that is designed to track a well-known market index. For example, investing in a mutual fund or an ETF that tracks the performance of the S&P/TSX Composite Index, or the S&P 500 Index is common form of passive investing.

Benefits and drawbacks of passive investing

The first benefit of passive investing is reduced transaction costs. Passive investing is typically buy and hold, meaning you are not making a lot of buys and sells in your portfolio. This has two benefits. First, you minimize your transaction costs. Second, you are also less likely to trigger capital gains, meaning you'll likely end up paying less in taxes, leaving more money in your portfolio to grow and compound over time. Another benefit is because passive investments tend to track well-known market indices, they also tend to charge lower fees.

Sound great, right? Well not so fast. There are some drawbacks to passive investing too. Perhaps the biggest drawback is that since a passive investment is designed to replicate a market index, the likelihood of you outperforming that index is extremely low. Another drawback is that certain investment markets may be concentrated in just a handful of industries. This can put you at a higher risk than if you were invested in something that is more diversified.

A great example of a market that is highly concentrated is right here at home. The S&P/TSX Composite Index is very concentrated in just three market sectors; financial services, energy, and materials. According to S&P, on January 31, 2020 the index had 32% in financial services, 16% in energy, and 11% in materials. In other words, nearly 60% of your investment would be exposed to just those three sectors. Any time you have a more concentrated portfolio, you are exposing yourself to a higher degree of risk than you would with a more diversified portfolio.

What is **active** investing?

While the goal of passive investing is to track a market index, the goal of active investing is to outperform a market index. To do this, a portfolio manager makes ongoing buy and sell decisions within the portfolio, trying to take advantage of opportunities to allow the fund to generate above average returns. Quite often, the portfolio of an active manager will look much different than the market in which they are investing. After all, if you want to beat the market, you can't be the market.

Benefits and drawbacks of active investing

It is this potential to outperform that draws many investors to active investing. Good active managers typically follow a very disciplined and repeatable investment process that helps them to not only identify high quality investment candidates, but also to position the portfolio for the market environment. For example, a manager may believe the market is very

overvalued and expected to fall. To prepare for this, the manager has a number of tools at their disposal including increasing the cash held in the portfolio or moving to those securities they believe will do better in a falling market environment. Conversely, if the manager believes the market is poised to move higher, they can increase exposure to the types of investments expected to perform best.

Another key benefit to an active investment strategy is the portfolio may be able to deliver a rate of return that is similar or in some cases better than the market with a lower level of risk. By effectively managing the risk, the portfolio can deliver better risk adjusted returns for investors.

When it comes to drawbacks of active investing, while active strategies have the potential to outperform the market, they can also underperform. Studies published by S&P Dow Jones Indices show that some actively managed funds trail their benchmark over time.

Active strategies may also expose investors to different risks than a passive investment. For example, an active investment may have "key person risk", which is the risk that the investment's performance may be negatively impacted if the investment manager is unable or unwilling to continue to manage the fund. An active strategy may also have a portfolio that is much different than the broader market, which may result in periods where its performance is dramatically different than the market.

Finding the right active strategy can be a complicated process, as there are many factors to review. A detailed review of an active strategy will typically involve an in-depth analysis of the investment's historic returns, investment management team, and investment process. This can be time consuming and may be difficult for the average investor to do effectively. But it can be done, and good high-quality active investment managers can be found.

What is **smart beta** investing

In recent years, a new type of strategy has been gaining in popularity. The strategy is a hybrid between active and passive investing and is commonly referred to as "smart beta". Smart beta is a catch-all term that refers to any strategy that is not purely active or purely passive. In most cases, a smart beta strategy is one that uses a systematic rules-based process to select securities and help build the portfolio. Some examples would include fundamental strategies, equal weight strategies, or factor strategies.

Benefits and drawbacks of smart beta investing

Smart beta strategies are designed to highlight some of the benefits of active and passive strategies, while helping to mitigate some of the drawbacks. For example, one of the issues with passive, cap weighted indices, is that larger companies make up a bigger component of the index than smaller companies. So instead of weighting companies based on their size, each company has an equal weight in the portfolio. Or, another way to weight companies may be used such as weighting securities based on their volatility, or dividend yield, or their score on several fundamental metrics. The result is a portfolio that is likely to be different than the broader market index.

Another smart beta strategy is factor or style investing. Factor investing looks to find securities that exhibit specific identifiable factors that have been shown by research to deliver above average returns over time. By investing in one or more factors, there is the potential to improve the return of a portfolio, while helping to reduce its risk.

Many factors have been identified over the years. Some of the more popular ones include low volatility, momentum, quality, value, and dividend yield. Low volatility looks for securities that have less day to day fluctuation than the average. Over time, securities with lower volatility have been shown to deliver average or better returns, with less risk over

the long-term. Momentum is based on the premise that stocks that are rising are likely to continue to rise. It looks to invest in those securities that are experiencing rising share prices and shun those that aren't. Quality investing looks to find those companies that have strong balance sheets and are delivering good return on equity. Quality stocks have been shown to outperform in rising markets and hold their value better in falling markets. Dividend yield is another popular strategy that looks for companies that have a strong history of paying and growing their dividends. Companies that can pay and grow dividends have historically delivered better than average returns over the long-term.

Value investing looks to find investments that are trading below what the managers believe they are worth. Many active managers use this approach, as do many smart beta strategies, with the key being the smart beta strategies will focus more on the quantitative metrics and the active managers may often incorporate more qualitative metrics, and use different ways to measure the true value of a company.

Smart beta strategies are not without their drawbacks. They typically cost more than passive strategies, which may eat into the return potential over time. Another drawback is different factors perform differently than the index in certain market environments. If you have too much exposure to one particular investment style that is out of favour with the market, you are likely to trail the market, at least temporarily.

Combining **active**, **passive**, and **smart beta** strategies

Now that we've highlighted some of the benefits and drawbacks of the different investment strategies, which strategy is best? To be honest, there is no "best" strategy. It is not always a matter of selecting either active or passive or smart beta; instead an investor may want to consider using all of these strategies. By combining the different strategies in one portfolio, you may have a much better chance of earning better risk adjusted returns, more consistently than by using just one approach.

For example, using a passive investment strategy as the foundation of your portfolio will provide you with the basic exposure to a particular asset class. However, if you are simply replicating the market, you will not likely be able to outperform the market in either up or down markets. Incorporating a blend of smart beta and active strategies with the passive foundation, you can help to better diversify the portfolio by providing exposure to different investment styles that may help enhance returns and potentially reduce your risk.

It is this approach that we used in building our Empire Life Multi-Strategy GIFs which include three equity mandates and three balanced funds. When building the portfolios, we started with a passive investment to provide the foundational exposure to the equity market we are investing in. Next, we layered in a mix of smart beta strategies selected based on our view on the markets, with the goal of earning better returns than the passive strategy, with less risk.

Finally, we brought in a select group of high-quality active managers that would help to enhance return and reduce overall risk. These managers were subjected to a rigorous investment review process that blends quantitative analysis with fundamental, qualitative research. Once we had all the components in place, we used a portfolio optimization approach to help find the mix of the various strategies that would give us the best chance of delivering strong risk adjusted returns and reducing the overall risk.

By blending passive, smart beta, and active strategies, Empire Life Multi-Strategy GIFs provide exposure across investment styles, geographies, and industry sectors to increase diversification. They are designed to complement our existing Empire Life Guaranteed Investment Funds, offering you more choice to help achieve your financial goals.

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A description of the key features of the individual variable insurance contract is contained in the Information Folder for the product being considered. **Any amount that is allocated to a Segregated Fund is invested at the risk of the contract owner and may increase or decrease in value**.

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