Seven trends in investment management to watch out for

Investment management is evolving into three distinct branches: indexing, smart beta/factor investing, and pure alpha

By : PAUL MCCAFFREY

RONALD N Kahn's book, The Future of Investment Management, drew its inspiration from the changes that have transformed the finance industry over the last several decades.

"What we do today and particularly what we do today in the details," Mr Kahn told delegates at the 72nd CFA Institute Annual Conference in London held from May 12 to 15, 2019, and hosted by CFA Society of the UK, "is completely different from what we did 20 years ago."

So from his perch as managing director and global head of Systematic Equity Research at BlackRock, Mr Kahn surveyed the landscape and sought to answer two questions: "What has changed, and how should we change with it?"

He looked at how the industry has evolved and sought to anticipate where it would be heading in the coming years. He highlighted seven key trends, with an emphasis on two in particular - big data and smart beta - that he saw as especially impactful.

"Smart beta is a disruption," he said. "Big data is the big opportunity for active management."

The way Mr Kahn sees it, investment management is evolving into three distinct branches: indexing, smart beta/factor investing, and pure alpha.

"Each of these three branches is going to offer two styles of products," he said. "Return-focused and sustainability."

Active to passive

The more or less one-to-one shift from active to passive or index funds is investment management's elephant in the room.

"It's certainly bad news for active managers," Mr Kahn said. Of course, it's difficult to call it news these days. "It's a phenomenon that's been going on for at least 10 years," he said.

And it's not hard to see why. The brief against active management is extensive and backed up by ample data. Although behavioural finance and excess volatility, for example, show that active management can outperform, that outperformance tends to be short-lived

Active managers can identify informational inefficiencies that the market doesn't yet understand and trade on them. But informational inefficiencies are what Mr Kahn calls "narrow and transient sources of return" - they work until the market figures them out and then they stop working.

So in order for active managers to outperform for an extended period, they have to keep finding informational inefficiencies. Otherwise they will return to the mean, which after expenses and fees are calculated, effectively means below it.

"We expect the average active manager to underperform," Mr Kahn said.

Increased competition among active managers

This is another round of bad news for active managers; increased competition means there are fewer hidden market inefficiencies and they are no sooner discovered than exhausted.

"As more people understand these market inefficiencies and trade on them, they disappear," Mr Kahn said, citing a paper by R David McLean and Jeffrey Pontiff, "Does Academic Research Destroy Stock Market Predictability?"

Academics uncover market inefficiencies, publish them, and the market trades them out of existence.

Indeed, Mr Kahn noted, the sell-side quant firms send out regular emails and basically everyone has relatively easy access to what the academics are identifying.

"One thing we know for a certainty," he said, "the next great investment idea is not going to come from SSRN."

Changing market environments

Michael Lewis got it wrong in Flash Boys, according to Mr Kahn. High-frequency-trading (HFT) and similar market developments are not quite the catastrophe for retail investors or the larger investment industry that Lewis described.

These shifting environments are mixed news for active management.

"On the good side," Mr Kahn observed, "as investment moves from active to index . . . the other side of the trade is likely to be an index fund." That means that active investors will be mostly competing against uninformed indexes.

The challenge then is for the institutional investors, those that occupy big positions and may have front-running and other concerns.

"There's always somebody on the other side trying to do the best they can relative to us," Mr Kahn said.

Big data

"If there's any great news for active management," Mr Kahn said, "this is it."

The data revolution, spurred by the internet, has closed the information gap in investing. Now anyone with an internet connection can access all the data that used to be the purview of professional investors.

At the same time, these developments have made countless new varieties and volumes of actionable information available. Definitions of big data vary, but Mr Kahn says it tends to be higher in volume and higher in frequency and reveals digital traces of human behaviour. Big data takes a variety of forms - text, search data, social media, images, and video, among them - and can provide investors with insight into alpha-generating market inefficiencies or potentially leading indicators that get them ahead of consumer sentiment.

"This explosion of available data, along with the analytical development of machine learning," Mr Kahn said, "is the greatest new opportunity for active management in many years."

Smart beta

But next to the potential possibilities big data may have for investment management and active investing is the disruptive force of smart beta.

"These are active products with some of the benefits of indexed products," Mr Kahn said. "It's not an investment innovation, it's a product innovation."

Such strategies are transparent and rules-based efforts to outperform the market. Small-cap, momentum, value, growth - these are all factors that were previously a form of active investing but that have now been a systematised and effectively indexed.

"None of these are new ideas," Mr Kahn said. "We've taken successful components of active management, and are selling them cheaply."

"What fraction of active returns are smart beta?" he asked. "On average, the factors explain 35 per cent of active returns."

If you're delivering smart beta returns, you shouldn't be charging active fees.

But what about pure alpha? Is there still an opportunity?

"Investors need all the returns they can get," Mr Kahn observed, whether they're university endowments or pension funds. "They want the returns from indexing. They want the returns from smart beta. They want the returns they can get from pure alpha. Pure alpha can only be gotten from active managers. This has to be a key focus for active management going forward."

Investing beyond returns

Environmental, social, and governance (ESG) investing and sustainability have generated an enormous amount of interest in Europe and increasing interest in the United States and Asia.

Mr Kahn describes this trend as "Investing beyond Returns", and says it's not strictly about risk and returns, but something else. He connects it to the concept of utility function.

"We may all want portfolios that reflect our own particular utility," he said, "and it may be harder to put together a one-size-fits all product."

That said, Mr Kahn believes that ESG can be delivered with more certainty by investment managers than active returns.

"There's a set of ESG investments that are pretty straightforward and satisfy a reasonable number of investor needs," he said. "No tobacco, oil, military defence - you don't need a lot of sophistication to deliver a portfolio that doesn't have those stocks."

Where it can get complicated is with ESG scores, which are often company reported and may reflect company policies rather than actual practice.

"This is where ESG and big data overlap," Mr Kahn said. "We can measure company performance. It may be a bit messy. The investors who are looking for more subtle ESG, without being just exclusionary . . . that might be an opportunity for active management."

There is also an opportunity for mass customisation. ESG criteria can be subjective, depending on the particular investor. They may want to put more emphasis on social justice issues, as opposed to environmental ones, or vice versa.

Whether such methods lead to higher returns is almost immaterial.

"I think this is here to stay," Mr Kahn said.

Fee compression

Given all these headwinds, fees have come down, even within product categories.

And one area where Mr Kahn expects further declines is in active fixed income, where fees have farther to fall.

The future

Active management is evolving into smart beta/factor investing based on risk premia, which, like indexing, provides exposures as cheaply and reliably as possible, and pure alpha investing based on informational inefficiencies.

These inefficiencies are "rare, capacity-constrained, and valuable", according to Mr Kahn, and big data might be able to uncover them. Investors can always find ways in which the markets don't reflect the underlying data.

That said, big data is no panacea for the challenges confronting active management.

"It's not a gimmick," Mr Kahn said. "But it's not a guarantee of success forever and ever."

The writer is the editor of Enterprising Investor at CFA Institute. Previously, he served as an editor at the H.W. Wilson Company. His writing has appeared in Financial Planning and DailyFinance, among other publications.