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Discussion of "*The Active vs. Passive Asset Management Debate*" by T. Roncalli

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Outline

Before Starting Any Debate: The State Of The Art

New Trends And New Regulations

Seen from a regulatory viewpoint; main **points of interest**

- Smart-Beta, Factor Investing, Indexing
- Closet Indexing, Transparency
- Shadow Banking, Stress Tests.

Recent regulations are addressing some of these points

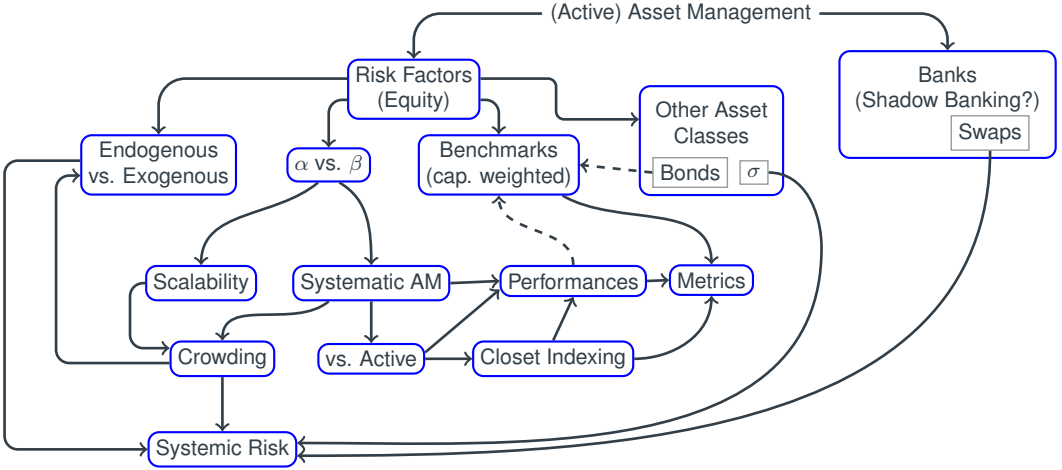
- Benchmark Regulation, PRIIPS, MiFID 2.
- Expected impact of these regulations on the asset management industry?
- Ex-post **metrics to measure their impact**?

Keep **new "trends"** in mind:

- "Artificial Intelligence",
- Alternative data.

Main Themes of Thierry's Presentation

A Lot of Concepts Linked Together



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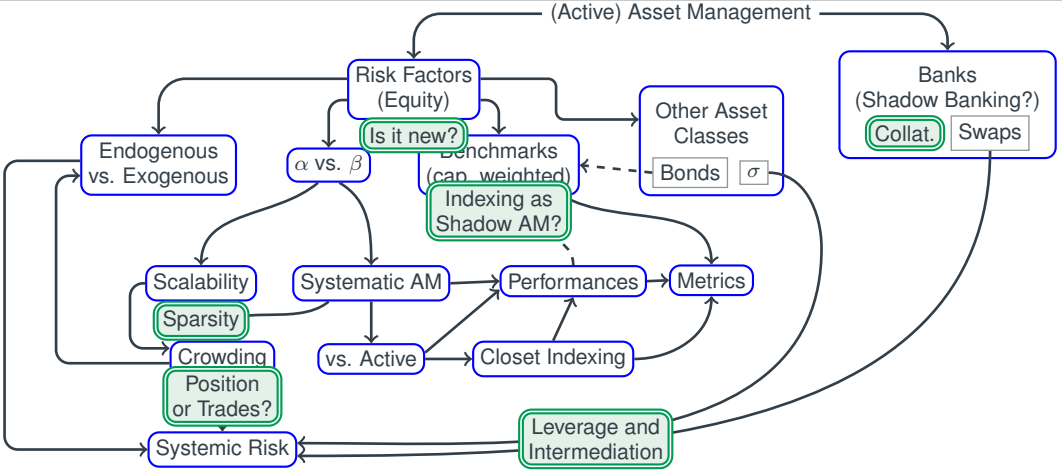

Systematic Asset Management

The Positionning of Systematic AM in Between Passive and Active Answers to a Lot of Questions

The term **systematic** is not easy to define and the term **rule based** is too vague, it is different from **automated** asset management. The principle is: "*you can introduce new rules, but you have to apply them universally*", while automation suggests you never change the rules.

The study of **systematic management** raises interesting question:

- On the one hand it provides **more transparency** than other forms of active management,
- On the other hand it could carry **operational risk**, and a fear of **systemic issues**.

As usual with automation and computerized systems, we will learn a lot in **applying any analysis** of systematic AM **to discretionary AM**.

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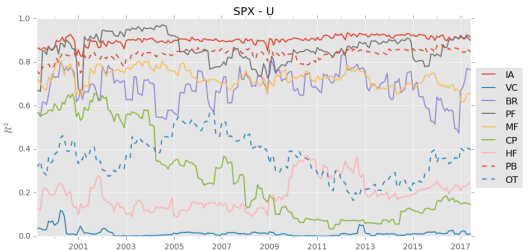
Crowded Strategies, Portfolios or Trades?

Is Crowding of Portfolios Important?

Topics about crowding have been raised by the marketing success of smart-beta and ETF. What if too many investors adopt the same investment strategies?



On-going work with Matthieu Cristelli (CFM)

In the 13F US database, you have enough information to investigate:

- If you look at an aggregated level for different asset manager types (IA: Investment Advisors, PF: Pension Funds, MF: Mutual Funds, HF: Hedge Funds),
- You can compute the proximity (R^2 of a regression on weights) of their portfolios with the market portfolio (restricted here on the S&P500).

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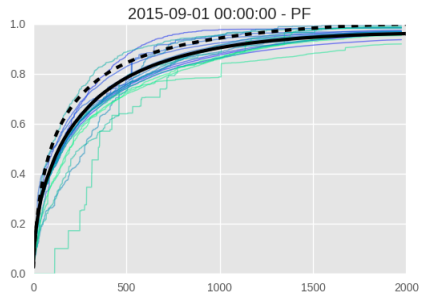

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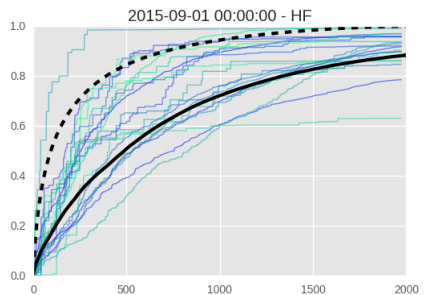

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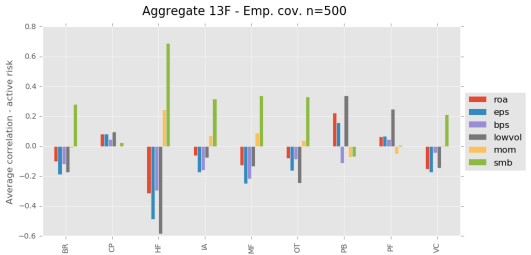
Crowded Strategies, Portfolios or Trades?

What About Crowding of Strategies? of Trades?

We do not fear “crowding” on the market portfolio, first because **it is endogenous**, and second because we believe it is **liquid enough**. In fact what concerns us is the trades, not the positions. In a factor-driven world, the trades are driven by maintaining an exposure to specific portfolios.



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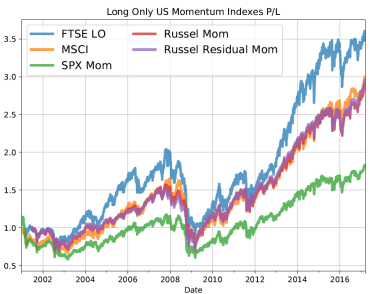

Joint work with Amine Raboun (Univ. Dauphine and Euronext)

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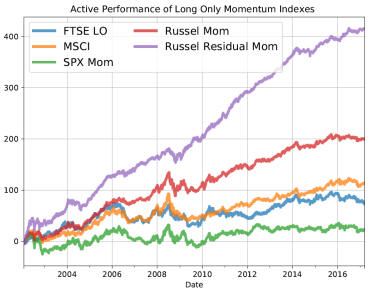

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- Just keep the active returns of these long only versions
- And compute their correlations: they are not that high...

Crowded Strategies, Portfolios or Trades?

To Summarize All These Charts: Systematic (and Factor Based) Investment Does Not Imply Similar Strategies

Is there a **risk of crowding** because of systematic strategies?

- Crowding of positions is not a problem by itself, the **crowding of trades** could be
- The example of Factor investing shows that even for the "same factor" (momentum), **implementation details decrease** the correlation between the trades (for more, have a look at [Benzaquen et al., 2017])
- Nevertheless, **most factors are not independent** (think about Small minus Big, Low volatility, ESG, etc)
- Moreover, are Factors very different from usual investment strategies (Quality and Value)?
- Probably only **risk-driven smart-beta** strategies are (max diversification, minimum variance, etc), and the associated portfolios are **sparse**.

☞ we should more fear the potential **temporary synchronization of trades** rather than the day to day crowding or herding.

This temporary synchronization problem is the same for systematic and discretionary strategies:

- Potential synchronization should come from **risk control**,
- **Stress tests** are clearly targeting this kind of issues, and should be applied to all the asset management industry.

Crowded Strategies or Similar Vocabulary?

The Emergence of a Common Language To Describe Active Exposure

To conclude the part of the discussion about crowding

- **Factor-driven literature** delivered a common language more than efficient strategies,
- **Smart-beta (ie risk driven) literature** improved the existing language on portfolio construction,
- All these concepts came from risk monitoring (MSCI-Barra, APT, etc).

Thanks to that investors, managers, regulators should be able to discuss relying on common concepts (analogy with financial mathematics). But we have some **remaining problems**:

- More academic work is needed: **independent factors, how to combine them?** (see [Roncalli, 2013] and [Darolles et al., 2012])
- **Market liquidity is missing**, it is needed to pay attention to the dynamics of a portfolio, especially to future trading costs (attempts: [Garleanu and Pedersen, 2013], [Cardaliaguet and Lehalle, 2017] and [Lacker and Zariphopoulou, 2017]).

The positioning of index-based ETF would be clear if the two upper points would have been solved. They would be the basic bricks of this language for investment.

Outline

From Shadow Asset Management to Shadow Banking

Who is Building Factor Driven And Actively Managed Products?

What could be **Shadow Asset Management**? Shadow Banking is Banking services provided by non banks; here we are talking about **Asset Management services provided by non asset managers**.
Typically:

- **Index providers** ;
- Banks providing **Swaps on "Factors"** .

The former are now better classified thanks to the **Benchmark Directive**, nevertheless (at author's knowledge) nothing addresses "backtests of indexes" (no PRIIPS for Indexes). Typically, investible **Indexes should be self-financed**.

As **intermediaries**, the latter are meant to provide risk transformation services, potentially using leverage. **What kind of risk is intermediated via Factor-Swaps?** Very difficult to say because of **a lack of data** (products, AUM, Benchmarks, etc). More transparency would help.

More standard forms of shadow banking takes place between asset managers and banks via lending, repo, etc.

Outline

The Asset Management Industry is Evolving Towards More Standardized Practices

Factors and Risk-Control Are Interesting Tools to Describe Strategies, But More Work is Needed

Twenty years ago, the asset management industry was driven by

- The **CAPM** credo $\Rightarrow$ all that is not cap. weighted is active and discretionary;
- The **Modern Portfolio Theory** $\Rightarrow$ i.i.d. risks and returns, no liquidity.

Now we have

- **Multiple rewarded risk drivers**, market anomalies and risk premia,
- Evolution in **portfolio construction** (risk budgeting, risk-driven smart-beta portfolios).

As a consequence, this industry is rethinking its business model: ETF, systematic management, Indexes, Swaps, etc. came in additions to “standard” passive and active management.

- First of all, the added value is **the emergence of a common vocabulary**, but it has to be stabilized (regulators could help).
- Second, part of the debate focused on systematic asset management (is it “really” active?) especially when you consider ETF on active Indexes. **If the issue comes from crowding, no need to focus on a specific type of asset management**.

We had now session of smart-beta and active management on the one hand, and sessions on behavioural bias on the other hand. **Could/Should we mix them?** What about using systematic management to prevent bad bias to harm investment strategies?

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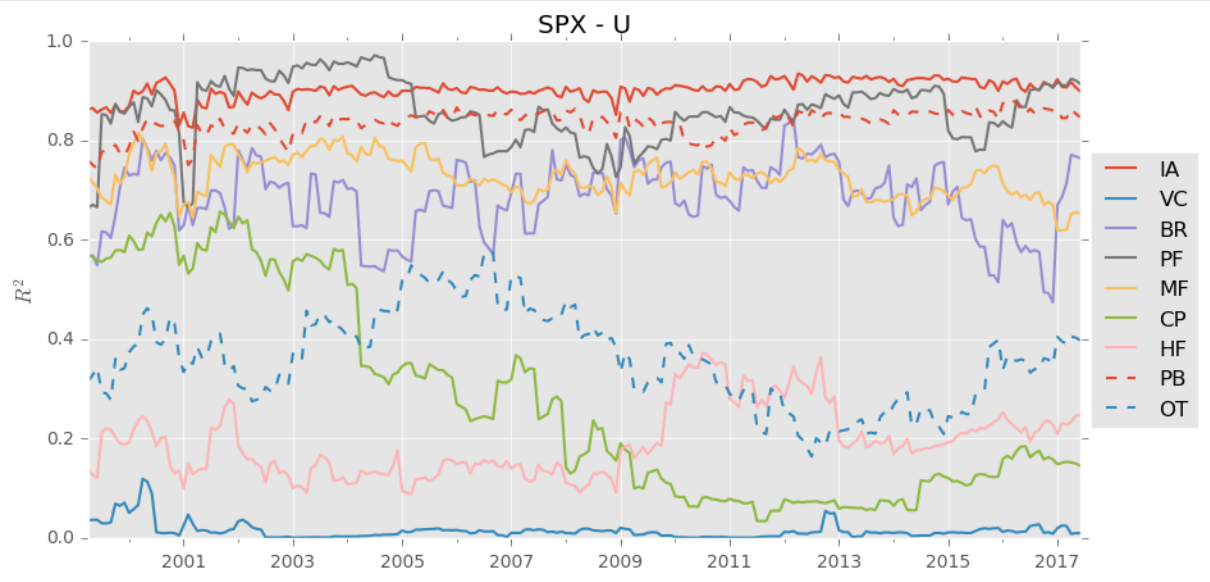
SPX - U
R^2
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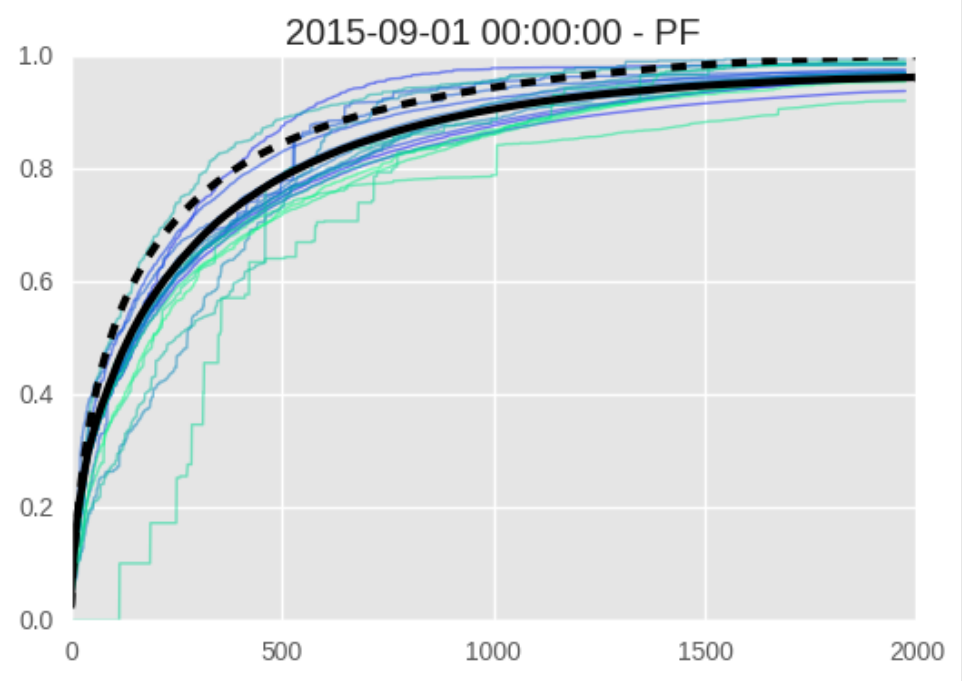
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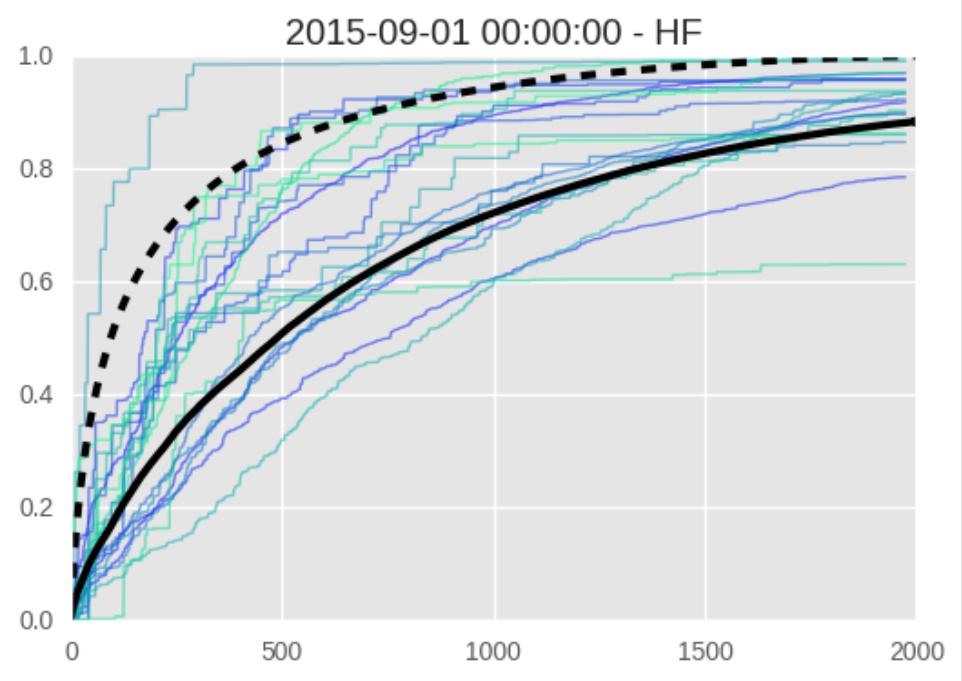
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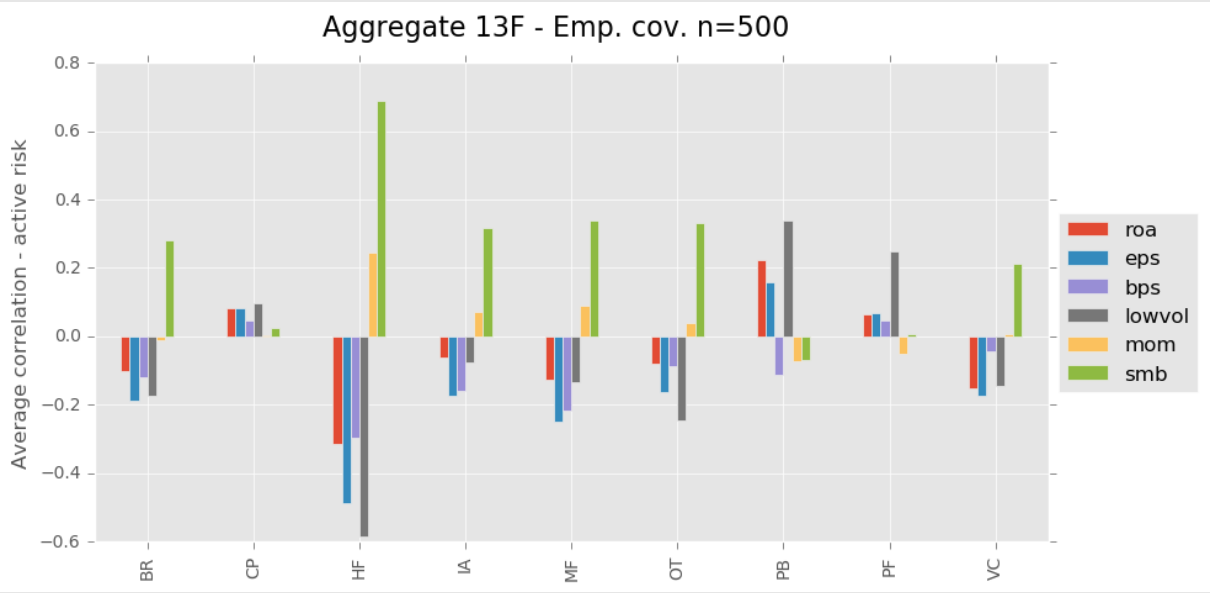
Aggregate 13F - Emp. cov. n=500
Average correlation - active risk
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bps
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mom
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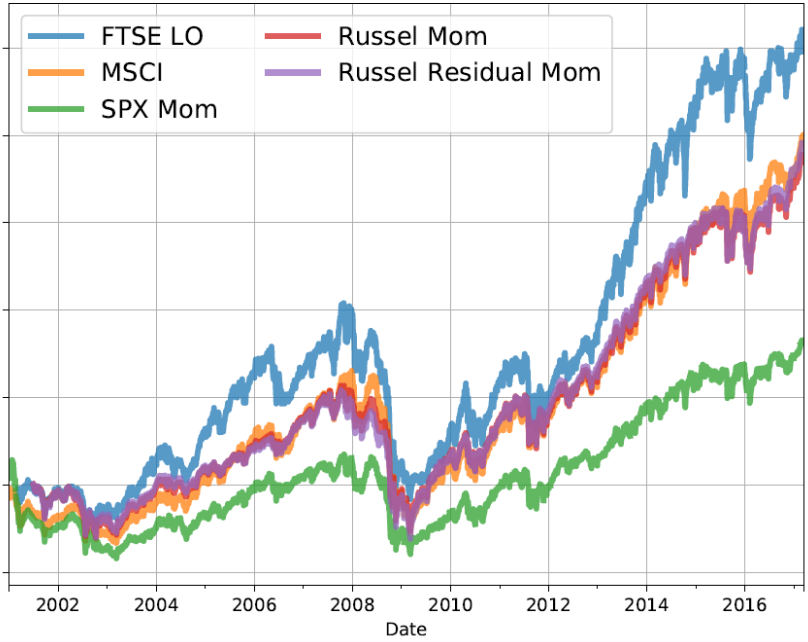
Long Only US Momentum Indexes P/L
FTSE LO
MSCI
SPX Mom
Russel Mom
Russel Residual Mom
3.5
3.0
2.5
2.0
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2002
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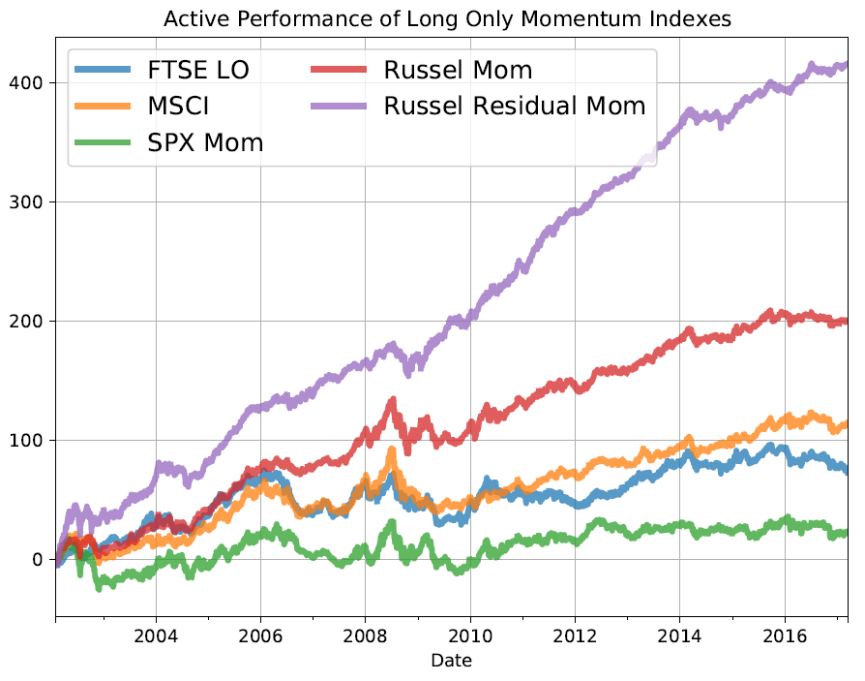
2016
Date


Active Performance of Long Only Momentum Indexes
FTSE LO
MSCI
SPX Mom
Russel Mom
Russel Residual Mom
400
300
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2004
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