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Bernstein's Passive-Active Strategy

Is 'pactive' really a new way to invest or another name for smart beta?

By Gregory Bresiger

Advisors can have the advantages of active investing yet simultaneously enjoy the benefits of passive strategies.

Such is the promise of a money manager who offers the best of both strategies through a blended style he calls "pactive" investing. It is the active use of passive investment vehicles such as ETFs and macroeconomic analysis, according to Richard Bernstein, the founder of his own money management firm, Richard Bernstein Advisors (RBA).

The pactive approach gets the best of both worlds by changing the debate over whether passive or active is the best long-term strategy, he says.

"It really doesn't make any difference whether it is active versus passive," he said at a recent conference. "The most important question to ask is what do you buy and when."

"RBA is a top-down, macro investment manager," Bernstein wrote in a letter to investors explaining his firm. That means he's putting little emphasis on individual stock selection.

"About 90% of the risk that we take in this portfolio is macro factor risk, whereas only about 10% is attributable to stock selection. A high-concentration stock-picking strategy would likely be the exact opposite, i.e., 90% of the risk would be stock selection risk and there would be very little macro risk," Bernstein wrote.

His firm has some $6.5 billion in assets. Bernstein says pactive, a term that the firm has trademarked, has many advantages. That's because it takes a unique approach to risk, he says. (Please see the sidebar, "Bernstein's Arguments for Pactive Investing.")

But some argue that the pactive approach is another kind of smart beta, getting the best of index investing with less risk because one doesn't stick to one style.

Various kinds of blended investing strategies have been around for decades. Pactive is one of a group of flexible investing concepts that came out of the tech crash of 2001, after so many investors were burned by excessive risk, says Chris Brightman, chief investment officer of Research Affiliates. Pactive investing, Brightman adds, is an important trend that has been going on for the last decade.

"Whether you call it smart beta, factor investing or pactive, it is all referring to the same thing," Brightman says. "It is using the technology of indexation to deliver the well-understood sources of excess return, a way to beat a simple index."

Richard Bernstein

Bernstein, however, says pactive is not smart beta. "Pactive is the decision regarding which beta to own and when," he said in an interview with *Financial Advisor*. "We've found that the choice of beta is considerably more important than whether beta is smart or dumb."

Still others say pactive investing is an example of something very old becoming new again. It is merely another kind of investment blending approach, says one market observer.

Ben Johnson, an analyst with Morningstar, contends that the mixing of various investment styles is not new. He adds it is too soon to decide if Bernstein's pactive idea works.

"In theory it sounds good. But in practice, this is still active management," Johnson says.

Bernstein's numbers are good. For instance, his Global Risk-Balanced Moderate ETF Strategy has returned 8.81% a year over the past five years through December 31, 2017, which is about 2% better than its style index. However, Bernstein's firm only began in 2009. Will pactive investing work in the next market crack-up?

According to Bernstein, it has already withstood some market woes, and he contends the style is essential for many investors and advisors. That's because typical individual investors, he warns, consistently underperform. They are buying the wrong funds, often oblivious to risk levels.

That means they are taking on too much risk or perhaps the reverse, Bernstein adds. "The numbers show that over the past 20 years, the typical investor has performed in line with cash," he said at a recent event.

He said that the average individual investor was scarred by the 2008 market disasters and has been on the sidelines since then, missing the huge stock market runup, and has only recently considered re-entering the market. So how will Bernstein do better for the average investor who often seems to jump into the market just as it is tanking and takes shelter in cash when the market is poised to roar?

Bernstein argues that his pactive approach minimizes risk through stringent beta measurement. He makes selections based on the dangers and opportunities, but he emphasizes the former. Without proper beta measurement, he cautions, alpha won't matter.

He adds that the best asset classes are rarely in the winner's circle from year to year because risk factors change quickly. Some passive indexes could become dangerous and burn investors as they did in the lost decade at the beginning of the century.

Real returns in U.S. large-cap stocks were in the red between the end of 1999 and the end of 2009, recording a loss of 4.21% a year, while U.S. small caps lost 0.09%, according to Thornburg Investment Management.

"The decade from 2000 to 2009 was marked by two bubbles that burst," Thornburg wrote in a report, emphasizing that it is in long-term holding periods of 20 to 30 years that investors obtained good returns. The money manager noted that the long-term returns of the stock market going back to the 1920s is 9% a year.

But many investors will never see that number, Bernstein says. In short periods of a decade or less, in times when investors and their advisors adopt one style and stick to it despite changing risk factors, returns can be egregious.

"Investor returns during the lost decade in equities were a perfect example of poor beta management," Bernstein says. The indexing pilot was on automatic, he complains.

"The widely held view during the late 1990s was stocks for the long term was a winning strategy, and that [investors] could not go wrong with a simple S&P 500. Unfortunately, the S&P 500 underperformed many other stock indices during the next 10 years," he says.

Investors and advisors had put too much faith in passive investing and forgotten which index fund to buy and when, according to Bernstein. He notes that autopilot investing is again becoming popular. But that could lead to more misery, although his short-term outlook for the market anticipates continued good times. Passive investing has become hugely popular over the last decade because this has been a great period of little volatility with no tech or housing bubbles.

It's a good time to run a fund family built around passive investing, and it has been for about a decade. Indeed in 2007, flows into funds using passive styles were slightly ahead of the active funds flows: $8.6 trillion to $7.2 trillion, according to Morningstar, which excludes money market funds. By last year, Morningstar said, the passive flows trend accelerated. It had reached $18.1 trillion versus $11.4 trillion for active funds.

The passive investing boom has even led the well-heeled to take another look at this pedestrian style. Indeed, even for wealthy investors, passive styles have a strong appeal, says Christopher C. Geczy, adjunct professor of finance and academic director of the Wharton Wealth Management Initiative.

"The big issue still applies," Geczy writes in a paper. "That's the issue of whether you believe in trying to beat the market or whether you believe in minimizing costs. Some of the most successful entrepreneurs I know think about costs."

But the focus on cost reduction and just trying to duplicate an index can lead investors into the stupor of forgetting the risk factors as they put portfolios on a passive autopilot, Bernstein warns. Some view it as just another example of how the average retail investor follows the latest shiny object and ends up with poor returns.

Brightman of Research Affiliates endorses pactive investing as one of the ways that advisors can reduce risk. "Yes, the reason why smart beta was developed was the horrible experience that people had with passive investing in the aftermath of the tech bubble," Brightman says.

He adds that those who had passively invested in a capitalization-weighted index "lost enormous amounts of their wealth." However, those using smart beta "didn't lose money." Brightman also finds parallels between today's market conditions and the euphoria of the late 1990s.

If another crash comes, Morningstar's Johnson says that pactive investing will be on trial because the active management of passive investing will be on trial. "We have no way [of knowing] whether the portfolio manager you have recruited to help you avoid any nastiness that would be associated with any downdraft in the market will be successful," Johnson says.

"The laws of active management still apply," he adds, "irrespective of whether or not the instrument you are holding in your portfolio are index ETF funds or individual stocks or bonds or some combination of all of the above."

Bernstein disagrees, and told *Financial Advisor* that his firm "managed to completely avoid the energy debacle in 2014." He added, "Our portfolios are currently positioned to avoid a significant fixed-income bear market. I guess we'll see if that works, but so far it seems to be working well." FA

Bernstein's Arguments For Pactive Investing

- It is a unique combination of active and passive management
- It is tactical and can take advantage of significant changes in asset class leadership
- It is a relatively low-fee active management
- It is transparent and liquid
- There is skill involved in allocating ETFs. History suggests that most investors are quite poor at asset allocation and equity allocation.

Richard Bernstein Advisors

Opinions and estimates contained in this article are subject to change without notice, as are statements of financial market trends, which are based on current market conditions. This article originally appeared in the April 2018 issue of *Financial Advisor* Magazine.