BALANCING PORTFOLIOS

Combine active and passive for optimum performance

Well-executed active management has the potential to add value relative to a static asset allocation implemented through index funds. Francois Passant at Vanguard Investments, explains the importance of asset allocation, the case for indexing and role of active funds in core-satellite portfolios

A portfolio's allocation among the major asset classes – stocks, bonds, and cash – is often claimed to be the most important decision in structuring a broadly diversified portfolio to meet an investment goal. When implemented through an indexing strategy, the asset allocation decision accounts not only for most of a portfolio's short-term variations but most of its long-term performance as well.

However, active management, when thoughtfully executed, can potentially add value relative to a static asset allocation implemented through index funds. Investors and their advisors can maximise a portfolio's potential for alpha by selecting talented managers with low costs and incorporating them into the portfolio in a manner that doesn't sacrifice control of systematic risk factors.

In short, indexing and active management can be complementary in a portfolio context. A core-satellite structure provides a useful conceptual framework when considering how to combine active and index strategies. In these portfolios, the core holdings, typically a large portion of the assets, are held in index funds. Satellites surround the core holdings and incorporate active strategies. The indexed core holdings provide the portfolio with a high degree of risk control and the active satellites provide the potential for enhanced performance. For the strategy to be effectively implemented, risk control must also be considered when selecting and incorporating the satellites.

"INVESTORS AND THEIR ADVISORS CAN MAXIMISE A PORTFOLIO'S POTENTIAL FOR ALPHA BY SELECTING TALENTED MANAGERS WITH LOW COSTS AND INCORPORATING THEM INTO THE PORTFOLIO IN A MANNER THAT DOESN'T SACRIFICE CONTROL OF SYSTEMATIC RISK FACTORS"

Vanguard now manages some $1.25 trillion in index and active funds across all major asset classes. By incorporating research and academic results with our extensive practical experience, we have a cogent perspective on how to construct risk-controlled portfolios likely to result in consistent outperformance.

DRIVERS OF LONG-TERM PERFORMANCE

The statement, "a portfolio's asset allocation is the investor's most important decision", makes intuitive sense. A portfolio of money market instruments can obviously be expected to perform differently from a portfolio of equities.

Empirical research studies performed over the past 20 years have documented the importance of the asset allocation decision in determining the portfolio performance of balanced investors. On average, conventional investment management activities such as security selection and sector rotation (or market timing) have a modest impact on long-term performance levels.

Recent studies by Vanguard's Investment Counseling & Research department[1] confirmed that asset allocation accounts for most short-term fluctuations. More importantly, we showed that, on average, over the long term, the index implementation of the static asset allocation decision resulted in higher returns than the actual return earned by active management for diversified portfolios.

ACTIVE VS PASSIVE RETURNS

A 2003 Vanguard study[2] showed that active strategies produced benchmark-lagging performance on average.

In contrast to conventional wisdom, the asset allocation decision matters in both bull and bear markets. For 66 balanced funds with returns during bear markets in US stocks (such as the autumn of 1987 and from January 2000 to December 2001), static asset allo-

cation implemented through index funds resulted in higher returns on average than the fund's actual returns. During the long secular US bull market from 1981 to 2001, similar results were observed on average for the 420 balanced funds in the study.

An additional study[3] by Vanguard confirmed that only a small percentage of active managers succeeded in producing alpha.

THE CASE FOR INDEXING

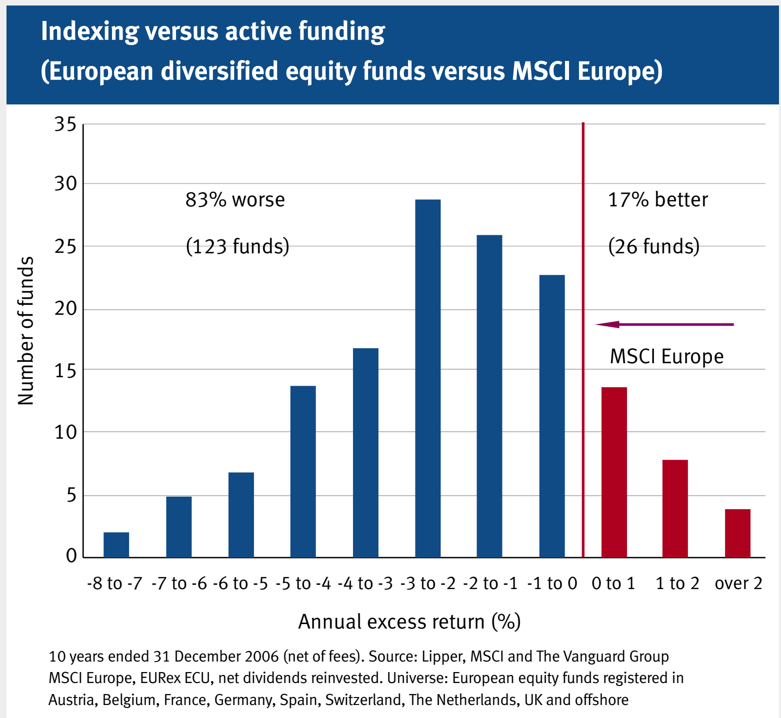
These studies have two implications. The first suggests that a balanced investor only needs to use index funds to implement an asset allocation policy. The second is that indexing can provide a floor for acceptable long-term performance. To fully understand these implications, consider why indexing works.

An index fund invests in the same securities, or a sampling of them, that compose its target market index. An index fund's performance will therefore approximate the index returns, trailing it only slightly because the index funds incur some management expenses while the index itself has none. Over time, the straightforward approach of matching the market's return results in relative outperformance.

The reason is simple mathematics. By definition, markets are a zero-sum game. Before costs, half of all euros invested in stocks or bonds will outperform the market, and half will underperform. Subtract transaction costs and management fees, however, and markets become a negative-sum game. The percentage of euros winning shrinks, the percentage of euros losing grows, and the average return of all investors trails the market return by the amount of their average costs.

Index funds typically boast much lower operating and transaction costs than actively managed funds. By losing less of the market return to cost, index funds

Indexing versus active funding
(European diversified equity funds versus MSCI Europe)



10 years ended 31 December 2006 (net of fees). Source: Lipper, MSCI and The Vanguard Group
MSCI Europe, EURex ECU, net dividends reinvested. Universe: European equity funds registered in Austria, Belgium, France, Germany, Spain, Switzerland, The Netherlands, UK and offshore

can beat a majority of active managers on an after-cost or net return basis. This fact has been confirmed through many studies of historical fund returns in markets around the globe.

Conventional wisdom holds that indexing is considered most effective in markets where systematic risks are predominant factors affecting the cross-section of returns, such as in the bond and the large-cap stock markets. In fact, indexing can be successfully applied to virtually any asset class.

Overall, when compared to the average active fund (see chart), index funds have provided superior long-term performance, greater predictability of returns, greater diversification, and applicability to any asset class or sub-class. Indexing establishes a "floor" under a fund's performance, making possible highly competitive returns in the long run and in any given year.

CORE-SATELLITE MANAGEMENT

The core-satellite framework is used to construct portfolios with the potential to add value above the performance floor provided by the indexing implementation of the asset allocation decision. In a typical core-satellite portfolio, a large portion of the assets are held in low-cost, broadly diversified index funds to provide the portfolio with a risk-controlled "core holding."

Portions of the assets, the satellite holdings, are held in actively-managed funds that seek to add alpha. By acknowledging that there are market segments where indexing is extremely effective, the core-satellite strategy tries to add value where it is deemed most likely to succeed. When gifted managers exist, a satellite holding can be used to add alpha.

The core-satellite approach may reduce overall portfolio management costs that undermine the performance of traditional actively managed portfolios. The core investment through index funds generates the market's return at the lowest cost. The satellite investment results in higher fees being paid only where higher returns are expected.

Risk control can be built into the satellite portion of the portfolio by assembling a group of

diversified active funds with a low correlation of alpha and reducing volatility.

While these concepts provide useful guidelines to mitigate individual manager risk, selecting talented, or even gifted, managers is critical.

At Vanguard, where independent firms manage many of our active funds, we look for firms that have strength in four areas: people, philosophy, process, and performance. The most effective firms, we have found, have long-tenured staff with strong continuity of leadership, proven expertise, and deep bench strength. These firms have a long-term orientation, an enduring philosophy, and clearly defined, disciplined processes.

Stability, along with low costs, stands out as essential for consistent competitive performance.

BASIC PRINCIPLES

When successful, a core-satellite strategy captures the predictability of indexing and the diversification benefits of low costs with the potential of active management. However, it is important not to lose sight of the larger picture. When implemented through an indexing strategy, the asset allocation decision accounts not only for most of a portfolio's short-term variations but most of its long-term performance as well. Investors should focus on adding incremental alpha above the floor of acceptable performance offered by indexing only after making their asset allocation decision and forming risk-controlled, broadly diversified portfolios.

"WHEN SUCCESSFUL, A CORE-SATELLITE STRATEGY CAPTURES THE PREDICTABILITY OF INDEXING AND THE DIVERSIFICATION BENEFITS OF LOW COSTS WITH THE POTENTIAL OF ACTIVE MANAGEMENT. HOWEVER, IT IS IMPORTANT NOT TO LOSE SIGHT OF THE LARGER PICTURE"

CONCLUSION

- Combining passive and active management can add value to a portfolio;
- The core-satellite concept helps to structure passive – active strategies;
- the index core holding provides the portfolio with a degree of risk control;
- the active satellites constitute a source of enhanced performance;
- The core-satellite approach perfectly applies to family offices/high net worth individuals portfolios as well as to any other institutional clients.

[1] Extended version of Gary Brinson's study in 1986 titled 'Determinants of Portfolio Performance'.

[2] A study, comparing the returns and the volatility of 420 actively-managed US balanced mutual funds to their benchmarks from 1962 and 2001, found that asset allocation explained 76.6 per cent of their short-term fluctuations in value. On average, the static asset allocation implemented through index funds also outperformed.

[3] Reviewing the performance of 214 balanced funds from 1966 to 2003, we found that, on average, the indexes outperformed the active funds by five basis points per month before costs and 22 points after subtracting the active funds' costs. At the same time, the index funds were only 90 per cent as volatile, on average.

CORPORATE STATEMENT

Vanguard INVESTMENTS

Contacts:
- François Passant, executive director
- Waterloo Office Park
  161 drève Richelle – Building P
  1410 Waterloo
  Belgium
- Tel: +32 2 357 14 10
- Fax: +32 2 357 14 49
- Email: info@vanguard.be
- www.vanguardeurope.com

Vanguard Investments Europe is the European asset management and marketing arm of The Vanguard Group, Inc (VGI). Founded in 1975, VGI is an independent asset manager owned by the U.S. funds it manages. We aim at being the world's highest-value provider of investment services, offering investment solutions at the lowest possible cost. Being a strong proponent of indexing, Vanguard has also over 30 years experience in advisory relationships with external specialist managers for its range of actively managed equity funds. In Europe, we promote Vanguard's high standards - in particular those of the "core / satellite" investment approach, strategic asset allocation, long term investment and cost optimization.