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SPECIAL REPORT: OUTLOOK 2018

Future looking bright for active management

Managers eye expected lower markets as way to draw investors from passive push

Taimur Hyat, Chief Strategy Officer and Head of Marketing and External Relations for PGIM

By James Comtois

Money management executives are expecting that low market returns and high volatility in 2018 will lead to more opportunities for savvy active managers.

That doesn't mean investor appetite for index strategies or exchange-traded funds is waning — just that prospects for active managers are expected to increase.

"Passive will continue to get good flows, but conditions are improving for active to add value," said Lori Heinel, executive vice president and deputy global chief investment officer at State Street Global Advisors, Boston.

With accommodative monetary policies by three central banks — U.S. Federal Reserve, European Central Bank and Bank of England — beginning to slow, halt and reverse, investors can expect higher dispersion in returns across asset classes such as equities, fixed income and currency. That, in turn, could provide more opportunities for active managers, Ms. Heinel said.

"The big theme (for years) has been the flows into passive. I think we're going to see a reversal of that trend," said George Gatch, CEO of asset management clients, J.P. Morgan Asset Management (JPM), New York.

Mr. Gatch expects active managers to see flows normalize and for there to be a greater interest in differentiated and higher value capabilities from institutional clients.

A survey released by Natixis Investment Managers earlier this month, showed that 76% of investors surveyed believe that several factors — including expected higher market volatility and asset bubbles in 2018 — are leading to an environment that favors active management.

Since many public plans are still in return-seeking mode and some have significant funding issues, many continue to seek alpha via alternatives and multiasset class solutions, said Keith Lewis, head of Americas for T. Rowe Price Group Inc.'s global investment services division, Baltimore.

Technology on the rise

Industry insiders also foresee technology — everything from artificial intelligence and big data to machine learning and risk analytics — will play a significantly increased role within money management.

"AI and big data being used to generate alpha is incredibly important. Likewise, with risk analytics to construct portfolios," said Geraldine Buckingham, BlackRock (BLK) Inc. (BLK)'s global head of corporate strategy in New York.

"Every asset manager has to consider how the role of technology plays into their business," she added.

For quantitative asset managers, technology has always played an essential role. So the increased focus by investors on the benefits of AI and big data is a huge boon to such quant firms as Acadian Asset Management LLC in Boston.

"Technology is another big trend in our direction," said Ross A. Dowd, Acadian's global head of marketing and client service. "We believe we're well-positioned."

Meanwhile, traditional managers looking to improve their technological capabilities will need to figure out how to integrate AI and machine learning into their investment processes, said Christopher Conkey, global CIO of Manulife Asset Management, Boston. However, Mr. Conkey warned: "It's not cheap. It's going to take capital."

As important as technological prowess has become, diversification also is becoming increasingly crucial for asset owners and managers alike.

"Diversification is going to matter. Having more exposure to alternatives and where you are in alternatives is going to

matter," said Margo Cook, president of Nuveen Advisory Services, Chicago.

The challenge, however, is that many investors are not adequately diversified, managers said.

"I'm seeing too much cash, too much U.S.-centric investing," said Douglas Cote, chief market strategist at Voya Investment Management, New York.

Mr. Cote noted that investors "need to be broadly globally diversified across equities and fixed income."

Hesitation over alts fees

One of the main reasons why investors aren't properly diversified is because of a hesitation over higher fees charged by alternatives managers, sources said. In fact, fee pressure and low returns have caused several alternative managers to struggle in recent years.

Joshua M. Emanuel, CIO, Wilshire Funds Management, Santa Monica, Calif., said that he's seen many asset owners reduce or even remove their allocations to alternatives after evaluating their investments and the value they're adding.

For example, Pensions & Investments reported in December 2016 that the $345.1 billion California Public Employees' Retirement System's investment committee decided to reduce its private equity allocation to 8% from 10%.

Also, Rhode Island State Investment Commission, Providence, approved significant reductions in September 2016 to the $8 billion Rhode Island Employees' Retirement System's allocations to hedge funds and infrastructure. At the time, the system had 15% of its assets invested in hedge funds and 11% in infrastructure. Its hedge fund investments have largely been pared in half, while its target allocation to infrastructure has been reduced to 4%, fund documents show.

But Mr. Emanuel advises that investors up those allocations.

"Now's the time for investors to increase their allocations to alternatives," he said. "Alternative investments, while not delivering total return, provide a material diversification benefit to a multiasset portfolio."

Sustainable investing and environmental, social and governance issues are also growing in importance for asset owners, according to several money managers. More investors are focusing on sustainable investing issues — and not just as a separate investment capability.

"Investors want to know whether their investment decisions are being informed not only by valuations and fundamental analysis but also on governance and environmental issues," said JPMAM's Mr. Gatch.

Acadian's Mr. Dowd noted that most mandates his firm is winning outside the U.S. have an ESG component.

More interest in ESG

The Acadian executive isn't the only money manager to see increased investor appetite for socially responsible investing. Jim McDonald, executive vice president and chief investment strategist for Northern Trust Corp., Chicago, also has seen a significant uptick in client interest in ESG issues.

"We're seeing very strong momentum on ESG investing. That wave is building and likely to continue for years to come."

Though most industry insiders believe the odds of a geopolitical event creating a sustained market disruption remain low — "there's a lot of data to show that geopolitical risks are transitory," said Mr. McDonald from Northern Trust — geopolitical risk is still something asset managers need to consider.

"We watch for it, but it's not something we let affect our investment-making process," said Dan Chung, CEO of Fred Alger Management Inc., New York.

Still, this type of risk is getting increased awareness from institutional clients. "Politics has moved significantly higher up on clients' agendas," said Taimur Hyat, PGIM's New York-based chief strategy officer.

Voya's Mr. Cote acknowledged that although some geopolitical risks such as the threat of war from North Korea are "very serious," he doesn't expect military engagement. "With common interests in common trade, I don't expect this to become a problem."

The Voya executive added that a cyberattack on the U.S. power grid is potentially a "very serious … tail risk that could disrupt markets and the economy."

Geopolitical shocks are difficult to prepare for, and although the market has largely shrugged off most events over the past couple of years, such as terror attacks, Brexit, or North Korea's missile tests, it's not something managers can shrug off.

"These (geopolitical shocks) could happen, and you may want to have some insurance in your portfolio, but we don't see anything that's likely to be systemic over the horizon," Ms. Heinel said.