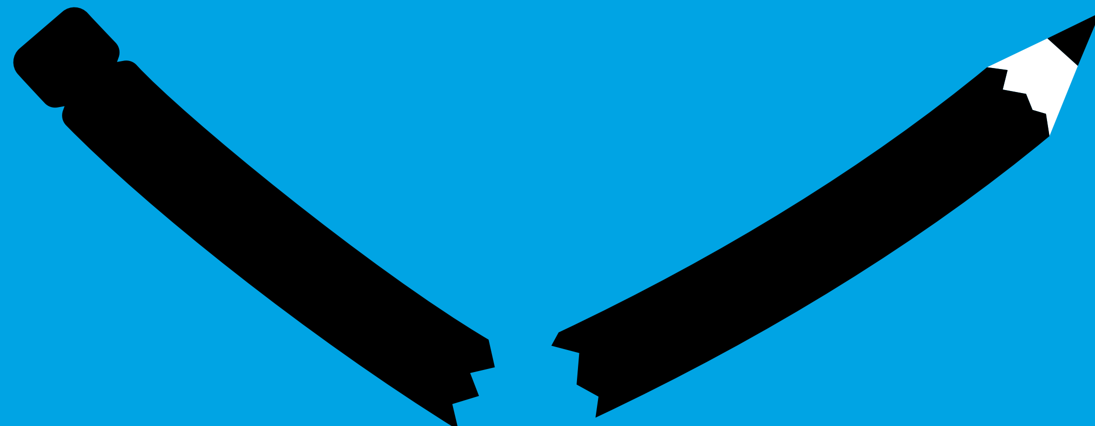
FOR PROFESSIONAL/QUALIFIED CLIENTS AND QUALIFIED INVESTORS ONLY

BREAK WITH TRADITION

Active portfolios start with indexing.



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FOREWORD

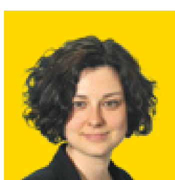
In Europe, profound changes are impacting the way institutions are building portfolios. Conversations with discretionary managers, heads of advisory propositions, unit-linked and fund-of-fund managers echo a consistent message: **end clients demand more for their money**.
In parallel, regulatory changes have put greater scrutiny on the suitability of investments and on cost transparency.

Against this backdrop, the importance of having a holistic approach to portfolio construction has increased. Many distributors and asset managers are re-evaluating their portfolio construction practices to drive greater efficiency. Current practices too often involve siloed decision-making which separates asset allocation decisions from product choices, leading to sub- optimal outcomes for end clients. This is not simply about cost, but also about eliminating unintended consequences and applying a more scientific approach to building a portfolio.

BlackRock has partnered with 750 institutions* as they evolve their business models and portfolio processes. Based on these interactions, work by the BlackRock Investment Institute (BII) and decades of experience from our multi-asset portfolio managers, we believe that today's environment demands a rethink of portfolio construction practices.

Capital at risk. The value of investments and the income from them can fall as well as rise and are not guaranteed. Investors may not get back the amount originally invested.

*Source: BlackRock Portfolio Analysis and Solutions, from January 2019 – May 2020.



Ursula Marchioni
Head of BlackRock Portfolio Analysis and Solutions
(BPAS) EMEA

INTRODUCTION

Across Europe, wealth and asset management businesses are being transformed by changing regulation and shifts in client demand.
A greater focus on value for money is increasing scrutiny on the products that investors have long used to meet client objectives. Transparency of traditional fee structures is changing revenue models. Technology is enabling new competition in the form of "robo" advisors and other automated offerings that deliver simple, cost-efficient portfolio solutions.

For those charged with building client solutions, the focus is moving from single-product considerations to overall portfolio outcomes as the basis for value propositions.

The 'value for money' conversation
The second Markets in Financial Instruments Directive (MiFID II) is focusing end clients' attention on the value for money given, and transparency of the fees they pay to distributors and asset managers. One consequence of MiFID II's transparency requirements is that clients are better equipped to compare propositions.

Distributors are adapting by re-thinking their product selection and balance of index, factor and alpha-seeking strategies, with the aim of reducing overall portfolio costs.

It's the outcome, not the product
Historically, portfolio builders have put significant emphasis and resources into selecting investment products. We believe changes in regulation and markets will move the focus away from products and onto portfolio construction.

In this new environment, the portfolio construction evolution is underway.

Many European investors already recognise this change.
BlackRock has partnered with over 600 institutions in assessing and repositioning existing portfolios, and in building new propositions. Based on these interactions, we reflect on three habits that are shared by some of the most effective 'active' investors.

1

Actively understand the portfolio
Investors are increasingly shifting their processes from fund selection to holistic portfolio construction, with a strong emphasis on technology to inspect portfolio alignment with desired outcomes.

2

Actively identify and combine different sources of resource
Investors are beginning to move past the out-dated dichotomy between 'active or passive'. They understand the importance of differentiating sources of returns within their portfolio -blending index, factor and alpha-seeking strategies.

3

Actively use the whole investment toolbox
With the expanding universe at their disposal, investors are shifting more attention towards greater indexing and a search for true alpha and alternatives.

Source: BlackRock, May 2020. For illustrative purposes only.

1. Actively understand the portfolio

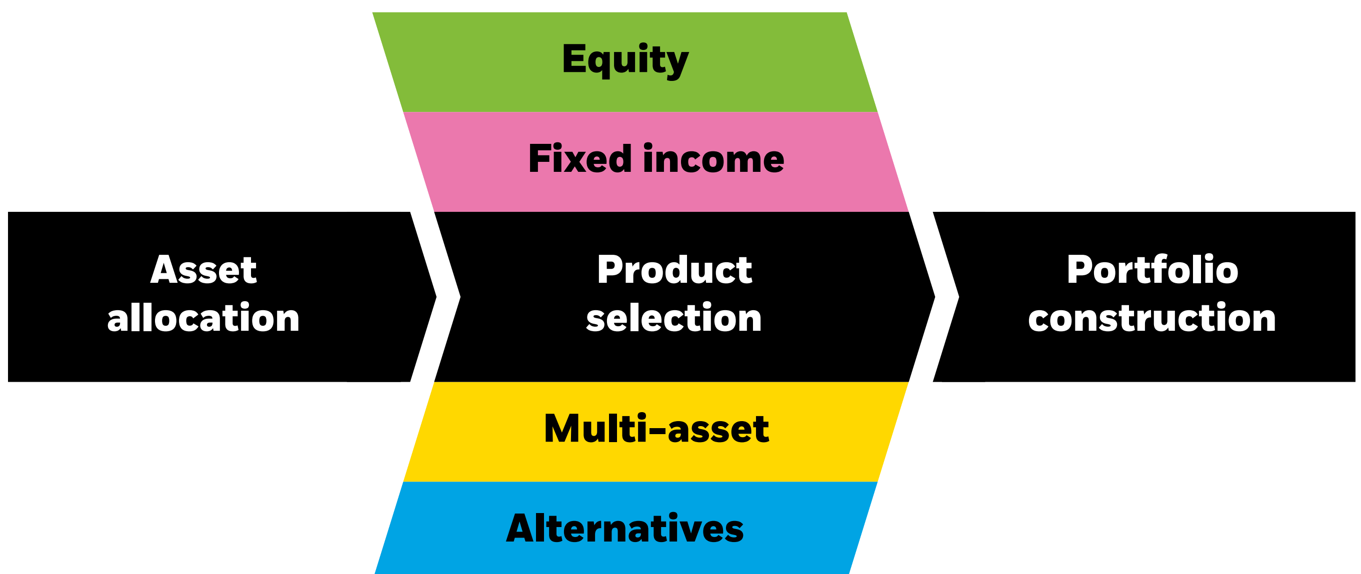
It is increasingly apparent that several product-focused practices favoured by portfolio builders for many years introduce a number of inefficiencies into a portfolio. Rather than a holistic approach which retains a focus on the investment objective and its key drivers, this siloed approach is based on separate asset allocation and product decisions which are then retro-fitted together. Inefficiency is an inevitable consequence.

1.1 Dissecting the status quo

Two of the common product-focused methods for constructing portfolios separate key decision-making activities.

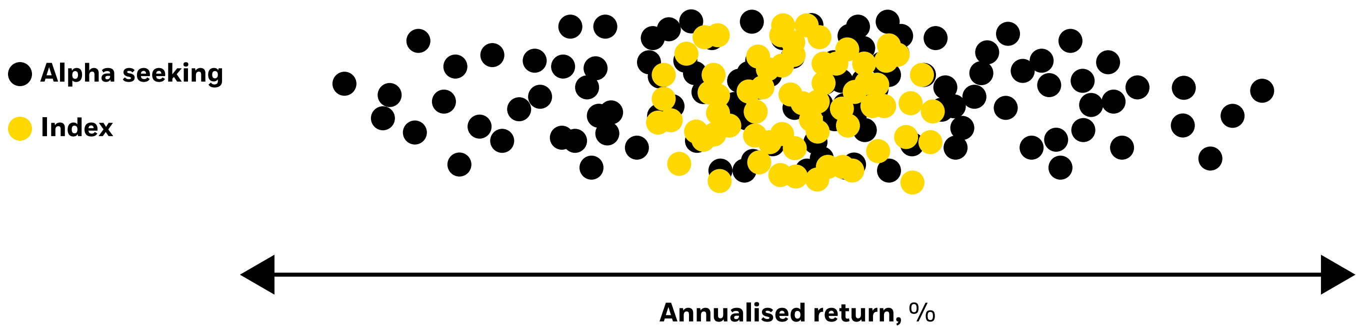
One popular method has three distinct pillars:

- Market insights are harnessed to craft a recommended target asset allocation (TAA) usually in terms of asset classes, regions, industries and sectors.
- The universe of funds that are available to investors are turned into a menu of preferred options for each asset class ('recommended' or 'buy' lists).
- Finally, client portfolios are implemented to mimic the TAA with a combination of products selected from the 'buy' list.



Source: BlackRock, May 2020. For illustrative purposes only.

A second popular, product-focused approach is based on the perceived potential to generate alpha in a specific asset class. Some investors view alpha-seeking managers as the best-suited option in asset classes that exhibit wider dispersion of returns (as illustrated by the black dots below), such as emerging market equities. On the other hand, these investors believe that index strategies are an optimal option in assets that have a tighter returns dispersion (as illustrated by the yellow dots below), such as US large capitalisation stocks.



Source: BlackRock, May 2020. For illustrative purposes only.

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1.2 A new role for technology

Whilst important, fund selection can only be relevant as part of a rigorous portfolio construction process that starts with a clear understanding of the underlying risks and performance drivers.

Multi-asset portfolios benefit greatly from truly holistic monitoring and risk-management systems. Using them, portfolio builders can:

1 Attribute alpha- seeking managers' performance across market, strategic factors, factor timing and security selection.

2 Identify which macro and style factor tilts each manager brings to the portfolio, often beyond the stated (typically asset class- related) objective.

3 Assess how multiple product choices impact each other, and how a combination of different products compare with the originally designed target allocation.

Risk: There can be no guarantee that the investment strategy can be successful and the value of investments may go down as well as up.

Several investors consulting with BlackRock over the past years have pioneered the adoption of technologies to explore holistic portfolio analyses.

Observing their results — and coupling them with practices and lessons learnt at BlackRock, where we have been using our proprietary enterprise system, Aladdin®,[1] for over three decades — we conclude that technology represents a potentially game-changing opportunity for investors.

Risk: While proprietary technology platforms may help manage risk, risk cannot be eliminated.

As systems are upgraded and more widely adopted, investors' ability to implement a more holistic approach will become a day-to-day reality.

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1.3 Controlling and monitoring portfolios holistically

Keeping investment portfolios on course is challenging without modern tools. Technology and risk management systems should therefore be at the core of investment processes.

Without the ability to be able to control and monitor portfolio holistically, investors face potential limitations and inefficiencies, both in terms of fees and risk.

Risk: While proprietary technology platforms may help manage risk, risk cannot be eliminated.

1

The first is that it makes it difficult to optimise fee budget allocation. A product approach prevents investors from assessing whether their overall selection of alpha-seeking managers is, in aggregate, delivering alpha worth paying for or whether — due to unintended cancellation of positions across managers — it is simply giving exposure to markets and factors which could be systematically captured more cheaply via other instruments. As we will see in section 2, these account for the major portion of returns in financial markets.

2

The second shortcoming relates to potential unintended tilts between the target portfolio (e.g. the Chief Investment Officer asset allocation) and the real, implemented portfolio. Investors are becoming increasingly aware that products chosen for a specific purpose — for example to access an asset class such as European equities — deliver additional exposures — for example to certain style factors such as value. These ‘secondary,’ unintended effects might contradict what the investor is trying to achieve through other products and cancel out (or indeed compound) choices voluntarily made elsewhere in the portfolio. In this respect, the absence of a feedback loop between the portfolio’s design and its implementation phase is a real issue.

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Case Study

Over-diversification of alpha

A large UK-based distributor asked BlackRock for help in restructuring its unit-linked product offering, invested across more than 70 investment products with around 50 managers.

BlackRock analysed the offering with the aim of attributing portfolios' performance to market exposure and style factors,[2] vs timing and security selection (alpha). Higher-risk portfolios appeared to generate less alpha than the more 'defensive' portfolios, with most of their performance being driven by market exposure.

Risk: Diversification and asset allocation may not fully protect you from market risk.

The figures shown relate to past performance. Past performance is not a reliable indicator of current or future results.
Source: BlackRock, from 31 May 2015 – 31 May 2020. Currency = USD. For illustrative purposes only. Case studies are for illustrative purposes only; they are not meant as a guarantee of any future results or experience, and should not be interpreted as advice or a recommendation.

2 For a definition of 'style' factors: refer to section 2 of this document or to the BlackRock Investment Institute, "Blending alpha-seeking, factor and indexing strategies: a new framework," July 2018.

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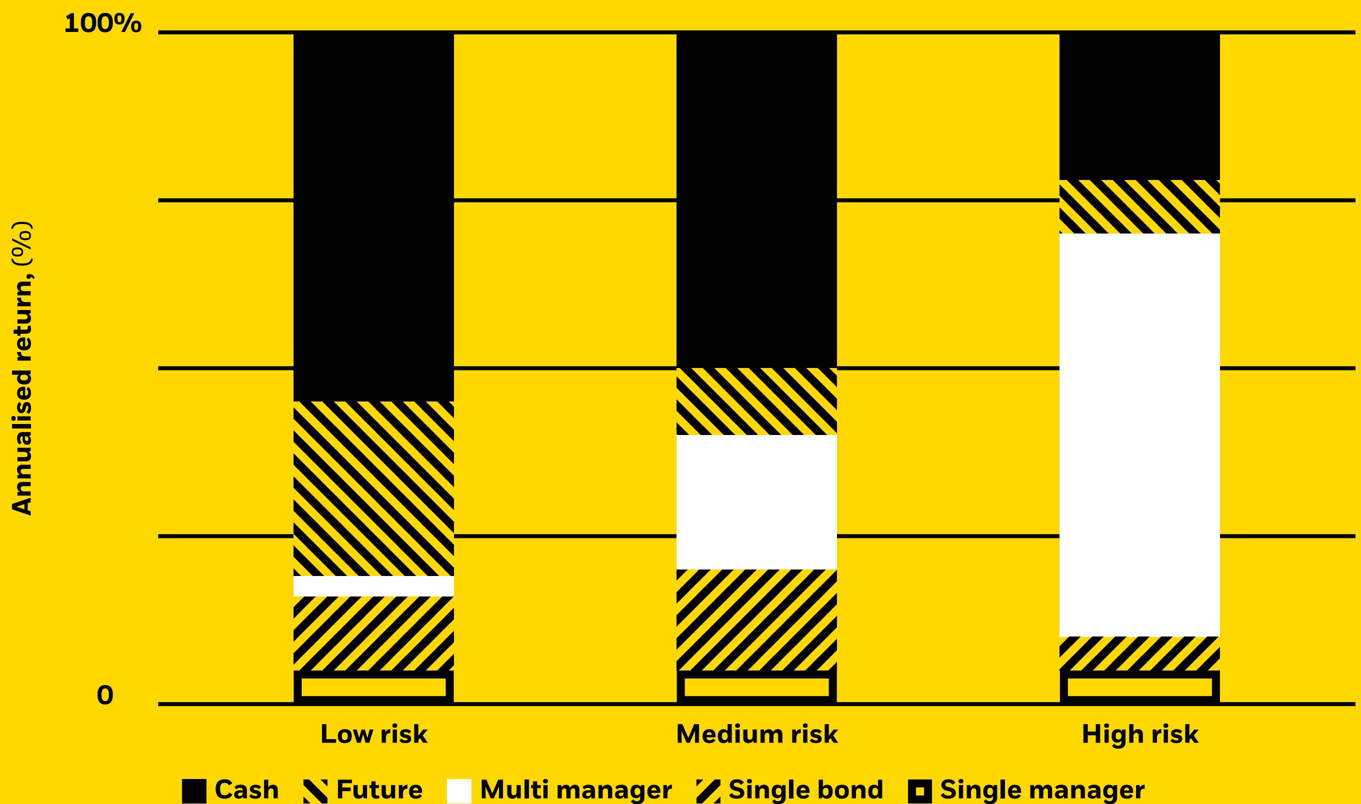
Where has the alpha gone?

% asset allocation by type



The figures shown relate to past performance. Past performance is not a reliable indicator of current or future results.
Source: BlackRock, May 2020. For illustrative purposes only.
Risk: Diversification and asset allocation may not fully protect you from market risk.

Why did the same pool of products deliver starkly different outcomes across the different risk profiles?

The answer lay in the high number of multi- manager vehicles used within the equity asset class. As they moved up the risk profiles within the range, the allocation to equity increased — and thus the number of underlying funds the client was exposed to through multi-managers also increased. For these profiles, it became evident that the efforts of alpha-seeking managers were cancelling out one another at the portfolio level.

Throughout the consultation, BlackRock highlighted the areas where the investor could achieve similar outcomes at a more attractive price point with a combination of broad market and factor index products. This allowed the client to focus on investing in truly performing alpha-seeking managers that would add value to the portfolio. These investments would gain a larger allocation within the portfolio due to the increased risk and fee budget that indexing allowed.

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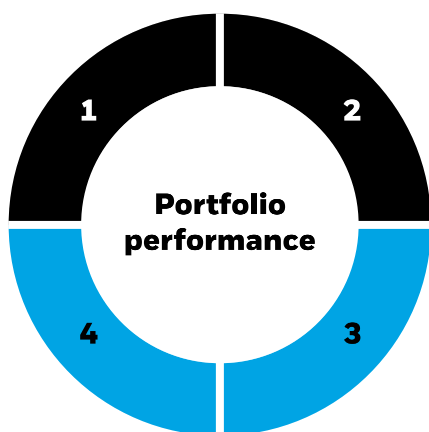
2. Actively identify and combine different sources of return

BlackRock believes that moving beyond siloed portfolio construction practices begins with a re-think of the drivers of portfolio returns.

2.1 Identifying drivers of returns

We identify four components which determine the outcome of a portfolio.[3]



Portfolio core performance

1. Broad market exposures
An investor's strategic asset allocation decisions, or the broad market exposures, and the relative weights the investor wishes to maintain for the long term.

2. Strategic factor tilts
Macro and style factor tilts the investor wishes to embed in the portfolio for the long-term, believing these rewarded drivers of return can help achieve the desired outcome. Popular examples include momentum, quality and size in the equity space and real rates, inflation and duration in fixed income.

Additional sources of return

3. Market and factor timing
Dynamic choices aimed at capturing shorter-term opportunities in asset classes or factors. Opportunistic over- and under-weights of asset classes, countries, industries of factors are primary examples.

4. Security selection
Expression of granular views at single stock or bond level — driven by insights which are not reflective of the broader market positioning.
Over- and under-weights of a single security vs its weight in a benchmark is an example of this.

Source: BlackRock, May 2020. For illustrative purposes only.

Risk: There can be no guarantee that the investment strategy can be successful and the value of investments may go down as well as up.

3 For additional academic research on this taxonomy, refer to: Andrew Ang, Michael W. Brandt, David F. Denison [2014]. Review of the Active Management of the Norwegian Government Pension Fund Global.

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Academic literature published since the 1980s has shown that a significant component of portfolio returns, often above 90%, is linked to choices made about long-term market exposures and strategic tilts at the core of investors' portfolios.[4] In equities, strategic market and style factor tilts can account for a predominant portion of the returns generated by many traditional long- only equity managers, such that simple low-cost and transparent portfolios of market cap index or factor funds often outperform.[5,6] Similarly, core market and style exposures account for significant returns in fixed income.[7] The dominance of market and style tilts is also seen in asset owners' portfolios where market capitalisation benchmarks account for the majority of the variation of returns for sophisticated institutions holding large amounts of illiquid, private market assets.[8]

2.2 Reallocating resources accordingly

Whilst this is not a new concept, investors are increasingly not only accepting these concepts, but also acting to align their day-to-day processes to them.

Knowing that the bulk of portfolio outcomes is largely determined by the first two drivers we described, successful investors have reallocated resources to focus on designing the right strategic asset allocation that balances risk with the required return. Portfolio implementation is then executed under strict monitoring of how the overall portfolio compares and contrasts which such theoretical asset allocation.

The availability of new technologies paired with an ever-expanding choice of investment strategies can, in our view help translate theoretical awareness into real-life portfolio construction practices — and evolve the portfolio construction status quo toward a new set of best practices, where the allocation of resources will be materially different.

2.3 A new framework: Blending across investment styles to achieve efficient outcomes

The role of manager selectors is progressively shifting focus – beyond sourcing outperforming managers and instead prioritising the sources of return that they want to capture and how these can be efficiently assessed through blending index, factors and alpha-seeking strategies.

Risk: There is no guarantee that a positive investment outcome will be achieved.

Going beyond the false dichotomy between 'active' and 'passive' investing, investors are increasing recognising the value of viewing the investment universe through a portfolio lens, and expressing long-term market and factor choices through index vehicles and deploying excess fee budget to acquire alpha excellence from managers skilled in timing exposures and in security selection.

4 Gary P. Brinson, L. Randolph Hood, and Gilbert L. Beebower [1995]. Determinant of Portfolio Performance
5 Eugene F. Fama, Kenneth R. French [2010]. Luck versus Skill in the Cross-Section of Mutual Fund Returns.
6 Joseph Gerakos, Juhani T. Linnainmaam, Adair Morse [2017]. Asset managers: Institutional performance and factor exposures.
7 Christopher R. Blake, Edwin J. Elton and Martin J. Gruber [1993]. The Performance of Bond Mutual Funds.
8 Dirk Broeders and Leo de Haan [2018]. Benchmark selection and performance.

BlackRock Investment Institute portfolio construction paper

Blending alpha-seeking, factor and indexing strategies: a new framework

To assist investors, BlackRock has published a detailed framework aiming to show how to evolve portfolio construction processes and successfully blend index, factor and alpha-seeking strategies.[9]

In this framework, we outline important ways to make portfolios more cost efficient. We believe it's important that investors:

Know what they're buying: Investors need to distinguish between alpha, broad- market and factor returns for two reasons. First, to allow them to allocate to genuine alpha opportunities, including tactical asset allocation. Second, because clarity on the sources of portfolio returns helps ensure investors stick to their strategic objectives by fully accounting for factor exposures across a portfolio's building blocks.

See the full picture: 'Active in X, passive in Y' is too simplistic. A blend based on investor objectives and constraints is preferable — there is no one-size-fits-all answer. Blending alpha-seeking managers with indexing and factor strategies should occur at a portfolio level rather than asset class by asset class.

Alpha-seeking strategies with higher expected alpha — net of fees — should be part of a portfolio regardless of the market and factor exposures driving their active returns, we believe, as these exposures can be accounted for.

Understand time is money: What matters are returns net of costs. Yet product fees vary widely and are client specific. Governance costs to find and monitor alpha-seeking managers can also be considerable.

Many investors have limited resources for these activities. That's why investors must ask themselves: 'Do I have the ability and research capability to oversee alpha- seeking managers?' Investors with a limited governance budget may opt to oversee just a few alpha-seeking managers — or even keep their entire portfolio in index products.

Risk: There can be no guarantee that the investment strategy can be successful and the value of investments may go down as well as up.

Jean Boivin
Global Head of Research for the BlackRock Investment Institute

9 BlackRock Investment Institute "Bllending alpha-seeking, factors and indexing strategies: a new framework", July 2018.

3. Actively use the whole investment toolbox

The surge in the number and variety of investment tools available means that investors can build portfolios in new ways. The growth in indexed investments, as well as an increasing growth in alternatives allowing access to illiquidity premia, are two of the standout trends.

As an example, index products are increasingly offering the breadth and granularity of exposures needed to reach most asset classes and factors. Across asset classes, ETFs deliver precise access to specific countries, market capitalisation segments and sectors. Growing pockets of product innovation revolve around sustainable funds and thematic exposures. The availability of style factor-based exposures is also growing — simplifying access to established rewarded factors such as value, momentum, size, quality and low volatility that, until recently, were only available via alpha- seeking strategies.
Indices with a factor focus are less diversified than their parent index because they have predominant exposure to a single factor rather than the multiple factor exposure of most indices. Therefore, they will be more exposed to factor related market movements. Investors should consider this fund as part of a broader investment strategy.

3.1 Resource and product allocations will evolve

Greater focus on value for money and investment outcomes means increased demand for portfolio precision, granularity in reporting and improved cost efficiency.

As a result, we estimate that index strategies will grow to account for a substantially higher component of European wealth portfolios in the future: from the current ~10% to ~50% and beyond.[10] Enabled by new technology and these investment tools, portfolio builders will focus more time and resources on asset allocation and capturing systematic returns which drive most portfolio outcomes.

At the same time, new opportunities for true alpha-seeking managers will emerge. Replacing 'active funds' that just deliver benchmark hugging returns or static factor tilts with indexing will create more room to focus on real alpha and alternatives where, in our view, investors will remain happy to access strategies at a premium.

10 Source: BlackRock, June 2019.

Case study

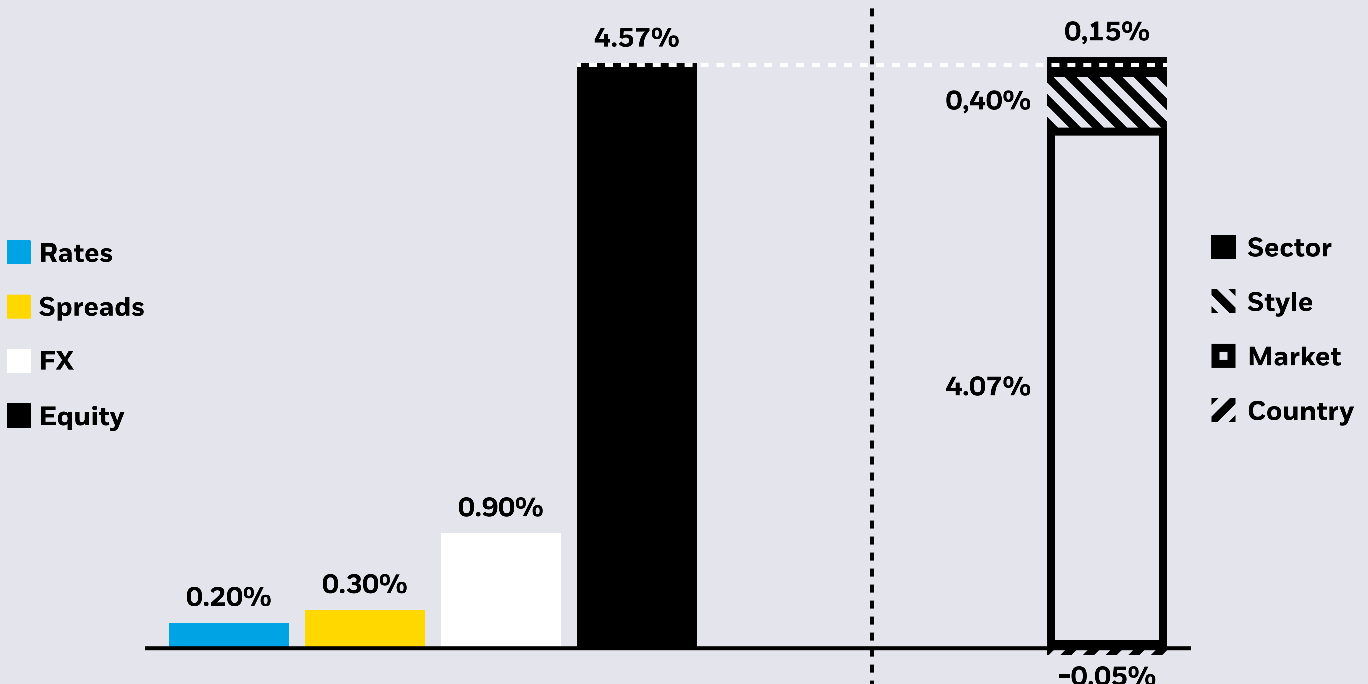
The power of indexing at the 'core' of portfolios

A European private bank asked BlackRock to partner towards achieving more efficiencies in their fund-of-funds offering – with the ultimate goals of reducing fees in the underlying funds and boosting net returns for end clients.

Our work showed how a large portion of portfolio risk was driven by exposure to broad market tilts — and was therefore replicable with a portfolio of ETFs.

Risk: While the investment approach described herein seeks to control risk, risk cannot be eliminated.

Deep-dive into risk contribution



Source: BlackRock, May 2020. For illustrative purposes only.
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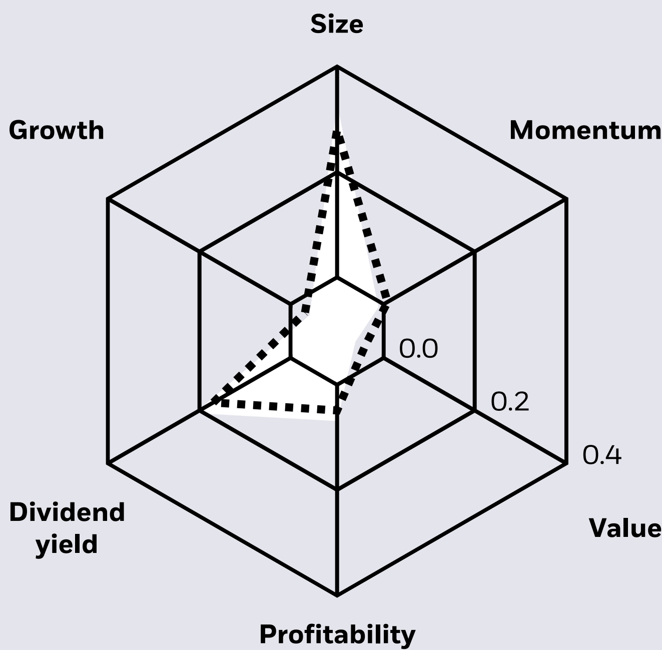
The ETF portfolio we built showed similar macro and style risk factors versus the original portfolio; equally, the two portfolios behaved similarly in backward-looking performance analyses.

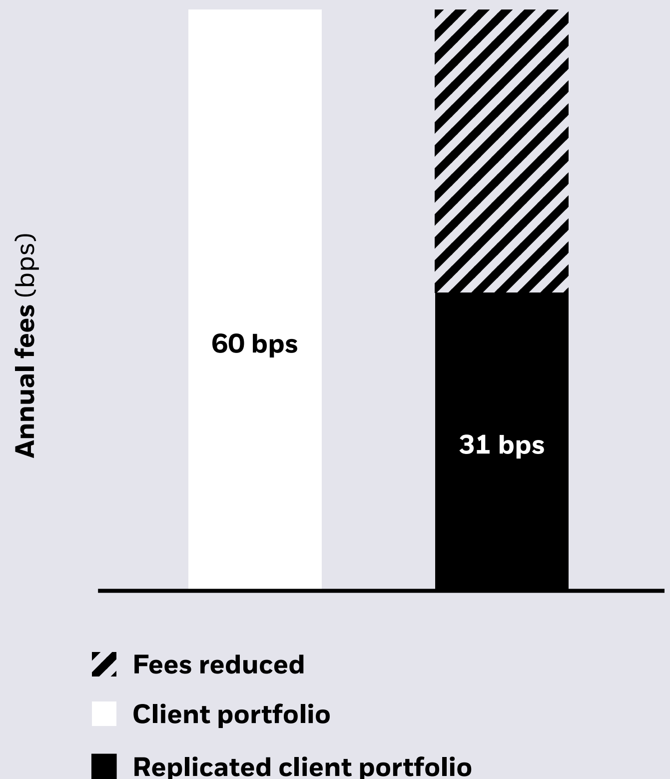
Yet, the new portfolio had the potential to reduce the average expense ratio by nearly 50% (29bps). With the reduction in fees of the investments that capture similar macro and style risk factors, the client was now able to spend more resources — both within dollar and risk terms — of the alpha-seeking section of the portfolio, leading the client to make extensive product substitutions.

Risk: There can be no guarantee that the investment strategy can be successful and the value of investments may go down as well as up.

Equity style factor exposures (Client portfolio)



Fee reduction potential



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3.2 Active portfolios start with indexing

When building portfolios, 'costs' charged to the end client typically reflect not only the annual fee of the instruments selected, but also the time and effort to select and monitor alpha-seeking managers: the constant search, selection, performance assessment and reselection[10].

Identifying 'valuable' managers and the persistence of their performance over time are crucial to manager selection. Sources of alpha are, by their nature, unpredictable and ever-changing. This makes the selection of performing managers both an art and a science.

The BlackRock Investment Institute (BII) conducted an extensive analysis on a sample of about 4,500 managers in the Morningstar database across 21 asset classes between 1997 and 2017.[11]

With a focus on alpha only managers, the analysis looked at top quartile performance persistence over 5-year periods. A meaningful persistence probability for this research would be above 25%.

Interestingly, the team found this to be the case for only a few asset classes based on the set of confidence bands.

In all other cases, the probability showed how the selection of a 'good' manager could not be set apart from a random activity. In other words, to build portfolios which consistently include top-performing managers, high turnover is a must. The perpetual research burden of constantly finding new managers as well as the implementation and transition costs will need to be taken into consideration.

Investors who do not have the capacity to research and regularly monitor their managers may be better off consolidating the number of alpha seeking managers in their portfolio and considering greater index selection. These choices will help to make portfolio and risk monitoring more efficient, while minimising implementation, transaction and governance costs and focusing selection selection skills on the areas of true expertise.

3.3 Striking a balance

Alpha management remains important but finding the right balance is too.

As the opportunity cost of searching for alpha opportunities becomes clearer, we believe manager selection practices will evolve and lead to a transformation of the alpha space which will ultimately benefit all investors.

Through a greater recognition that all investment decisions are active, a consolidation of the number of alpha-seeking holdings in portfolios combined with index strategies taking a greater role at the core of portfolios will enable investors to focus on delivering outcomes with greater efficiency.

Risk: There is no guarantee that a positive investment outcome will be achieved.

11 BlackRock Investment Institute "Bllending alpha-seeking, factors and indexing strategies: a new framework", July 2018.

Conclusion

A new dawn

With new regulation, improved technology and a broader toolset acting as catalysts, investors now have the opportunity to build better portfolios.

To succeed in this new world, we believe institutions should look to shift from product to portfolio outcomes for their clients, and move away from the traditional siloed approaches to a holistic portfolio construction approach.

Our thesis, combined with the habits observed or some of the most effective 'active' investors, is that more efficient outcomes result when holistic decisions are made in the context of the overall portfolio. This stems from a continuous flow of integrated activities — asset allocation, implementation and product choices, and ex-post monitoring — all feeding into one another. The whole process is powered by integrated, multi-asset class portfolio risk monitoring and portfolio construction technology platforms.

Technology powers an integrated approach to portfolio design and product selection, where multiple product combinations can be tested to assess their overall delivery against the target portfolio outcome.

Within an integrated portfolio framework, investors need to place greater emphasis on the strategic tilts and long-term market exposures that make up the core of their portfolio and drive most of its performance. For this, we believe they should embrace ETFs and indexing as the most efficient tools of choice to express views and strategically tilt between asset classes and factors.

The result: a transformation of portfolios with far greater indexing coupled with true alpha-seeking and alternative managers potentially resulting in better returns to end investors.

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Risk Warnings

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