BLACKROCK INVESTMENT INSTITUTE

Looking beyond the silos

A new approach to portfolio construction

The traditional approach to portfolio construction looks outdated. Investors often start by asking themselves whether to choose an active or passive allocation in a given asset class. This is the wrong approach, in our view. To achieve optimal portfolio outcomes, investors should stop thinking in 'active versus passive' terms. It is time for investors to ask how best to blend different sources of return. There is no one-size-fits-all answer: Investors should seek varied return sources in cost-efficient ways depending on their objectives and constraints.

A holistic view

The investment returns generated by managers beyond a benchmark fall into two categories: 1) returns that can be replicated systematically and cost-efficiently by broad market and factor indices, and 2) returns that are driven by true investment skill and cannot be systematically captured through an index. We call the latter alpha. Think of security selection, tactical asset allocation across asset classes and market timing strategies.

Alpha opportunities exist in all asset classes, our work shows (pages 7-8). Yet choosing alpha-seeking managers asset class by asset class can drag down overall returns. And managers should be assessed on the alpha they deliver net of fees. Without a clear understanding of different return drivers and costs, investors can unintentionally fall short of their risk and return objectives. The good news? This is easy to fix. It means breaking down returns. To do so, we turn to factors – the broad, persistent drivers of returns that straddle asset class boundaries.

A holistic approach to a portfolio's returns requires a view on factors – both macro and style factors. Many investors focus on equity style factors such as momentum. Yet macro factors – especially economic growth, real rates and inflation – explain the lion's share of returns across asset classes. See our definitions below. Portfolios may not be as diversified as they look from an asset class perspective. In addition, alpha-seeking managers should be assessed on the role that factors play in their returns. Both factor returns and alpha have a place in a portfolio – and investors should pay appropriately for each. Any investor needs to be factor-aware, in our view.

Understanding factors

BlackRock's definitions of macro and style factors

MACRO FACTORS — **Explain returns *across* asset classes**
Primary drivers of returns that have historically rewarded investors for taking on non-diversifiable risks

STYLE FACTORS — **Explain returns *within* asset classes**
Historically rewarded characteristics that capture a risk premium, behavioural anomaly or structural impediment

Macro factors		Style factors	
ECONOMIC GROWTH Exposure to the business cycle	**CREDIT** Risk of company defaulting	**VALUE** Companies priced at a discount	**MOMENTUM** Taking on trends
REAL RATES Risk of rising rates	**EMERGING MARKETS** Exposure to political and sovereign risk	**CARRY** Harvesting income	**LOW VOLATILITY** Lower volatility than broad market
INFLATION Risk of changes in prices	**LIQUIDITY** Exposure to illiquid assets	**SIZE** Small versus large companies	**QUALITY** Companies with high-quality balance sheets

Source: BlackRock Investment Institute, July 2018. Notes: This graphic shows BlackRock's definitions of macro and style factors. It is for illustrative purposes only.

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BLACKROCK®

Understanding return drivers

Separating alpha from active returns

Investors may not truly understand how different return sources are driving their portfolio – potentially leading it astray. The vast majority of a portfolio's returns will stem from broad market allocations. Yet investors also need to know the make-up of factor returns across the portfolio. These can be acquired in a more cost-efficient manner with indexing and factor strategies, including exchange traded funds (ETFs).

Active returns: Many investors still have relatively high return targets for a low-return world. Broad market returns alone may not be enough to reach those targets. The implication? Generating active returns – those earned beyond a benchmark – is essential. A portion of active returns is often due to persistent tilts to factors. This includes some of what was considered alpha in the past – and now can be acquired efficiently through indexing and factor strategies. Investors should be aware of such tilts and can either keep, replicate through cheaper factor strategies or correct them.

Alpha: We view alpha as the return above static factor tilts. It is driven by investment skill and commands a higher price for that reason. Alpha ultimately comes down to security selection within an asset class, tactical asset allocation (TAA) across asset classes, and timing broad market and factor moves – including with indexing strategies. These are returns that static allocations to indexing strategies cannot capture. See the light blue circles below.

Alpha's evolution: Factors are the latest chapter in how perceptions of alpha have progressed over the years. A few decades ago, alpha and active returns were seen as the same. Then active returns were separated from beta. Now factors have turned into investable strategies. Our empirical work has uncovered what we call common alpha: The return that is common across managers and could reflect systematic strategies not yet captured by an existing index. See the dark blue circle below. Common alpha is grouped with other alpha in our *Classifying returns* graphic. Yet common alpha could be another chapter in the evolution of alpha: It may morph into new factors and indices in the future.

Costs: Costs matter for building a more efficient portfolio. Consistent with decades of academic research, our work shows average fund managers have historically failed to generate alpha net of fees. An investor needs to maintain top-performing managers over time. The constant search, assessment and maintenance of top performing alpha-seeking managers is costly. Yet failure to do this means alpha could be elusive. We call these expenses governance costs. Because fees and governance costs can change and are client specific, our framework for blending alpha and index looks at returns and costs separately.

Classifying returns

BlackRock's taxonomy of returns

RETURN DRIVERS

PRODUCTS/ STRATEGIES	FACTORS: BROAD MARKET	FACTORS: STYLE & MACRO	ALPHA: COMMON ALPHA	ALPHA: MARKET & FACTOR TIMING	ALPHA: SECURITY SELECTION
INDEX/ETF	✓	✓	✗	✓ (self-generated)	✗
FACTOR	✓	✓	✓	✓	✗
ALPHA-SEEKING	✓	✓	✓	✓	✓

Source: BlackRock Investment Institute, July 2018. Notes: This box shows different sources of return and whether they can be currently acquired with an indexing, factor or alpha-seeking strategy. 'Self-generated' refers to alpha investors can generate themselves using index/ETF products.

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How to implement

A new framework

Portfolio construction blending alpha-seeking, factor and indexing strategies

Source: BlackRock Investment Institute, July 2018. Notes: This graphic depicts BlackRock's view of how to best blend alpha and indexing strategies in a portfolio. It is for illustrative purposes only.

We provide a sketch of our new framework above. The design phase takes all the above into consideration: determining the portfolio's return mix while identifying and allocating to alpha efficiently, rather than focusing on active returns. Unlike the traditional approach, assumptions on alpha returns can bring alpha into the design phase along with the usual mix of index returns. Constraints – including regulatory or cost-related – shape the design phase when finding the right blend of returns to meet individual objectives. In the implementation phase, individual alpha-seeking managers are assessed for the factor returns they bring along for the ride. Adjustments can then be made, if desired, to ensure the investor is paying for alpha – not factor exposures.

Key takeaways

1 **Know what you're buying:** Investors need to distinguish between alpha, broad-market and factor returns. Why? We believe there are two main reasons. First, the distinction is needed to allow investors to allocate to genuine alpha opportunities, including tactical asset allocation. Second, clarity on the sources of portfolio returns helps ensure investors stick to their strategic objectives, by allowing them to account fully for factor exposures across underlying portfolio building blocks. Our full empirical work can be found in Blending alpha-seeking, factor and indexing strategies: a new framework.

2 **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 – a holistic approach must be taken. 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.

3 **Time is money:** What matters are returns net of costs. Yet product fees vary widely by client and over time, making them 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 have to 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.

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BlackRock Investment Institute

The BlackRock Investment Institute (BII) provides connectivity between BlackRock's portfolio managers, originates economic, markets and portfolio construction research, and publishes investment insights. Our goals are to help our portfolio managers become even better investors and to produce thought-provoking investment content for clients and policymakers.

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