Active Management Review

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Tom Toth, CFA, Managing Director
Ali Kazemi, Vice President

Active vs. Passive Management

- What is active management?
- What is the role of active management?
- How do you measure active management?
- What are some pitfalls in using active management?

The World Through Risk Lenses

Wilshire views the world through six different risk lenses. Finding the optimal balance between mitigating certain risks while profiting from others is the key to long-term success.

To minimize the potential for Shortfall Risk, investors may take on Active Risk in the form of Active Management

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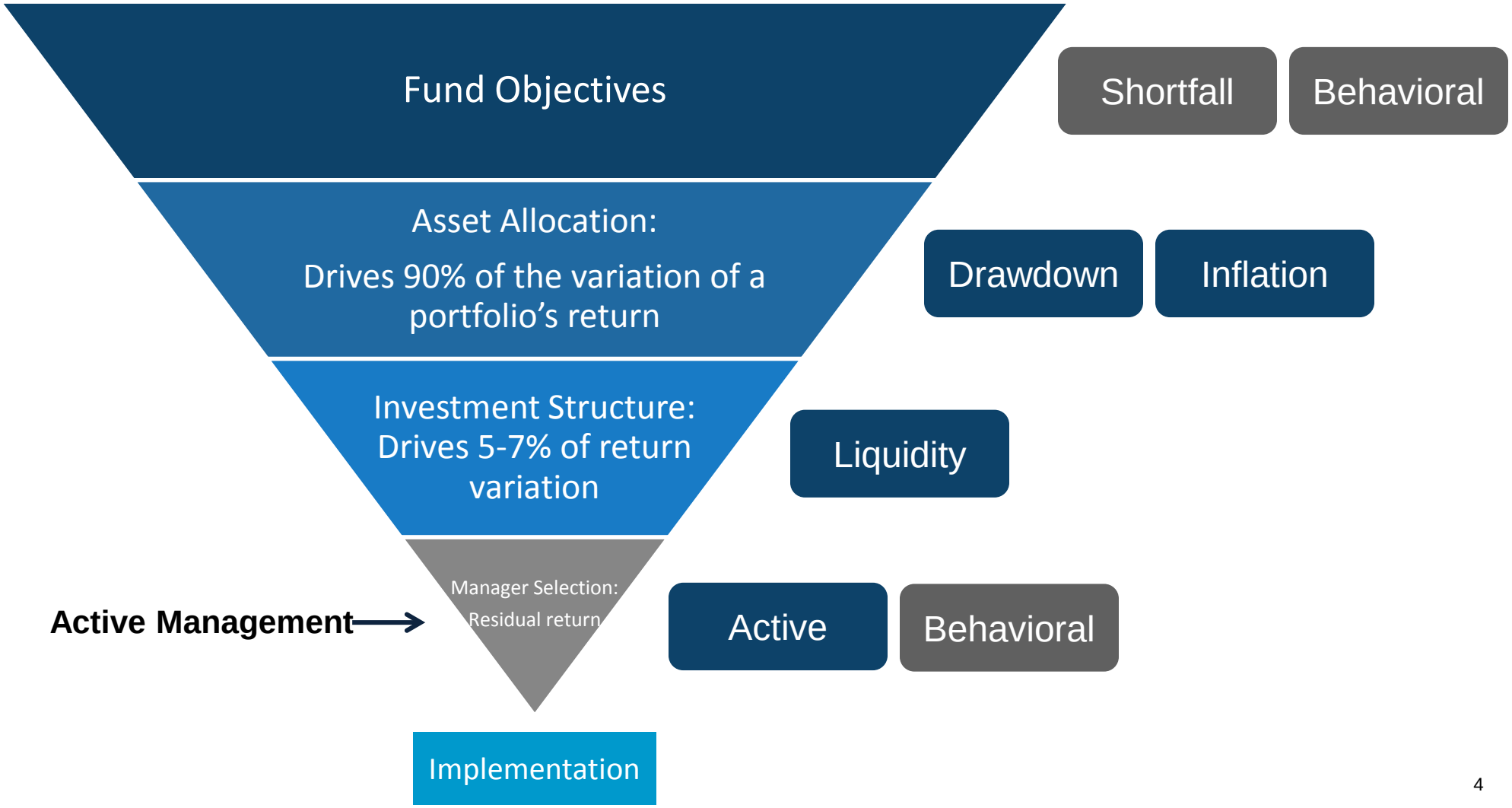
Address Key Risks Throughout the Investment Process

Many of the six key risks are present at multiple points in the investment process, but each distinct step in the process is focused on one or two primary risks.



Defining Active Management

- An active portfolio looks different than the market
  - Active managers select securities to add alpha
- In aggregate, investors own the market
  - Alpha is a zero sum game
- Some sources of alpha include:
  - Security Selection
  - Industry/Sector Allocation
  - Country/Region Allocation

Required Beliefs to Pursue Active Management

1. Market inefficiencies exist
2. Managers can consistently add positive excess returns through a risk controlled process
3. Expected excess return is greater than increased cost of active management
4. Ability to identify skillful managers
5. Access to managers believed to have skill

Starting Point: Market Efficiency - Philosophy

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Investment Category	Market Observations	Recommended Implementation
Equity		
US Large Cap	Highly Efficient	Passive, Enhanced index
US Small Cap	Moderately Efficient	Active
Non-US Developed Markets	Moderately Efficient	Passive, Risk controlled active
Non-US Emerging Markets	Inefficient	Active
Fixed Income		
Core-Oriented	Moderately Efficient	Passive or Active
High Yield, Bank Loans	Inefficient	Active
Emerging Markets Debt	Inefficient	Active
Alternative / Other		
Private Equity	Inefficient	Active
Public Real Estate	Moderately Efficient	Passive or Active
Private Real Estate	Inefficient	Active
Commodities	Moderately Efficient	Passive or Active
Currency	Moderately Efficient	Passive or Active

Starting Point: Market Efficiency and Tracking Error

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- ***Rule of thumb*: Pursue active management only when confident in ability to achieve consistent excess returns <u>net of fees and costs</u> and at reasonable levels of active risk**
- We measure net of fee, risk-adjusted results via information ratio ("IR")
  - Excess return ('alpha') divided by excess risk ('tracking error')
- All else equal, information ratios <u>decrease</u> as we move from:
  - Inefficient to highly efficient markets
  - Low risk i.e., ('tracking error') to high risk strategies

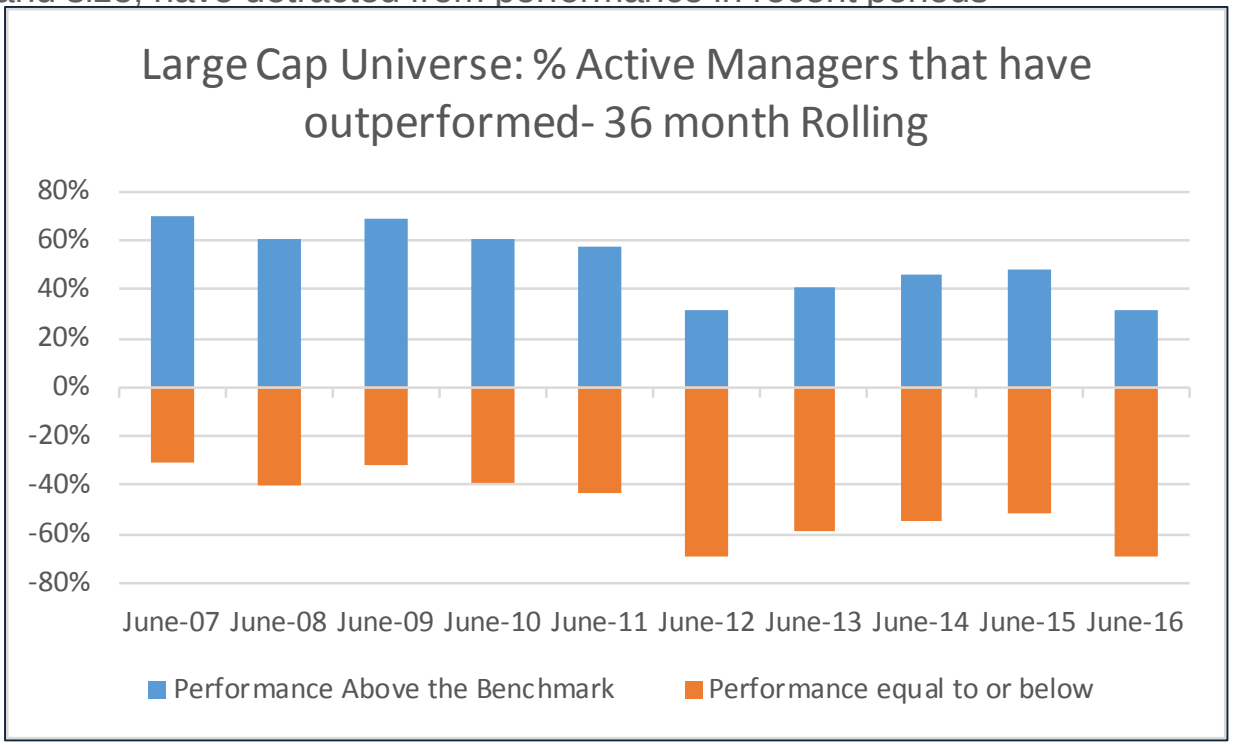
Highly Efficient	Large Cap Domestic Equities		
	Core Bonds, TIPS	Small & Mid Cap Domestic Equities, Developed Market Non-U.S. Equities	REITS, Commodities, Other Public Assets
Inefficient		High Yield, Bank Loans and EMD Bonds	Emerging Market Equities
	Low TE		**High TE**

Active Management Results

Active management across asset classes has struggled in recent years as the very unique and extraordinary monetary policies are affecting financial markets today

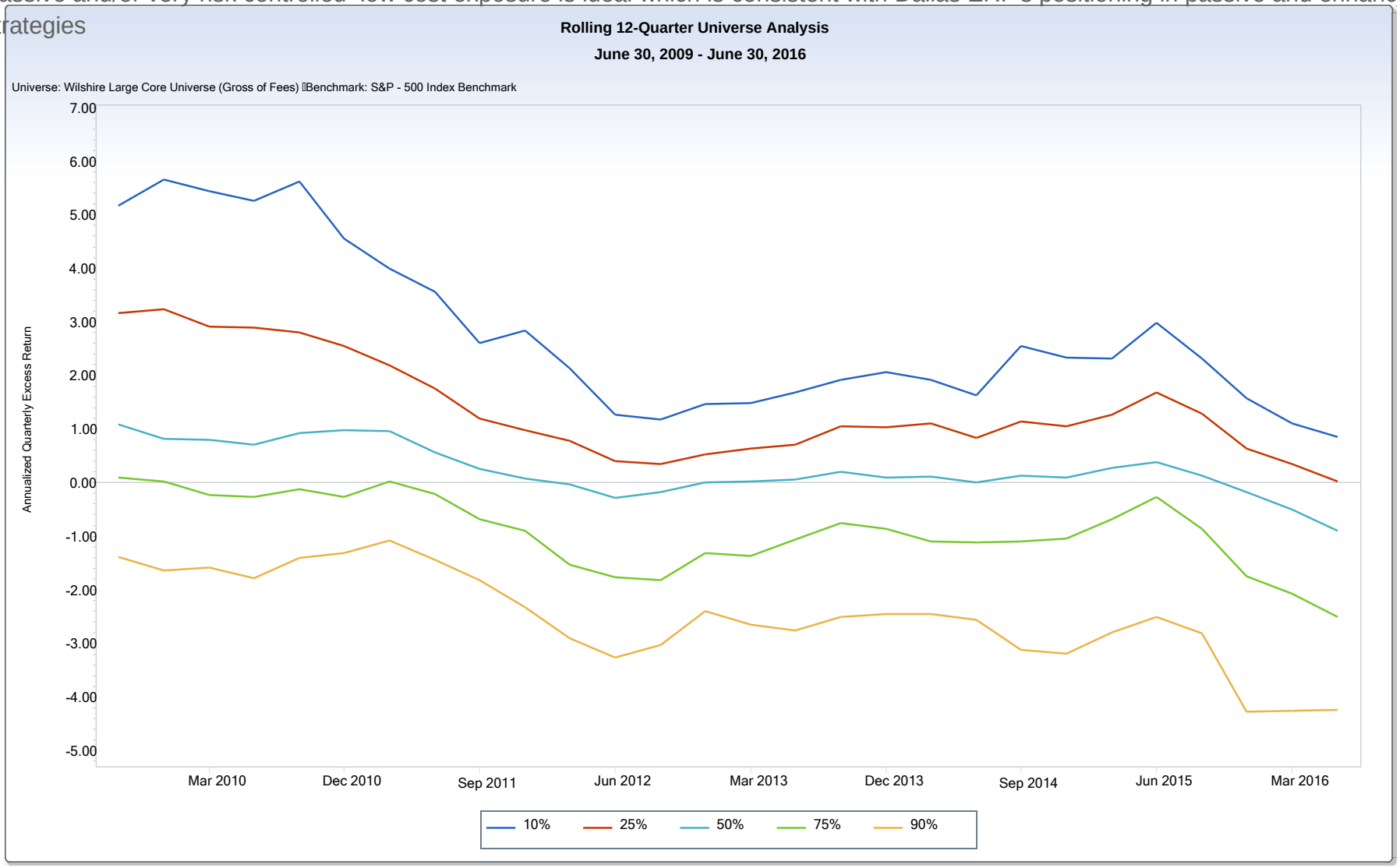
- *Quantitative easing (QE) has significantly changed the discount rate applied to all financial assets thereby causing a surge in values but with relatively little impact on the real economies in the world.*

This helps explains the difficult environment for active management as traditional active manager style tilts, like value and size, have detracted from performance in recent periods



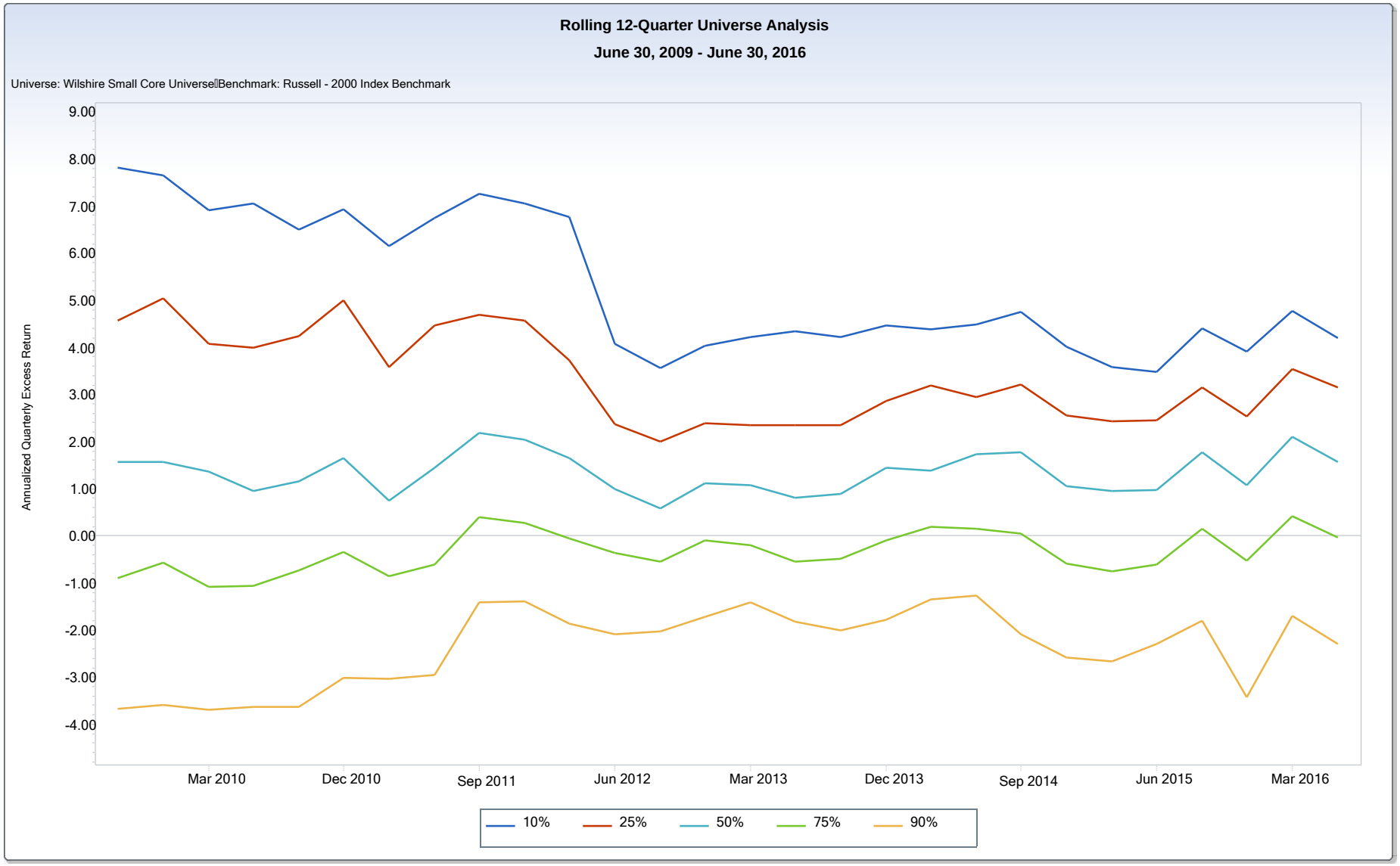
Active Management Results – Large Core

- More than 75% of active Large Core managers have underperformed over the last 3 years
- More generally, the large core active management universe does not appear to add consistent value, net of fees, over longer term rolling 3 year periods
- Passive and/or very risk controlled low cost exposure is ideal which is consistent with Dallas ERF's positioning in passive and enhanced index strategies



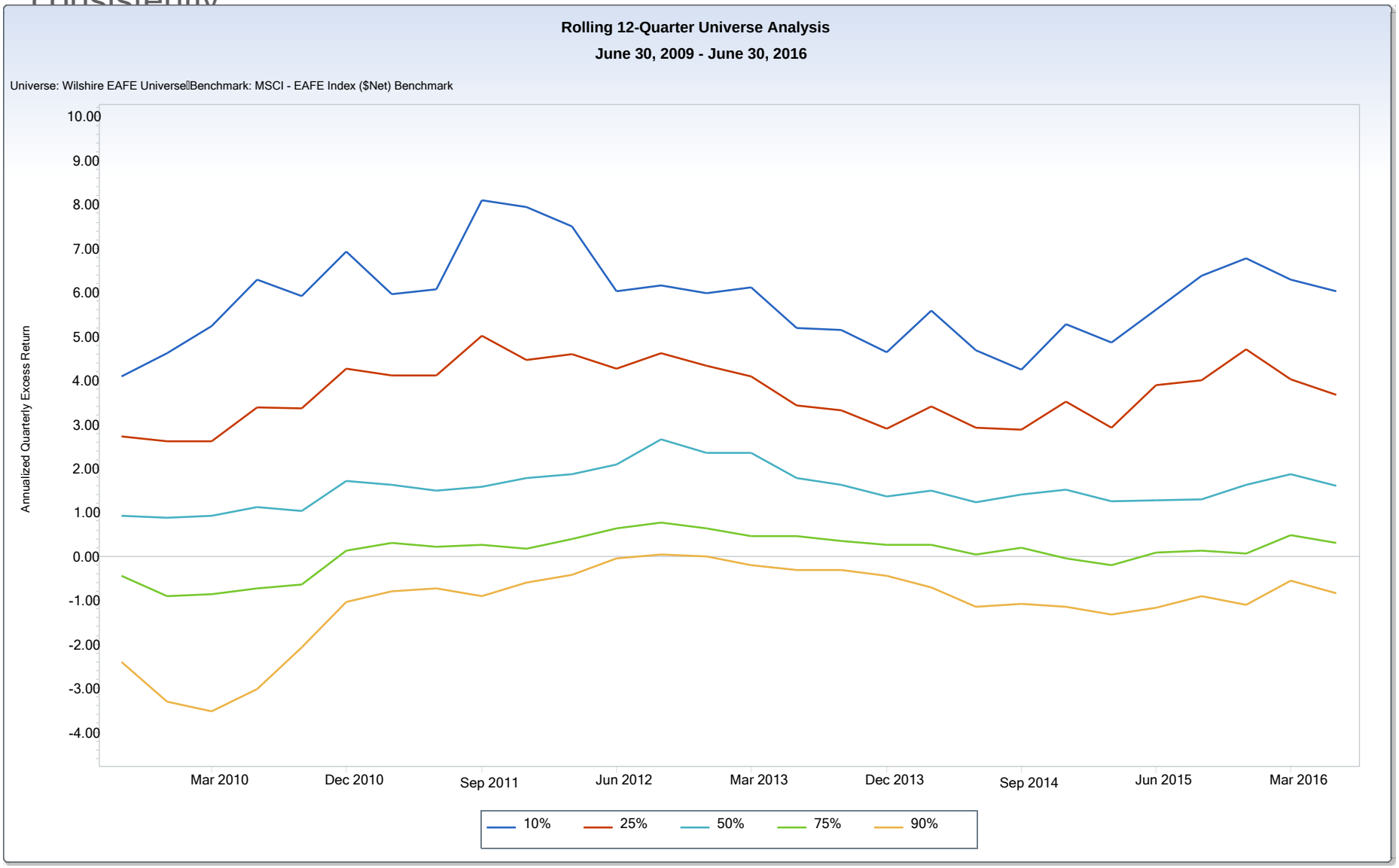
Active Management Results – Small Core

- More generally, the small core active management universe does appear to add value more consistently



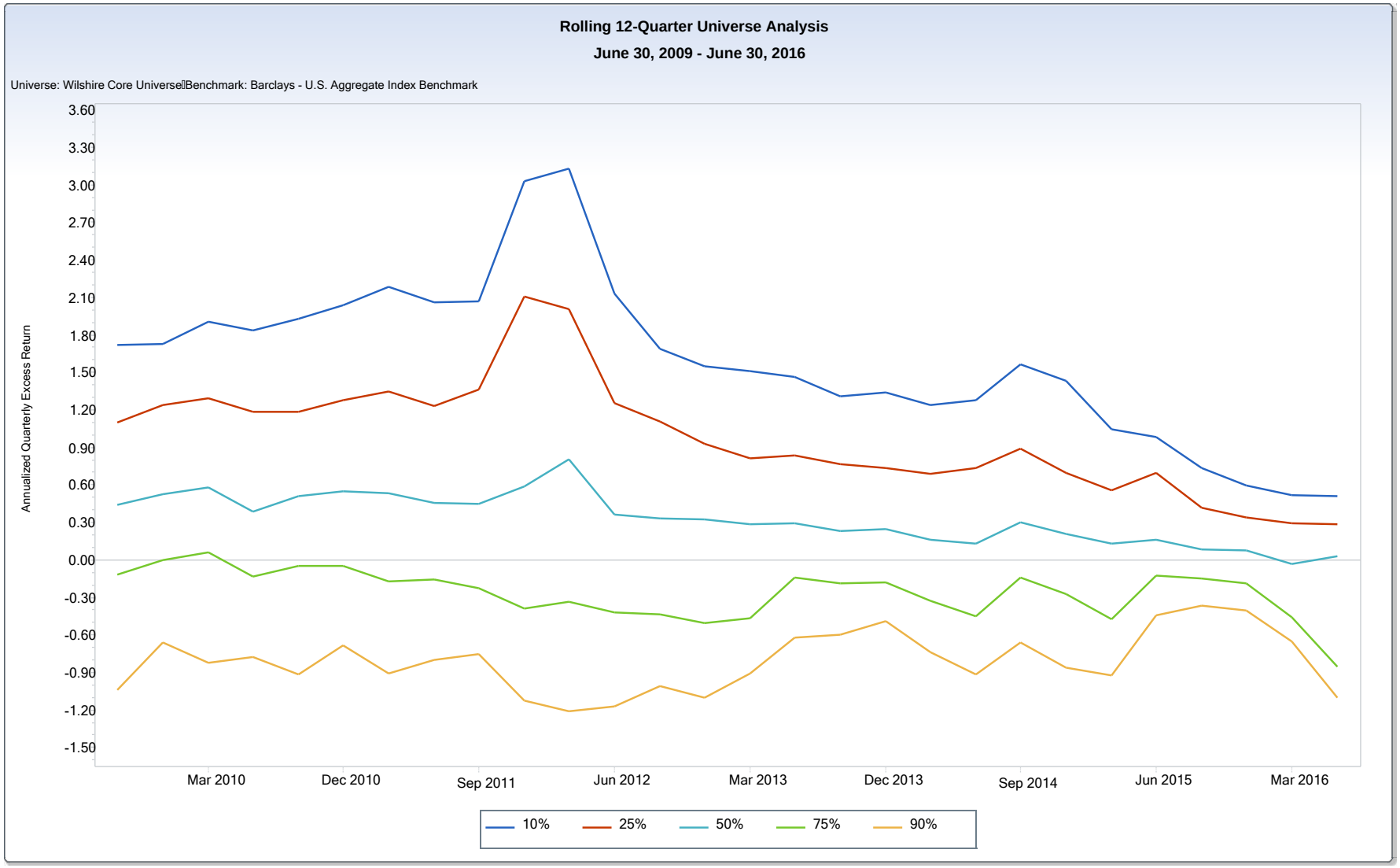
Active Management Results – International

- International active management universe does appear to add value more consistently



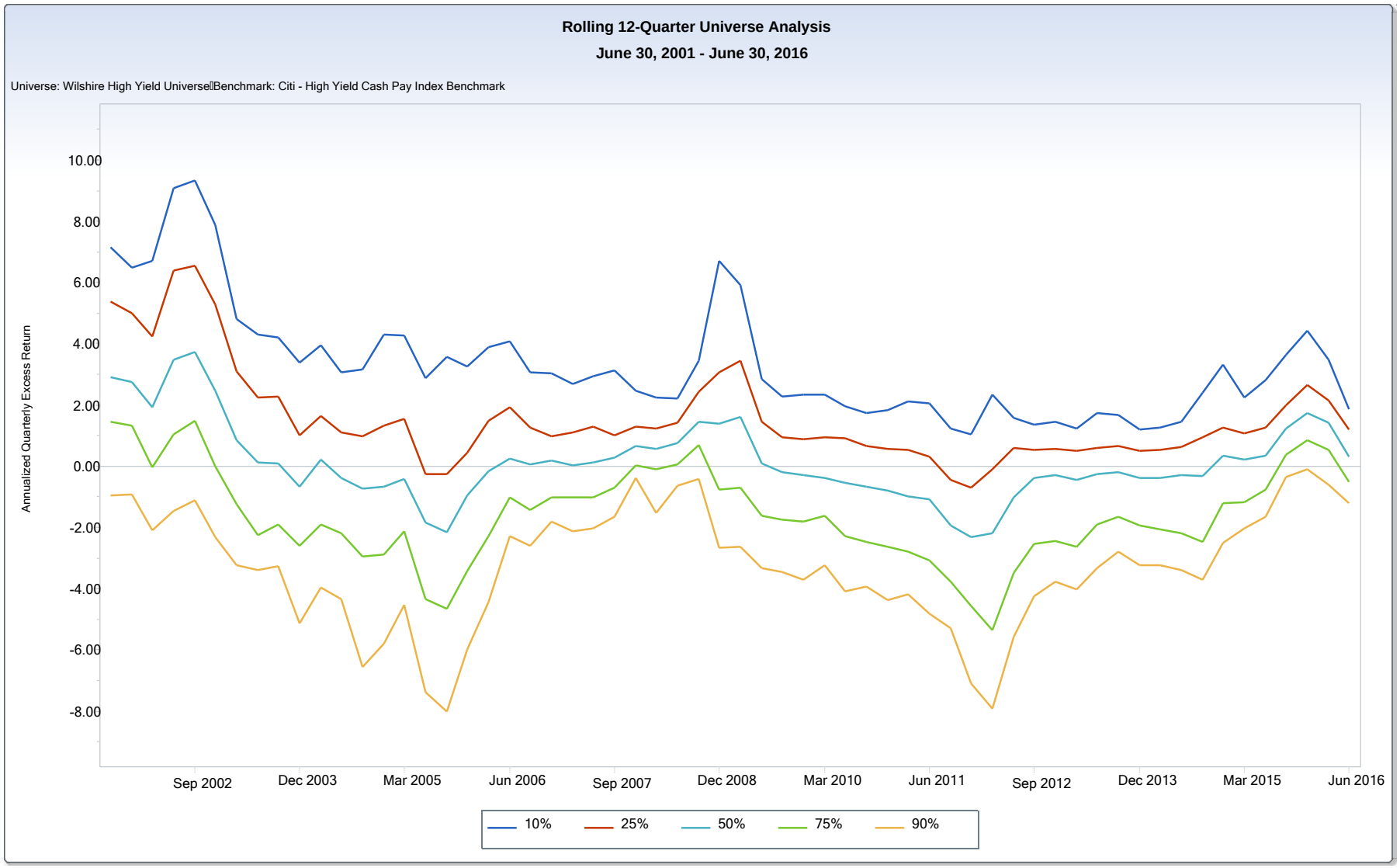
Active Management Results – Core Fixed Income

- Historically, active Core Fixed Income has tended to add value, but most recently that has not been the case given the policy driven interest rate environment combined with material swings between risk-on and risk-off environments
- Expectation is that as interest rate policy normalizes, active management will again add value



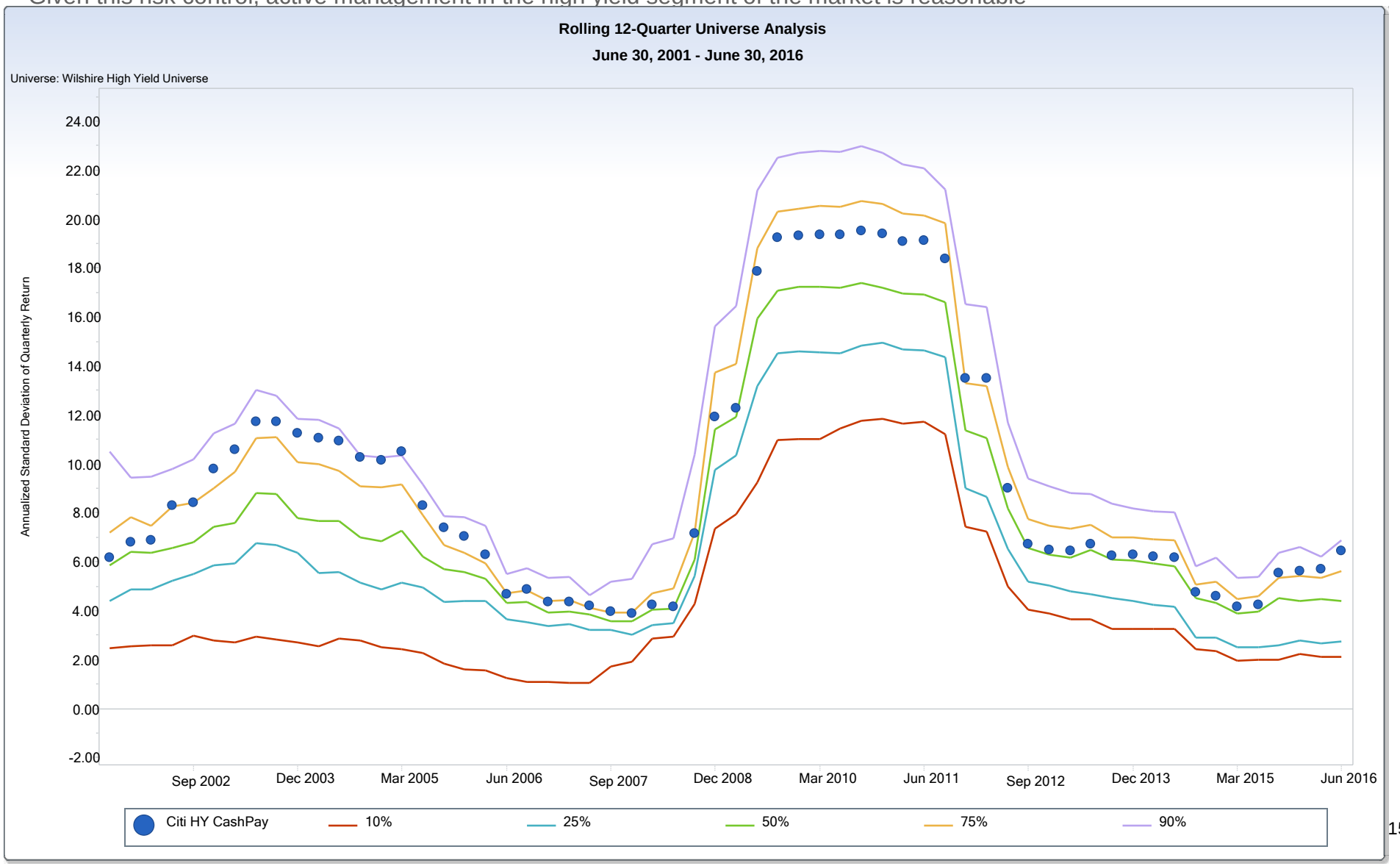
Active Management Results – High Yield

- High Yield active management success has been much more episodic, i.e. active management tends to add value for a period of time (2000-2002) and then tends to lag the index (post credit crisis)
- These periods tend to correlate with low quality rallies



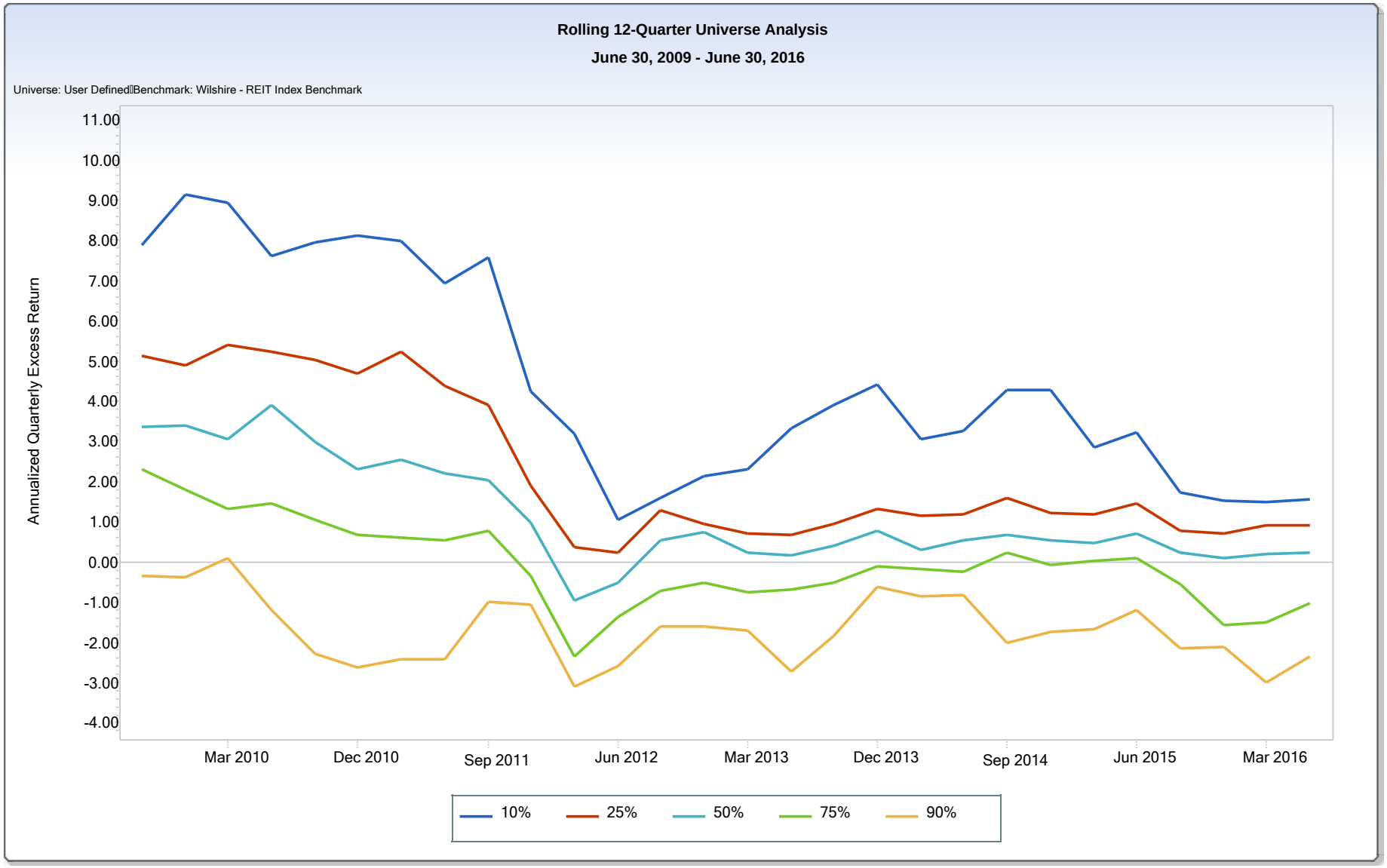
Active Management Results – High Yield

- High Yield active managers tend to have a consistently lower risk level than the index, reflecting a preference for higher quality issues
- Given this risk control, active management in the high yield segment of the market is reasonable



Active Management Results – REITs

- Median active REIT managers generally outperformed on a gross of fee basis, but net of fee returns are more mixed.



Active Management Results – REITs

- REIT active managers tend to have a consistently lower risk level than the index
- Given this risk control, active management in the REIT segment of the market is reasonable

Manager Research Process

Manager Research Process

Our process is heavily qualitative

- Focus on six key areas; conduct more than **1,500** manager meetings annually
- Analysts have dedicated asset class coverage, with some compensation linked to research/forecasts

Quantitative analysis seeks to uncover portfolio characteristics

- Conduct returns-based, holdings-based and multi-factor risk analyses using sophisticated proprietary analytic tools
- Seek to uncover the key drivers of performance.
- Attempt to determine what risks a portfolio presents

Research team delves beyond the numbers

- Understand investment philosophy
- Evaluate manager and organization

Knowledge sharing with our clients

- Clients have access to manager research professionals
- Weekly News Alerts provide the latest manager news with perspective and context from our manager research analysts

Develop expectations of future performance

- Derive explicit performance and risk forecasts for managers

Investment Due Diligence– Qualitative

Qualitative Due Diligence

Organization
- Evaluating the investment team resources and background, including how the overall organizational structure promotes stability and focus

Information
- Understanding a manager's edge in gathering and processing information

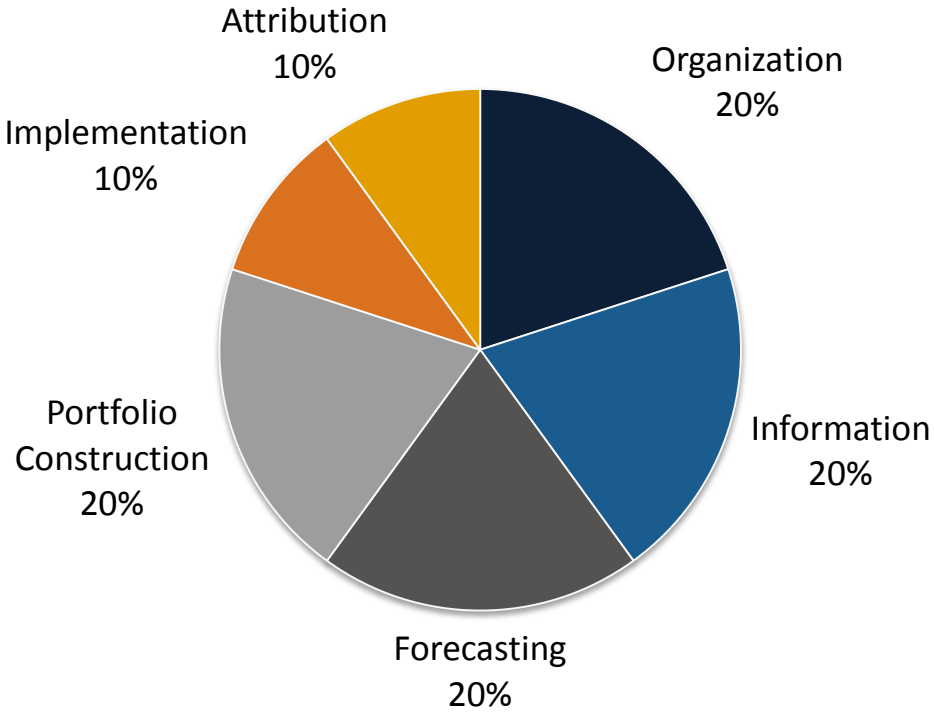
Forecasting
- Evaluating how a manager creates forecasts, the accuracy, and how they compare to peers in terms of uniqueness

Portfolio Construction
- Rating how a manager properly aligns assumed risks with their forecasting ability/skill

Implementation
- Strong focus on operational effectiveness: measuring a manager's ability in regards to trading and back office efficiency

Attribution
- Assessing a firm's willingness and ability to constantly revaluate its own investment process / performance and incorporate feedback to improve their decision making ability

Breakdown of Total Rating



Wilshire recently adopted a dynamic weighting process in which significant deterioration in specific, more critical, component ratings will impact their weight in the overall total rating

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