Northern Trust | The Active Risk Storm

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Despite modestly higher equity market volatility, in the first half of 2019, most active managers underperformed their benchmarks. The media has chalked this underperformance up to shoddy sources of alpha and overbought investment strategies. However, we feel this view is short-sighted, as poor management of active risk is often the real culprit. Here's why.

Recent data suggests more than 70% of active global developed funds and 75% of active emerging market funds have failed to deliver positive excess returns, a trend that has persisted for several years. In many global equity strategies, one of the largest sources of active exposure stems from country and region mis-weights. In the past, managers relied on relatively high and stable correlations among developed market countries to justify overweights to their favorite geographies, which, at least from a risk perspective, all looked relatively similar. Well, no more.

Since 2012, correlations among major developed economies, such as the US, the UK, Germany, and Australia, have been cut in half, no doubt due, at least in part, to divergent monetary policies among these nations. Meanwhile in July, correlations between the US and China reached an all-time high, as the fate of both economies seems to rest on mutual trade agreements. To the naive market participant, changing country and region correlations can lead to high levels of unexpected active risk and potentially dangerous outcomes.

Sector correlations have also changed dramatically, with return volatilities between sectors, such as utilities and technology, rising to levels not seen in 20 years. It's well known that sectors carry very different sensitivities to interest rates, inflation, and real economic output. As global recession probabilities increase, macroeconomic uncertainties have put interest sector returns on a roller coaster. Sector bets, long a staple of active equity management, are more menacing now than ever, and more than a few active strategies have recently experienced large drawdowns from incautious sector biases.

While on the surface equity markets appear relatively calm, don't be fooled. What lies beneath is a seething tempest of active risk. Investors must look only to well-designed equity strategies that are exceedingly thoughtful about their active risk control. Now more than ever, the risk governance practices of your active managers needs to be scrutinized. Although market risk is relatively tame, active risks are approaching hurricane force.

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