

Active or Passive? For Diversification and Return Potential -- Consider Both

QS Investors Combines Active Strategies with Passive Products to Balance Portfolios, Seeking to Take Advantage of Best Attributes of Each

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NEW YORK, Sept. 9, 2015 /PRNewswire/ -- With recent equity market volatility after hitting all-time highs earlier in the year and government bond rates at or near zero in many countries investors face conflicting choices. Many have done very well investing in large-cap U.S. stocks, increasingly through passive vehicles like exchange traded funds (ETFs).

Should they keep their money there? Or is it time to seek expert help?

These questions are as central to professional asset managers as they are to investors. There are many ways of achieving goals like portfolio balance, growth and capital protection, but for many the guiding precept comes down to a seemingly simple and oft-asked question: active or passive? Legg Mason affiliate QS Investors believes the best answer is both: active *AND* passive.

"The only free lunch in investing is diversification," said QS Investors portfolio manager Wayne Lin, who heads the firm's multi-asset class portfolio strategies. "Combining active and pass strategies is a great way to achieve another dimension of diversification within a portfolio."

"Our response to the active versus passive debate is *NOT* to debate, but rather to recognize that there is a role for both active and passive within a portfolio. By seeking to use the best attributes of each, we can construct portfolios that serve investors' interests – and at more attractive prices."

What are the features of passive and active, and when should investors choose one over another?

"Passive products are very helpful when you want to implement tactical bets," Mr. Lin advised. "They allow investors a quick and cost effective way to get in and out of asset class exposures. Also, they track the broader indices well, so you have a better understanding of your exposures."

"Investors can choose from a variety of ETFs that are liquid and span major asset classes. This gives investors reasonably priced tools to construct long-term portfolios and take tactical bets." If costs are reasonable and the quality of passive products high, why would investors use active?

QS Investors believes passive vehicles are only as good as the index or market they track. If the index is poorly defined, or if the market has significant region or industry concentrations, passive strategies may not be the best choices: higher concentrations can also mean concentrated risks.

"Every index is constructed with different rules," Mr. Lin observed. "The more liquid and actively traded a market is, the better the price discovery. Large cap U.S. equity markets are sufficiently diversified and well-defined that their benchmarks are universally understood. When the index is well constructed it can be hard to beat, net of fees. Because of their low costs, ETFs and other passive products can make a great deal of sense in broad, liquid markets."

By contrast, markets that have high sector concentrations or are more illiquid can provide active asset managers with opportunities to exploit information asymmetries and manage risk. Sector concentration can happen in any market, but it can often be seen in emerging markets (EM).

"EM countries' markets are often dominated by one or two sectors," Mr. Lin explained. "Energy and materials make up a large percentage of the Brazilian equity market, for example. Canada's equity market was once dominated by telecom and has always had high exposures to energy."

"Bond markets have always had a large number of bonds that don't trade daily. This can lead to illiquidity – and potentially to prices that don't effectively reflect bonds' default risk. In the types of markets, active managers have greater opportunities to capitalize on mis-pricing. They can also generate better risk return profiles than the index, which benefits investors."

To QS Investors, the evidence that active management can outperform passive – net of fees – is clear. Mr. Lin cited fellow Legg Mason affiliate Western Asset Management, which consistently beat many fixed income benchmarks. Many strategies at ClearBridge, Brandywine Global, Royce & Company and QS Investors have outperformed their benchmarks over full market cycles.

"These active investors know their markets inside and out," Mr. Lin said. "They can use that knowledge to deviate from the passive indices to reduce risks and make money for investors." Yet fees are always important, which QS Investors recognizes and factors into its analysis.

"Ultimately, the acid test for choosing an active strategy is whether the investor believes the active manager can beat a passive strategy over a full market cycle, net of fees," Mr. Lin said. "Investors need to understand why they should choose passive or active. Sometimes both work."

All professional asset managers may not share this zeal for balancing passive and active strategies, but QS Investors considers an enlightened approach the best way to serve investors.

"There is a clear role for active management, but it matters where investors apply it," Mr. Lin advised. "In situations where benchmarks or markets are poorly defined, active can work. We advocate for active whenever it helps counter illiquidity and unintended risk concentrations, or where active managers can take advantage of information asymmetries within a market. In well-understood markets it's hard to beat the benchmarks, and that can make passive attractive too."

About Wayne Lin

The Head of Multi-Asset Class Portfolio Strategy and a Portfolio Manager with QS Investors, Wayne Lin has more than 20 years of financial services experience. He joined Legg Mason Global Asset Allocation, LLC (LMGAA) as an investment strategy analyst in 2005, in the acquisition of Citigroup Asset Management, and moved to QS Investors when it merged with LMGAA in 2014. Previously Mr. Lin worked as: chief of staff for the Office of the CIO at Citigroup Asset Management; an internal management consultant with TIAA-CREF; associate director, strategy consulting for Barra Strategic Consulting Group; and an associate with Booz Allen Hamilton. He has a B.A. in economics from the University of Chicago and earned an M.B.A. with honors in finance and management of organizations from Columbia University.

About QS Investors

A wholly-owned, independently-managed affiliate of Legg Mason, Inc., QS Investors, LLC was formed in 1999 as the quantitative platform of a global asset manager. As an investment firm providing asset management and advisory services to a diverse array of institutional clients, QS Investors delivers disciplined, systematic solutions that address clients' complex challenges. The QS team has developed unique approaches to integrating quantitative and behavioral investment insights and dynamically weighting opportunities in response to changing economic and market conditions. Risk identification, assessment and management are intrinsic to their process. Based in New York, QS Investors offers a broad spectrum of strategies to clients worldwide including actively managed U.S. and global equities, liquid alternatives and customized solutions.

About Legg Mason

Legg Mason is a global asset management firm with \$696 billion in assets under management as of July 31, 2015. The Company provides active asset management in many major investment centers throughout the world. Legg Mason is headquartered in Baltimore, Maryland, and its common stock is listed on the New York Stock Exchange (symbol: LM).

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International investments are subject to special risks including currency fluctuations, social, economic and political uncertainties, which could increase volatility. These risks are magnified in emerging markets. Losses for highly concentrated products may be magnified from events affecting a particular security.

Diversification does not guarantee a profit or protect against a loss.

Historical differences between passive and active strategies:

Securities in passively managed products (such as passively managed ETFs) do not involve any active security analysis or research by portfolio managers. Instead the securities that comprise a passive product are selected by replicating the securities, and the weights of the securities, of the corresponding index. This process can reduce the management fees of a passively managed product as opposed to an actively managed product, and can lead to better performance which can benefit investors.

There are also differences in the way ETFs and traditional mutual funds trade. ETFs are traded on major stock exchanges at any time during the trading day. The price of an ETF fluctuates throughout the trading day, similar to a stock. Mutual fund shares are priced once a day after the close of the markets.

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