S&P Dow Jones Indices

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Institutional Talks

The Rise of Passive Strategies in Public Pensions

With Marc Levine, Chairman, Illinois State Board of Investment

Institutional Talks is an interview series where industry thinkers share their thoughts and perspectives on a variety of market trends and themes impacting indexing.

Marc Levine has served as Chairman of the Illinois State Board of Investment (ISBI) since 2015. He is a Certified Public Accountant with over 25 years of investment experience and was the founding principal of Chicago Asset Funding LLC.

S&P DJI: Tell us a bit about ISBI, your role there, the participants you serve, and ISBI's investment philosophy.

Marc: The Illinois State Board of Investment (ISBI) manages assets on behalf of more than 140,000 state employees. ISBI manages the Defined Benefit (DB) assets of the State Employees' Retirement System, the General Assembly Retirement System, the Judges' Retirement System of Illinois, and the Illinois Power Agency. The DB plan has about USD 18 billion in assets. We also manage the State of Illinois Deferred Compensation (DC) Plan, which has about USD 4 billion in assets. The choices in the DC plan are made by the employees directly and there's no employer match.

I spent my life in the financial markets. I was an investment banker and I owned my own boutique financial firm. I believe that simple is better, and that's our approach at ISBI too.

In my role as Chairman, I work with our board to make sure we're working toward our goal of returning long-term value to our beneficiaries. That means keeping costs low and making sure that our target allocations are designed to meet our risk-adjusted return goals. We believe that adhering to a simple, diverse, strategic asset allocation plan over the long term is what drives returns.

S&P DJI: So where does passive investing fit?

Marc: The most important thing in the pension space is a strategy has to be digestible by busy volunteer board members that meet infrequently but effective over our long-term investment horizon. And the beautiful thing about passive investing, it's not only simpler and cheaper; research shows that it's actually better. It's like nothing else that I can think of in the investment world. The S&P Indices Versus Active (SPIVA®) report you publish semi-annually shows how hard it is for active managers to beat the benchmark. And S&P DJI's Persistence Scorecard shows that it's even harder for active managers to repeat outperformance even if they manage it.

Our approach to active and passive management is different for the DC and DB plans. In the fall of 2016, we moved to all passive in the DC plan. So now, other than the Federal Thrift Savings Plan, we may have the lowest cost and simplest DC plan in the U.S. About 2/3 of our DB portfolio is now passively managed and, of the 1/3 of the portfolio that's actively managed, most of the active is in private markets, which you can't index.

Since I was elected chairman in 2015, we have terminated over 100 active managers because the passive argument holds. By moving the money to indexing, we are making a structural decision designed to lower costs, improve returns, and serve our beneficiaries' goals. As a result of the switch, we have less work day-to-day. We don't have a huge staff, but now we have time for the really important work. We can look down the shorter roster and evaluate our strategies and the managers who made the cut. And we know what we're looking for, we're looking for meaningful and persistent alpha.

S&P DJI: What are some of the passive benefits that led to your shift away from most of your work with active managers?

Marc: It's very hard to build a team that can pick active managers who can beat market-weighted indices and manager selection tends to destroy value. When you index, the asset allocation strategy you have in place will drive returns and you can re-allocate the time you previously spent on manager due diligence.

Something that I think is underappreciated that we've implemented, and that I feel should be a best practice, is having some portion of each asset class indexed and using passive as a governance tool. For every asset and sub-asset class in your portfolio, even if you're a firm believer in active, we've found it really helpful to have a portion invested in a passive vehicle. Then when you're reviewing managers you've got the tangible evidence to compare to. And if you need to move away from an active manager but want that exposure, you can get reinvested quickly without the tracking error issue.

Indices are a powerful tool of comparison and they've also proven to be very effective operationally. When you index, you're avoiding all the trouble you could have when you start layering in active money management alternatives. Public pension systems have fundamental challenges, some of which are unique to pensions, which I actually think are potential strengths. The boards are all filled with volunteers, many of whom are not investment experts and they experience regular turnover. Like all government organizations, they are resource constrained, and there's an opportunity for political interference. What we've found is that passive investing is wonderful for dealing with those challenges. Pension staff can add support, but like the boards, those positions can be politicized. Indexing is simple for board members to understand, and it takes emotion and politics out of decisions and focuses them on allocations, and it does it for less money.

S&P DJI: How did the board react to the shift to mostly passive?

Marc: When I was first elected Chairman, my philosophy was simple is better, so we looked to shorten our manager roster. If you're going to make active management bets, only make a few and they better be meaningful. So the easiest thing to do in my view was to first look at who was on our watch list. We had four managers who had underperformed for years. And we went into the board meeting with a motion to terminate those four and it got very heated. After a lengthy debate, one of the trustees said alright, you're taking the money management away from these guys, you're likely going to give it to your guys. Tell us who you're going to give it to and we can address it? And I said, "We're not giving it to anybody. It's going to be indexed." And the heat went out of the room. It transformed the conversation. It took the politics and any personal insult out of the equation and clearly identified the solution as a structural decision. And the terminations were then supported by nearly all of our board members.

S&P DJI: How often are you evaluating managers and what criteria do you focus on?

Marc: Most public pension boards meet 4-6 times a year so there isn't a lot of time for analyzing individual manager performance. We basically evaluate once a year, but during the period of portfolio restructuring, we were more aggressive. In our public markets we're looking for material alpha, we're talking much more than 50 bps, and in our private markets we're looking for top-quartile managers. With our strategic partners who are actively managing public market assets, we tell them to go where the alpha is. While we've outsourced our selection of active managers, we work with that group to do detailed manager assessment, and a key tool there is measuring against a passive benchmark. As for all the managers we have terminated, we haven't even had to discuss persistence because all but a couple were underperforming their benchmarks. Our remaining roster of active managers has a superior track record of alpha generation, but we're obviously counting on persistence and subject to our own survivorship bias.

S&P DJI: You also recently shifted from the Russell 2000 to the S&P SmallCap 600® to access U.S. small caps – why?

Marc: Because of the simplification benefits of going mostly passive and the shorter manager roster, we were able to sit back and think about what allocation strategies we actually have, and that included looking at the benchmarks we were using. We moved to the S&P SmallCap 600 because after taking that time for analysis, it made sense for a couple reasons.

In addition to the purer small-cap exposure that the S&P SmallCap 600 has relative to the Russell 2000 - based on the size of the companies that are actually in the index - it just felt like the quality factor that S&P DJI uses made intuitive sense. It didn't feel like we were second guessing market weight, which you generally want to avoid as an indexer. I also felt having a quality factor built into a small-cap methodology would keep out many little companies that have far greater potential for business and even fraud risk and, perhaps, shouldn't be public in the first place. It's not complicated; the S&P SmallCap 600's quality screen is a basic test of profitability. And that's simple. And we like simple because it helps us understand what's in our portfolio.

S&P DJI: Why does the underlying index matter so much?

Marc: When you're managing money for 140,000+ beneficiaries, the fewer surprises the better. To me, transparency is the key to an underlying index and any product that's based on that index - so that when you open up the paper, you can see how the index is doing, and you know what's going on with what you own.

Benchmarks can sometimes feel like an accounting tool, but when you have real money invested in passive, you have tangible proof and results to inform your future decisions. We've had times when we needed to move away from managers when a team left or another dire circumstance. Not having a passive option that we could simply shift money to was time we couldn't be in an allocation we had conviction in; because changing managers takes time, RFPs, and due diligence. And that's time where you could already be in the market with a passive solution that meets your allocation strategy.

S&P DJI: As more asset owners embrace passive, what are some of the key things they may want to consider when selecting an index-based strategy to access the market?

Marc: Be realistic about what your resources are and what your board has time to digest. Simple is better, and all investors are lucky that the simplest way to do things, the thing that takes the least time to do, also just happens to have the best performance historically. Why wouldn't you do as much of that as you could?

It may sound counterintuitive, but the less time you spend on manager selection the better. Index where there aren't great alpha opportunities, which some people would say is everywhere, but let alpha inform your decisions. If an asset owner feels like there is greater alpha in emerging market equities, which may be the case, then they can tilt more toward active in that segment. But when it's available, the passive comparison can be used to assess manager performance and you can always adjust that tilt based on actual results.

The dirty little secret, certainly that hedge funds don't want anyone to know, and I've found that pension staffs tend to agree – we are long-term investors. The cash needs of our pension fund are about 2% annually. The endowment model uses about 4% annually – these numbers are tiny. So if you think about it, 5 years go by, we've got a need for 10% of our assets to pay our beneficiaries – that means that we're a long-term investor so we need to ignore short-term blips. And that's where so much of the noise of active managers comes from –short-term valuation and volatility concerns. The research shows that market timing is a losing proposition.

I feel like many asset owners or boards don't want to admit when they've made a mistake, and that's led to some inertia for active. But to me, it's just common sense. If something's not working, why would you pay for it when there's something that's cheaper and better? And when people disagree, I like to remind them that Warren Buffett and David Swensen are on my side.

S&P DJI: Do you think factor and multi-factor indices raise the bar even higher on active managers?

Marc: I'm a big fan of market-cap-weighted indices, but I think factors can be very valuable when boards are really concerned about risk or volatility. A lot of boards have been trained to think that active management is the solution to risk, but factors are a simpler and cheaper solution they should consider.

We want our approach to remain simple and understandable at ISBI, so the evolution of multi-factors doesn't really apply to us at this time. But we can look at the primary factors from Fama French and use them to assess managers and now, we can even use them in passive strategies. And that's something we didn't have the attention span to deal with when we had over 100 managers. It goes back to the idea that indexing and having a short manager roster gives you more time to think, and factor and multi-factor strategies are something we now have time to consider and we plan to do just that.

S&P DJI: What's one key indexing lesson you've learned that you'd like to leave our readers with?

Marc: The governance benefits of indexing are so underappreciated and so powerful. And that's not just in public pensions – I think that's with any board. Boards consist of busy volunteers and staff members are always stretched thin. Why ask them to do something complicated that history shows doesn't add value? Indexing is simple and we believe it's better, which is why it is our primary strategy.

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