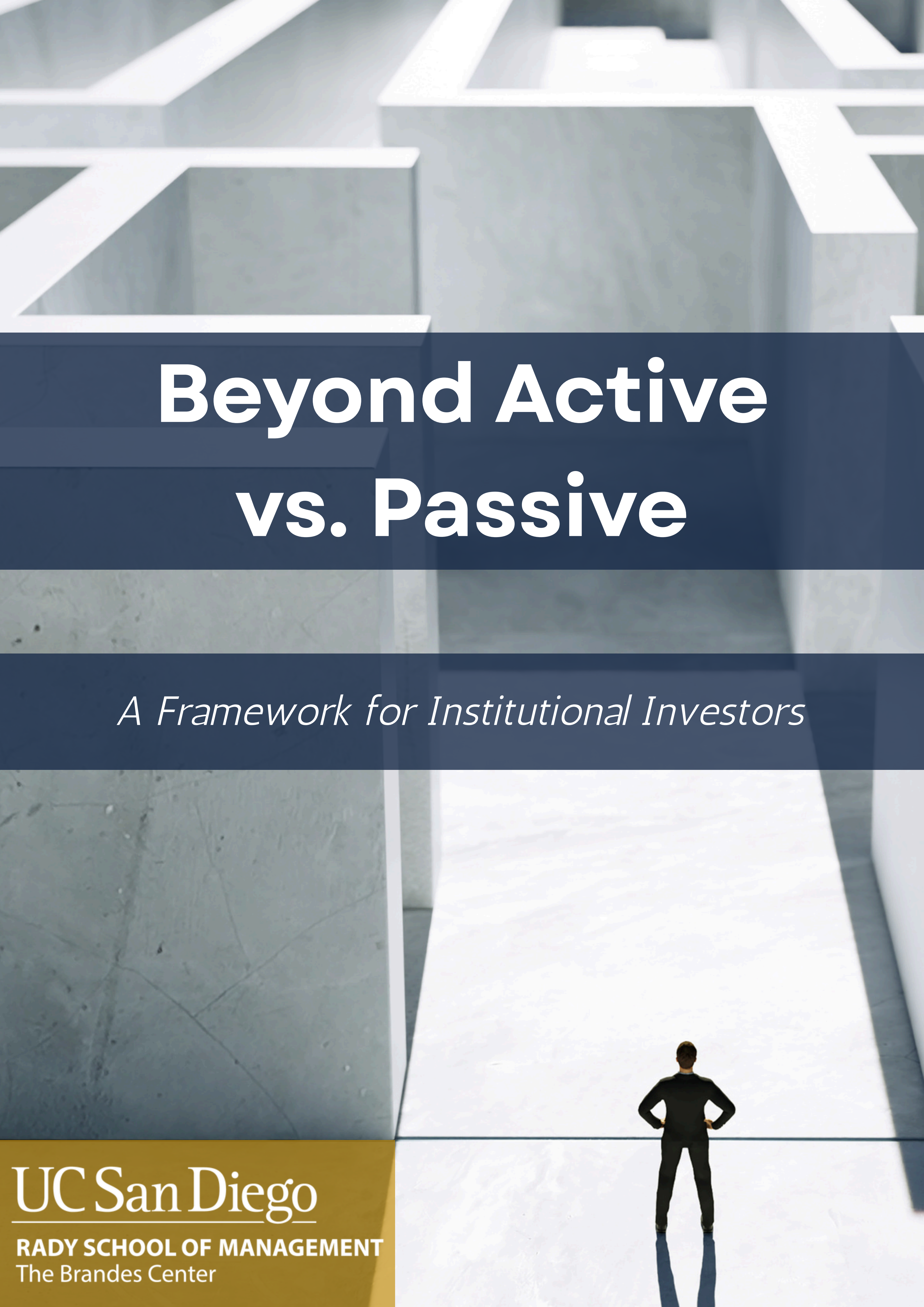
Beyond Active vs. Passive

A Framework for Institutional Investors



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Beyond Active vs. Passive: A Framework for Institutional Investors

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Recently, I talked with Brandes Center Advisory Board member David Iverson about active and passive investing. We recorded the discussion and asked ChatGPT to summarize it. Then, I did quite a bit of editing on the AI-generated draft and added several specific comments David made to give this summary a bit more punch.

For decades, the institutional investment debate on active and passive investing has been framed as a binary choice. But that framing may obscure more than it reveals.

For many institutional asset owners, the more important question is not whether to pursue alpha, but which *type* of alpha offers a realistically attainable goal given an institution's structure, governance, time horizon, and organizational capabilities.

This distinction may help investors better assess their teams' competitive edge as not all forms of active management are alike.

Some are zero-sum games. Others are compensation for bearing risk. Still others arise from market frictions, regulation, or the unique characteristics of institutional balance sheets.

As Chief Investment Officer at the New Zealand-based Accident Compensation Corporation (ACC), **David Iverson** oversees ~NZ$50 billion. He has been at ACC for more than five years.

Previously, he was Head of Asset Allocation for the New Zealand Super Fund for 12 years, a Director of Institutional Investment Services & Quantitative Research with Goldman Sachs and Head of Consulting for Russell Investments.

Iverson is also a member of The Brandes Center's Advisory Board.

"Successful investing is not just about choosing active or passive. It's about understanding which forms of alpha are actually available to your institution."
--David Iverson

In practice, many institutions group these together under a single "active management" approach. The result may trigger confusion around fees, implementation, staffing, and expected outcomes.

Iverson suggests a more useful framework that separates active investing into distinct categories — each with different economic foundations, capacity constraints, organizational implications, and governance requirements.

The Starting Point: Passive Investing as the Baseline

Market-cap-weighted passive investing may be viewed as a default option for institutional investors as it provides for:

- low cost,
- diversification,
- transparency,
- scalability,
- and market exposure.

Iverson said here is where many investors stop when thinking about active or passive approaches. "Usually, when it comes to active, it's, 'Oh, we think markets are inefficient, therefore we should be active.'" Iverson said. "That tells you why most investors head down the traditional alpha route."

But the debate may become more nuanced once investors gain awareness of various types of alpha. At that point, Iverson invites institutions to ask, "What specific source of return are we attempting to capture? And why do we believe we are structurally equipped to capture it?"

Three Distinct Forms of Alpha

Iverson shared a framework that identifies three primary forms of alpha generation, each grounded in different economic realities.

1. Traditional Alpha: The Zero-Sum Game

This is the classic perception of active management. Managers attempt to outperform a benchmark (typically a cap-weighted index) through:

- superior information,
- security selection,
- timing,
- forecasting,
- or analytical insight.

Measured against the target index, this form of alpha reflects a fundamentally zero-sum game before fees — and negative-sum after fees. It also may be the most capacity-constrained form of alpha:

- excessive asset growth can dilute returns,
- skill is difficult to identify ex ante,
- outperformance persistence is notoriously elusive.

"The minute you say 'alpha,' people immediately go straight to hiring expensive external managers with special skills," Iverson said. "Often, they can't help it."

But this narrow, binary framing misses other economically distinct sources of excess return.

2. Risk-Factor Alpha: Harvesting Systematic Risk Premia

A second form of alpha comes not from forecasting individual securities, but from systematically tilting portfolios toward various market factors. While the list of factors researchers have identified has grown, by some counts, into triple digits over the years, the basic, Fama-French factors include:

- market,
- value,
- size,
- profitability,
- investment

Other popular factors may include momentum, quality and low volatility, among scores of others. Factor-based investing often is labeled as "smart beta," though that terminology can obscure its economic foundation. Unlike traditional active management, manager insight does not drive factor-based investing. Instead, it reflects deliberate exposure to risks that investors believe offer compensation over time.

The institutional implications for such offerings vs. traditional active management include:

- generally lower fees,
- very large capacity,
- the importance of implementation efficiency,
- and the critical role of portfolio construction.

"With traditional alpha, you are concerned about how large a fund gets and whether they seek asset gathering over value creation," Iverson said. "Risk-factor investing is different — the capacity is large because you're harvesting a risk premium, not competing away insight."

Still, in many cases, the challenge is not identifying factors but harvesting them efficiently without excessive turnover/trading costs or abandonment during periods of underperformance. Factor investing also forces institutions to confront a difficult reality: Not every historical factor premium survives practical implementation. Some anomalies disappear once widely recognized. Others may never have represented economically meaningful premia in the first place.

That raises important governance questions around:

- diversification across factors,
- patience through multi-year cycles,
- and the distinction between statistical backtests and durable economic drivers.

3. Transactional Alpha: Monetizing Market Frictions

A third category of potential alpha arises from market structure itself. Financial markets are not frictionless. Regulation, capital requirements, liquidity constraints, and institutional limitations create opportunities for investors with flexible balance sheets.

> *"With traditional alpha, you are concerned about how large a fund gets...."* --David Iverson

This "transactional alpha" often emerges through:

- liquidity provisions,
- balance-sheet intermediation,
- securities lending,
- structured financing,
- or other market-completion activities.

Unlike traditional alpha, these opportunities are frequently positive-sum rather than zero-sum. One institution's regulatory constraint may create another institution's investment opportunity.

For example:

- banks facing capital constraints may pay institutional investors to absorb certain risks,
- long-horizon investors may provide liquidity where regulated entities cannot,
- and less constrained balance sheets may earn compensation simply for warehousing risk others are unable or unwilling to hold.

This framework is particularly relevant for large asset owners with:

- long-duration liabilities,
- stable capital,
- minimal leverage constraints,
- or limited regulatory burdens.

In such cases, the institution's balance sheet itself becomes a competitive advantage. "There are certain types of risk that banks can't handle," Iverson said, citing an example. "They're short-dated balance sheets with limited capital. Larger balance sheets with longer horizons can absorb that risk."

But, he added, "You have to have both the balance-sheet characteristics — what I call structural advantages — and the developed advantages. You have to have the people in the room who are actually able to do it."

The Question Investors May Miss

Perhaps the most important implication of this framework is organizational rather than financial. Different forms of alpha require fundamentally different capabilities. Institutions often combine all active investing into a single investment function. But in practice, traditional alpha, factor investing and transactional alpha require different:

- talent,
- governance,
- incentives,
- risk systems,
- trading infrastructure,
- and evaluation frameworks.

For example, traditional alpha requires research skill, manager selection, and strict capacity awareness. A factor-based portfolio requires operational efficiency, disciplined implementation, and patience. Transactional alpha requires balance-sheet expertise, legal sophistication, liquidity management, and deep understanding of market structure. Treating these as interchangeable forms of "active management" can create profound organizational mismatches.

Structural Advantages vs. Developed Advantages

The framework also distinguishes between two forms of institutional advantage: structural and developed.

Structural Advantages

These are characteristics inherent to the institution itself:

- long investment horizon,
- tax status,
- low liquidity needs,
- governance stability,
- or limited regulatory constraints.

Large sovereign wealth funds and certain pension systems often possess structural advantages unavailable to smaller or more constrained investors.

Developed Advantages

These are capabilities the institution builds:

- investment teams,
- sourcing networks,
- risk systems,
- trading expertise,
- or domain specialization.

Importantly, possessing structural advantages does not automatically confer investment skill. An institution may have the ideal balance sheet for transactional alpha, but lacks the internal capabilities required to execute effectively.

A Possible Fourth Category: Development Alpha

Iverson also touched on a possible fourth source of alpha, "development alpha." This refers to value creation that occurs through originating, developing, and operationally improving assets over time.

Examples include:

- private equity operational transformation,
- infrastructure development,
- real estate development,
- or direct asset origination.

Rather than purchasing fully formed assets, investors participate across the entire lifecycle:

- sourcing,
- development,
- de-risking,
- scaling,
- and eventual monetization.

In this sense, institutions are not merely harvesting market returns, they are participating in value creation itself. Large Canadian pension plans have become particularly associated with this model. See the table in the Appendix for a brief overview of each potential alpha source addressed in this article.

"If you're willing to go right to inception, you own all the risks all the way through — origination, development, operations, asset management — and you capture all parts of the value creation," Iverson said. He added, "Our private markets may contain risk factors. We're paying managers to capture a source of return that isn't in the public domain but exists in the private domain."

The Governance Challenge

Ultimately, the active-versus-passive debate may be less important than institutional self-awareness. "The framework starts with: why are you there? What advantages do you actually have?” Iverson asked. “And what does that imply about the forms of alpha you should pursue?”

Every asset owner may want to start—or reevaluate—several foundational questions:

1. What are our true structural advantages?
2. What capabilities have we genuinely developed?
3. Which forms of alpha are realistically accessible to us?
4. Which are scalable?
5. Which justify higher fees?
6. Which require internal implementation?
7. Which risks can we tolerate over long periods?

Many institutions default into active management simply because peers do. Others abandon active management entirely because they define alpha too narrowly. Both approaches risk missing the deeper issue: Successful investing is not about choosing “active” or “passive” in the abstract. It is about aligning investment strategy with institutional reality and organizational capability.

“The old framework was: build portfolios using bonds and equities and then implement,” Iverson said. “That framework is breaking down because institutions are now thinking much more deeply about what skills they actually possess.”

The alignment between beliefs, structure, capabilities, and implementation may ultimately determine which institutions compound advantages over decades and which merely accumulate complexity.

Appendix | Types of Alpha and Considerations

Alpha Type	Capacity	Fees	Features
Traditional	Low, given need to trade on the information quickly to get ahead of others	High	• Investment process & philosophy gives the manager an edge • Well-resourced • Suitable delegation for decision-making • Alignment of incentives (alpha vs. asset growth)
Transactional	High, but may be sporadic	Depends	• Manager needs to be well-financed, • face low regulation and have low-cost structure • Trading can be executed in size
Dimensional (Smart Beta)	High, can be scaled with diluting premia	Low	• Risk factors are proxies for systematic risk premia • Implementation important to keep transaction costs low
Development	Limited. Depends on availability of opportunities at the time	Low (reduces fee drag to GPs)	• Suitable internal capability and resourcing • Reputational and concentration risks • Operational and development risk • Governance risks

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