Enduring thoughts

The price of outperformance

Are investors being adequately rewarded for the risks they take in pursuit of better returns?

> *The chance of gain is by every man more or less over-valued, and the chance of loss is by most men under-valued.*
>
> Adam Smith, The Wealth of Nations, 1776

The visible cost of active investment management is its fee. The less obvious cost is the return forgone when decisions made in pursuit of outperformance prove unsuccessful. Investors understand that an active manager must take contrarian positions that differ from the market and that some of those decisions will be wrong.

Investors accept the possibility of underperformance in the expectation of better returns. Whether the potential reward is sufficient to justify the additional uncertainty deserves more attention than it generally receives.

Most investment portfolios begin with a strategic asset allocation, reflecting the investor's objectives, investment horizon and appetite for risk. This 'risk budget' establishes the broad market exposures considered appropriate for achieving their long-term goals. Investment managers then seek to improve on that starting point by adjusting allocations, favouring particular markets and selecting securities they believe offer better prospects.

The combination of individual decisions is the manager's secret sauce and how they hope to earn their fees and justify their role managing your money. Taken together, they also determine how far the investor's eventual return may depart from the return their original, unvarnished strategy would have delivered.

Evidence from active management

The historical evidence for the trade-off of making tilts away from the market offers little comfort. According to the SPIVA Europe Mid-Year 2026 report, 94% of actively managed equity funds and 76% of actively managed fixed income funds underperformed their respective benchmarks over the preceding ten years. These are fund-level comparisons rather than measures of multi-asset portfolio performance, but the scale and persistence of underperformance raise serious questions about the rewards available from conventional active management.[1]

The ARC Private Client Indices provide a different perspective. They measure the actual net-of-fees returns achieved by multi-asset discretionary investment managers across portfolios grouped by their realised risk relative to world equities. They reveal considerable differences in the outcomes achieved by managers operating with broadly comparable risk exposures. The returns earned by investors therefore depend on much more than the level of market risk they have agreed to accept.[2]

There is another dimension to this question that also receives too little attention. We tend to judge investment success by the wealth accumulated over a given period, with volatility serving as a convenient measure of the risk involved. Yet investors experience risk more tangibly.

[1] S&P Dow Jones Indices, SPIVA Europe Mid-Year 2026, October 2026. www.spglobal.com/spdji/en/spiva/article/spiva-europe
[2] S&P Dow Jones Indices, ARC Wealth Indices: Methodology and FAQ. www.spglobal.com/spdji/en/landing/topic/arc-wealth-indices-faq

A portfolio that suffers a substantial loss and takes several years to recover may eventually deliver a respectable return, but the discomfort endured along the way still matters. Such losses are an unavoidable consequence of accepting market risk. Active management introduces a different source of disappointment: the portfolio may rise in value yet still leave the investor worse off than their strategic allocation would have done. The cost is not necessarily a loss of capital, but the return forgone—and the regret of having accepted the risk of departing from the strategic allocation without receiving the expected reward.

Behavioural economics provides a helpful explanation. Loss aversion describes the tendency for financial losses to hurt more than equivalent gains please us. The value people derive from an outcome, or its 'utility', also need not depend solely on the final financial outcome. An investor may reasonably prefer a somewhat lower return achieved with fewer painful setbacks to a higher return accompanied by repeated and prolonged losses. The experience along the way matters, particularly if the discomfort of investing causes people to abandon a sensible strategy at the wrong moment.[3]

Implications for portfolio construction

This creates a problem for portfolio construction. Reducing risk by retreating from markets may ease the discomfort of drawdowns but the returns subsequently forgone can be equally disappointing. The investor has chosen a particular risk budget because it is appropriate to their circumstances. The task is to make better use of that budget, weighing the prospect of additional returns against the possibility of underperformance and the consequences of being wrong.

The analogy with navigating a real-world journey is useful. The strategic asset allocation is the dual carriageway, selected to reach the investor's destination with an acceptable level of risk. Active decisions are possible detours, taken in the expectation of finding a better route. Some will prove worthwhile, but the historical record suggests that the attractions of a shortcut have too often been overstated. Investors might reasonably ask how much additional reward they should expect before accepting the possibility of a longer or bumpier journey down a single-track country lane.

This does not mean accepting market returns uncritically or rejecting active investment decisions. It means placing a higher burden of proof on those decisions, recognising that their potential benefits must be weighed against the additional uncertainty, costs and risk of underperformance they introduce. Departures from the strategic allocation should offer a sufficiently compelling prospect of improving outcomes to justify the risk of sacrificing market returns. The continuing rationale for those departures matters as much as the original decision to make them.

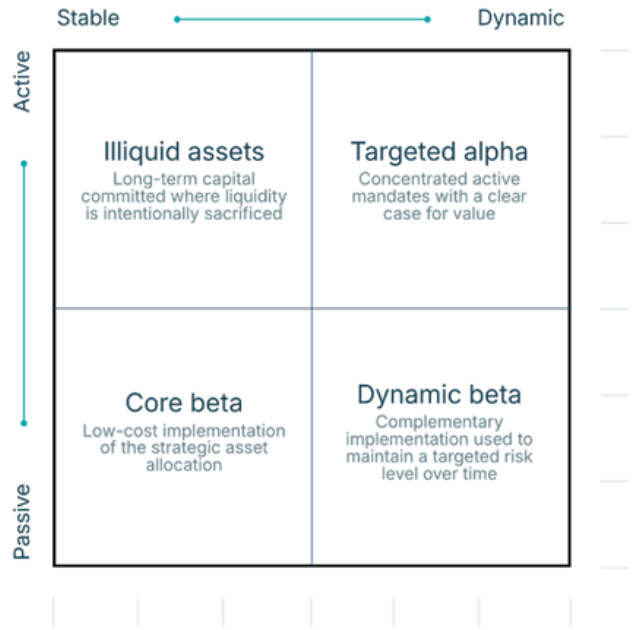
A higher burden of proof does not, however, remove uncertainty about which active decisions or investment methods will succeed. If no single approach can be relied upon to consistently deliver superior outcomes, concentrating any portfolio in one style of decision-making creates a further source of risk. The case for diversification therefore extends beyond markets, asset classes and securities to the investment approaches through which those exposures are managed.

[3] Kahneman, D., Wakker, P. P. and Sarin, R. (1997), Back to Bentham? Explorations of Experienced Utility, The Quarterly Journal of Economics, 112(2), pp. 375–406

Diversification by investment approach

Investors should therefore think more carefully about how they diversify their investment management arrangements. Appointing several managers may create the appearance of diversification while leaving the investor exposed to remarkably similar underlying investment philosophies. Different managers can own different securities yet share the same underlying assumptions about markets, make similar allocation decisions and experience much the same periods of underperformance.

One way to examine this is to consider two dimensions of portfolio construction: whether investments are implemented actively or passively and whether asset allocations remain relatively stable or change dynamically.



Diversification is not only about what a portfolio owns but about how investment decisions are made.

This framework separates two choices: active or passive implementation and static or dynamic asset allocation. This establishes four distinct approaches.

Dynamic beta combines low-cost passive implementation with a disciplined process for adjusting allocations as risks and opportunities change.

Figure 1: Approach to portfolio construction

This categorisation produces four broad styles, each reflecting a different combination of investment judgements. There is no particular virtue in allocating equally to all four but the framework helps reveal whether a portfolio is genuinely diversified in the way investment decisions are made, as well as in the assets it owns.

For investors and their advisers, the practical question is therefore wider than which managers have the best prospects of outperforming. It is worth examining how much active risk the portfolio is taking in aggregate, where that risk originates and whether the prospective rewards justify the possibility of disappointment.

It is also worth asking whether combining different approaches to portfolio construction could improve the experience of investing without abandoning the market exposure appropriate to the investor's long-term objectives.

The prospect of outperformance will always be attractive. The question is whether investors have given enough thought to its price and whether their portfolios have been constructed to manage that cost as carefully as they pursue the potential reward.



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