RETHINKING WHAT IT MEANS TO BE ACTIVE

INTRODUCTION

In the world of active equity investing, we love a good label. "High active share." "Low tracking error." "Factor neutral." These terms are thrown around in investment meetings like confetti at a wedding. But what if we told you that two portfolios with identical active share could behave entirely differently under the hood? Or that a portfolio with modest tracking error might be taking on more risk than one with double the number?

Welcome to the paradox of activeness—where looking different from the benchmark doesn't always mean you're taking different risks, and where being "active" can sometimes be surprisingly passive.

THE MIRAGE OF THE ACTIVE SHARE

Active share has become a darling of the investment world. It's simple, intuitive, and easy to calculate: how much of your portfolio differs from the benchmark? A high number suggests boldness, conviction, and perhaps even alpha. But here's the catch: active share is blind to risk.

Imagine two managers. Both have an active share of 50%. One has spread their bets across sectors—energy, banks, tech—each with different economic drivers. The other has doubled down on a handful of highly correlated energy stocks. On paper, they look equally "active." In reality, one is a diversified contrarian; the other is a concentrated risk-taker. Same active share, wildly different risk profiles.

RISK SHARE: THE MISSING LINK

This is where risk share enters the conversation. Risk share doesn't just ask how different your holdings are—it asks how different your risks are. It considers how much each asset contributes to the portfolio's overall volatility. And here's where things get interesting: portfolios with similar active share can have vastly different risk shares.

Why? Because risk isn't evenly distributed. Some assets punch above their weight. A 5% position in a volatile, highly correlated stock can dominate a portfolio's risk profile, while a 10% position in a low-volatility, uncorrelated stock might barely register. So, while active share tells you what's different, risk share tells you what matters.

TRACKING ERROR: A PROXY WITH PERSONALITY

Now let's talk about tracking error—the standard deviation of a portfolio's active returns. It's often used as a proxy for activeness, and rightly so. But it's not just a measure of how much a portfolio deviates from the benchmark; it's also a window into the types of risk being taken.

Here's the twist: you can build two portfolios with identical active share, but one might have double the tracking error of the other. Why? Because of correlation. Overweighting two highly correlated stocks (say, oil majors) amplifies active risk. But spreading that same active share across uncorrelated sectors (say, energy and banks) reduces it. The portfolio is just as "different" in holdings, but far less risky in behaviour.

This is where the art meets the science. A skilled manager doesn't just aim to be different—they aim to be efficiently different. They seek to maximise the information ratio: the return per unit of active risk. And that means being thoughtful not just about what they own, but how those holdings interact.

FACTOR RISK: THE HIDDEN PASSENGER

Let's not forget the silent stowaway in many portfolios: factor risk. A portfolio might appear diversified on the surface but be heavily exposed to a single factor—momentum, value, low volatility. These exposures can drive performance in ways that aren't immediately obvious from holdings alone.

Two funds might have similar tracking errors and even similar returns, but one could be riding a wave of momentum while the other is leaning into value. When the tide turns, their fortunes will diverge dramatically. Understanding factor risk is essential to understanding true activeness.

CONCLUSION: BEYOND THE NUMBERS

So, what's the takeaway? Activeness is not a one-dimensional concept. Active share, risk share, tracking error, and factor exposure all tell different parts of the story. Relying on a single metric is like judging a book by its cover—or worse, by its font.

In a world where investors are increasingly focused on outcomes, not optics, we must move beyond superficial measures of activeness. We must ask not just how different a portfolio looks, but how differently it behaves—and why.

Because in the end, it's not about being active. It's about being intelligently active.

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