



To: Members of the Investment Committee

From: Stephen Quirk, Investment Officer *Stephen Quirk*

Date: October 1, 2025

Subject: Education Session: Public Equity Active v Passive Investments under the current Capital Market conditions

Background

Over the course of three 2025 Investment Committee meetings, Staff and NEPC reviewed the current Public Equity structure in consideration of a possible restructure to thoughtfully implement the updated Public Equity Policy (48% MSCI ACWI IMI), to potentially enhance ACERA's Total Fund performance, and to ensure that the structure is fully compatible with the current market environment (Active v Passive was last reviewed in 2015).

Discussion

The previous decade was challenging for active management across the entire equity space, but alpha generation is cyclical, so it's imperative to evaluate the current active management environment. Active global equity managers may provide favorable potential for positive net excess returns according to NEPC research and there are multiple benefits to hiring global mandates to cover both US and International developed large cap equity markets:

- Expanding the opportunity set for a skilled active manager who understands multinational companies in a globalized economy may increase the likelihood of positive net excess returns. There is greater dispersion and outperformance in the Global equity manager universe than in the US and International developed large cap equity manager universes (see Attachment #1 for details).
- For institutional allocators, attempting to dynamically shift between the US and International allocations correctly is extremely difficult and Staff does not have dedicated tactical resources, so this critical investment decision is better delegated to a global manager. With the recent dominance of U.S. equity markets, many global equity active managers have not added meaningful value over the past several years shifting between US and International markets.
- Operational simplicity is a helpful global equity by-product as the rebalancing burden between US and International allocations on Staff is relieved as global equity mandates are consistent with the public equity Policy benchmark. A simplified global structure with larger allocations to fewer managers will likely trigger lower active fees, provide greater performance clarity, and enable improved risk management.

Next Steps

The 2025 NEPC Active vs. Passive Study helps to identify public equity markets that may be more suitable for active management based on historical data as of 6/30/25. However, there is no active management panacea, and rigorous manager selection and diligent risk management supersede the market environment in building a successful active public equity program. At the November Investment Committee meeting, Staff and NEPC will present a range of public equity structures that reflect the current research and make a recommendation for a new structure.

Attachments

1. Education Session: Public Equity Active vs. Passive Investments under the current Capital Market Conditions



EDUCATION SESSION

PUBLIC EQUITY ACTIVE VS. PASSIVE
INVESTMENTS UNDER THE CURRENT
CAPITAL MARKET CONDITIONS

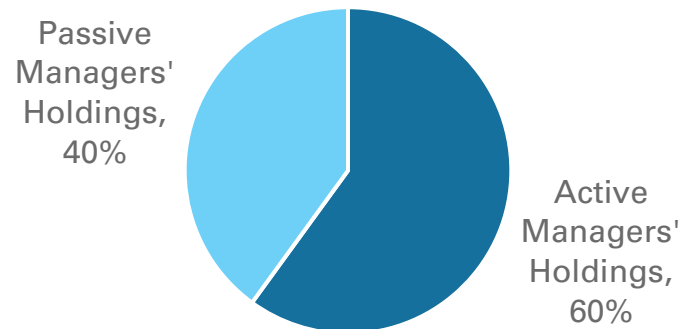
Sam Austin, Partner
Will Forde, Partner, Head of Marketable Equity
Investments



MARKET COMPOSITION

- Collectively, all investors own the market
- The market is simply the sum of all active portfolios plus all passive portfolios
- If one manager beats the market, this implies that another manager must underperform by the same amount, since collectively they are the market

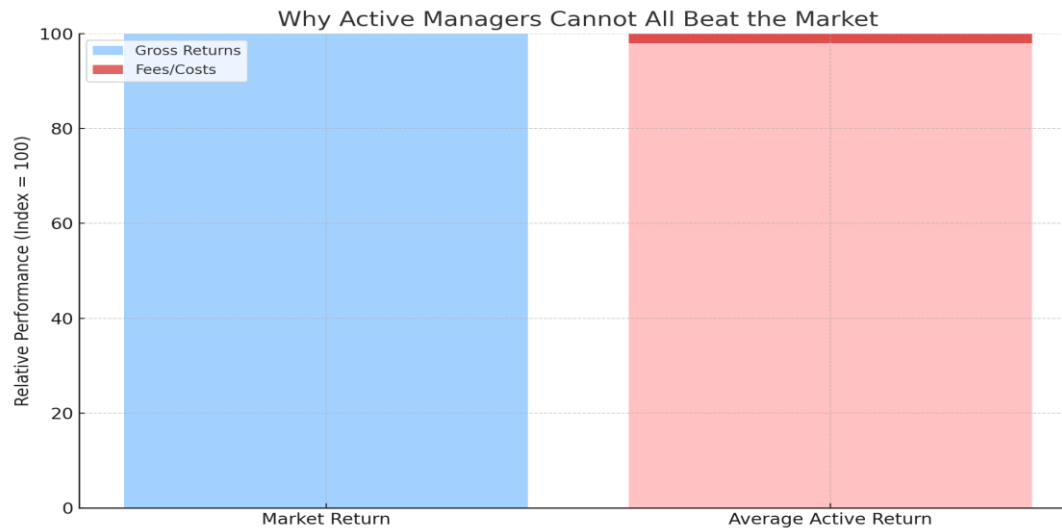
The Market = Active + Passive



For illustrative purposes only. Actual ratio between active and public will vary based on time and market.
Source: William F. Sharpe, 1991, *The Arithmetic of Active Management*

CHALLENGE OF ACTIVE MANAGEMENT

- On average, before fees/costs, active managers as a group will equal the market return
- On average, after fees/costs, active managers as a group will underperform the market
- Passive managers on average will do better than the average active manager due to lower fees and costs



For illustrative purposes only. Actual empirical data will vary.
Source: William F. Sharpe, 1991, *The Arithmetic of Active Management*

LEVERS OF ACTIVE MANAGEMENT

- **An active manager may be able to outperform the market through skill and breadth**
- **Information Advantage – Have better forecasts than the market (skill)**
 - Consistently predict something that the market has not fully priced in, such as earnings, risk, growth, credit events, etc.
 - Act on information before market catches up
- **Implementation Advantage – Exploit forecasts with portfolio construction (breadth)**
 - Build and size positions in a disciplined way
 - Turn many small forecasting edges into a consistent source of returns by diversifying them properly

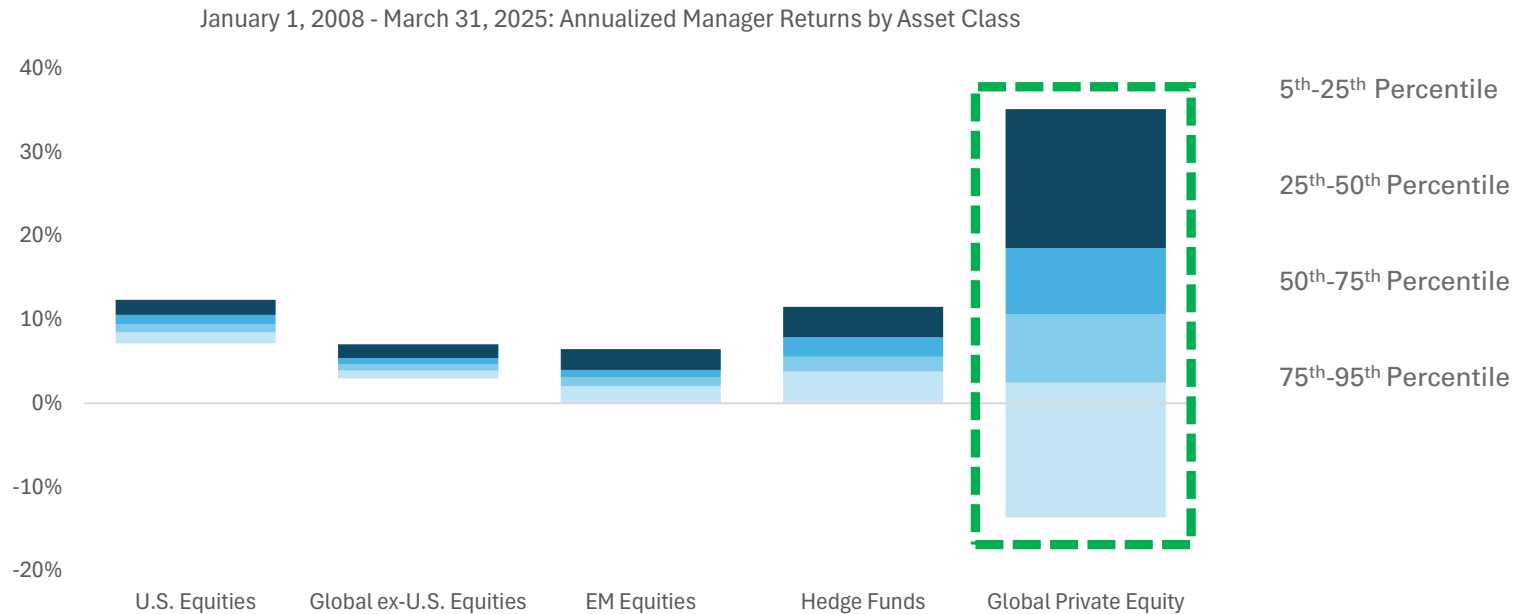
$$\text{Information Ratio} \approx \text{Skill} \times \text{Breadth}$$

Performance depends on accuracy of forecasts (skill) multiplied by how many independent chances a manager gets to apply that skill (breadth)

PUBLIC MARKETS VERSUS PRIVATE MARKETS

- All things being equal*, applying a bigger share of your active risk budget to private markets tends to yield a larger opportunity set for generating higher and more persistent alpha than applying a big share of active risk budget to public markets.

*All things are NOT equal (i.e. access to best managers, manager selection skill, fees, plan liquidity, etc.)



Source: eVestment and Cambridge Associates. Returns data are time-weighted except for Global Private Equity and Global Private Credit, which are dollar-weighted. Based on data obtained as of September 2025.

SUMMARY

- **On average, active managers cannot collectively outperform the market once fees and costs are considered, since their collective net return is lower than the market return**
- **Passive managers, who simply hold the market and have lower costs, will on average perform better than the average active manager**
- **Not all active managers are average – a genuinely skilled manager may be able to add consistent value through forecasting ability and disciplined portfolio construction**
- **Rigorous due diligence and manager selection are critical to identify active managers with genuine skill**
- **Evidence suggests that active managers may have a better chance to generate consistent alpha in certain market segments**
- **The following slides from NEPC's Active vs. Passive Study helps to identify public equity markets that may be more suitable for active management based on historical data as of 6/30/25**



NEPC ACTIVE VS. PASSIVE STUDY

NEPC ACTIVE VS. PASSIVE RESEARCH STUDY

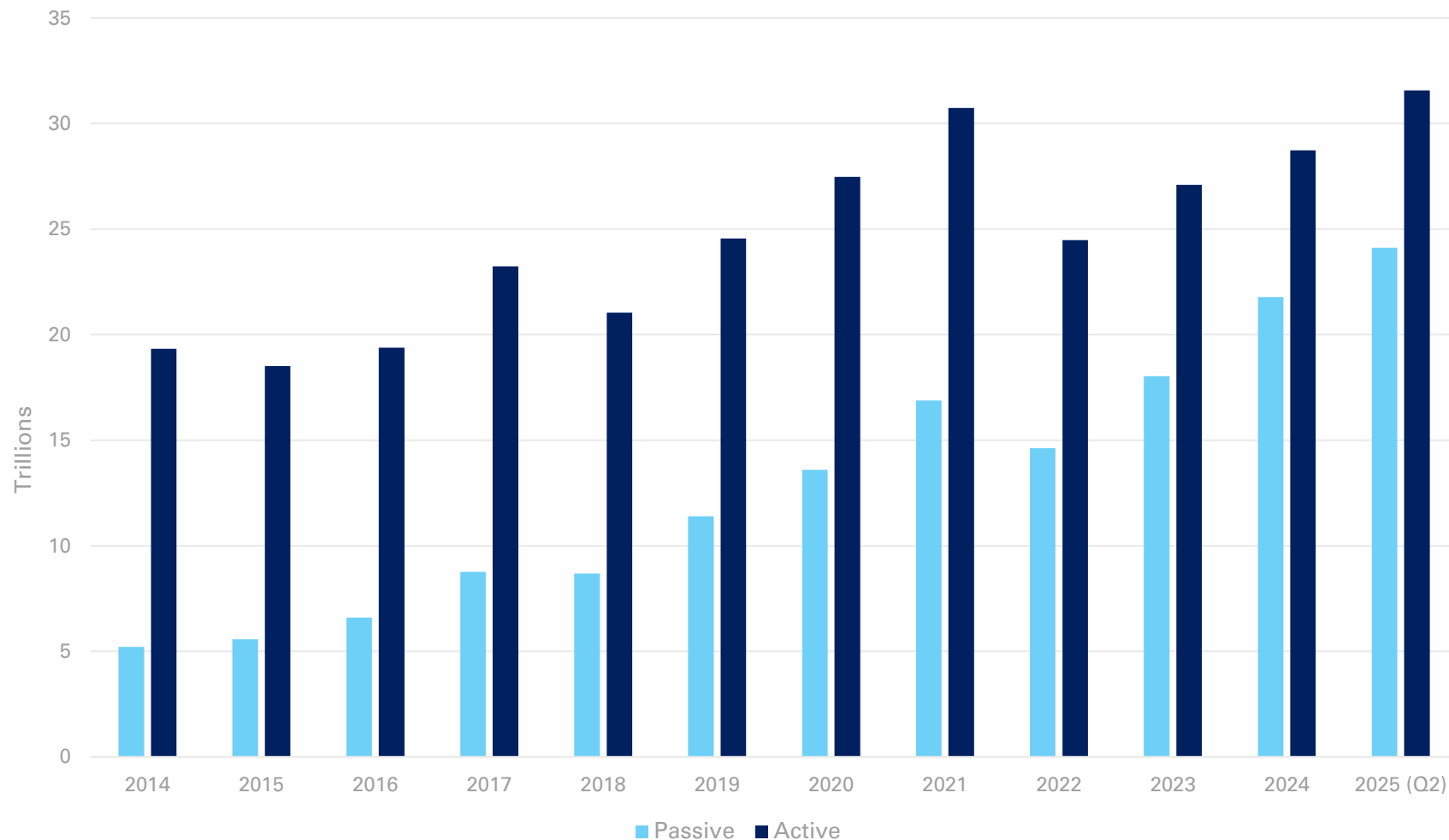
- **NEPC conducts an annual study of the performance of active vs. passive investment strategies in public markets**
 - In addition, we also provide an annual update of asset flows across both active and passive investments
- **We evaluate the decision for active management across two tests:**
 - **Test 1** considers whether there is wide dispersion between manager returns across the trailing 10-year period
 - **Test 2** considers whether the median manager outperforms the benchmark, net of fees, on a rolling 3-year basis
- **While this study is meant to be based on our quantitative tests, there are several things that clients should consider as they review the study**
 - The active vs. passive decision should also incorporate the individual goals of clients and the allocation specifically
 - Passive implementation in some asset classes may be costly or may not fully replicate its index



ACTIVE VS. PASSIVE ASSET FLOWS

ACTIVE VS. PASSIVE TOTAL ASSETS

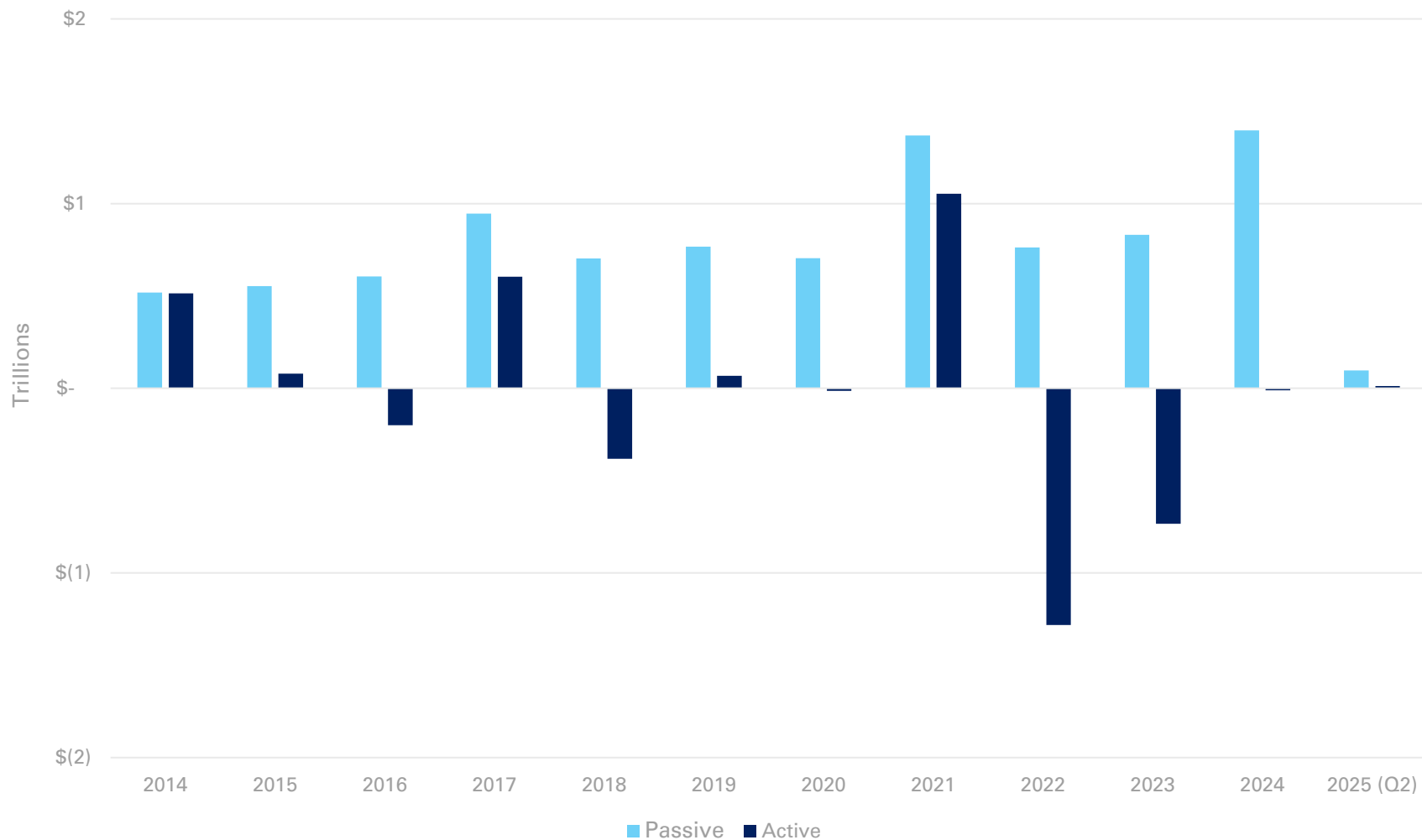
TOTAL NET ASSETS BY CALENDAR YEAR



Source: Morningstar Direct; Based on US domiciled funds

ACTIVE VS. PASSIVE FLOWS

NET FLOWS BY CALENDAR YEAR



ACTIVE VS PASSIVE TOTAL ASSETS & FLOWS

TOTAL ASSETS & FLOWS BY ASSET CLASSES

Asset Class*	2025 (Q2) Flow USD Bil	% of 2025 (Q2) Flow	Assets USD Tril
Equity	3	3%	34.9
Fixed Income	98	92%	13.4
Alternatives	14	13%	0.9
Multi-Asset	-11	-11%	5.1
Other	3	3%	1.3
Total	107		55.6

Source: Morningstar Direct; Based on US domiciled funds

*Details on the components of each asset class can be found within the appendix



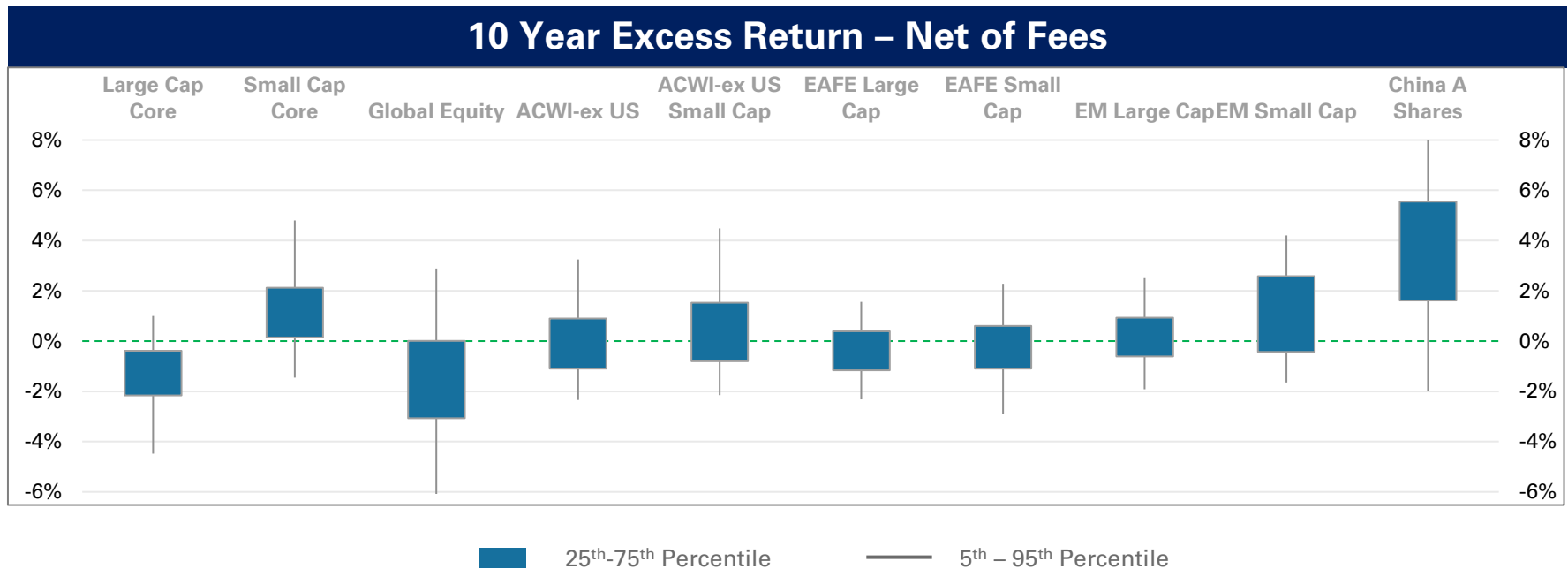
ACTIVE VS. PASSIVE VIEWS

EQUITIES

ALL EQUITIES

ACTIVE VS. PASSIVE VIEWS

	Large Core	Small Core	Global Equity	ACWI ex US	ACWI ex US Small Cap	EAFE Large Cap	EAFE Small Cap	EM Large Cap	EM Small Cap	China A Shares
Test 1 (Dispersion)	Pass	Pass	Pass	Pass	Pass	Fail	Fail	Fail	Pass	Pass
Test 2 (Rolling Outperformance)	Fail	Pass	Pass	Pass	Pass	Pass	Pass	Pass	Pass	Pass
Efficient Passive Option	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes

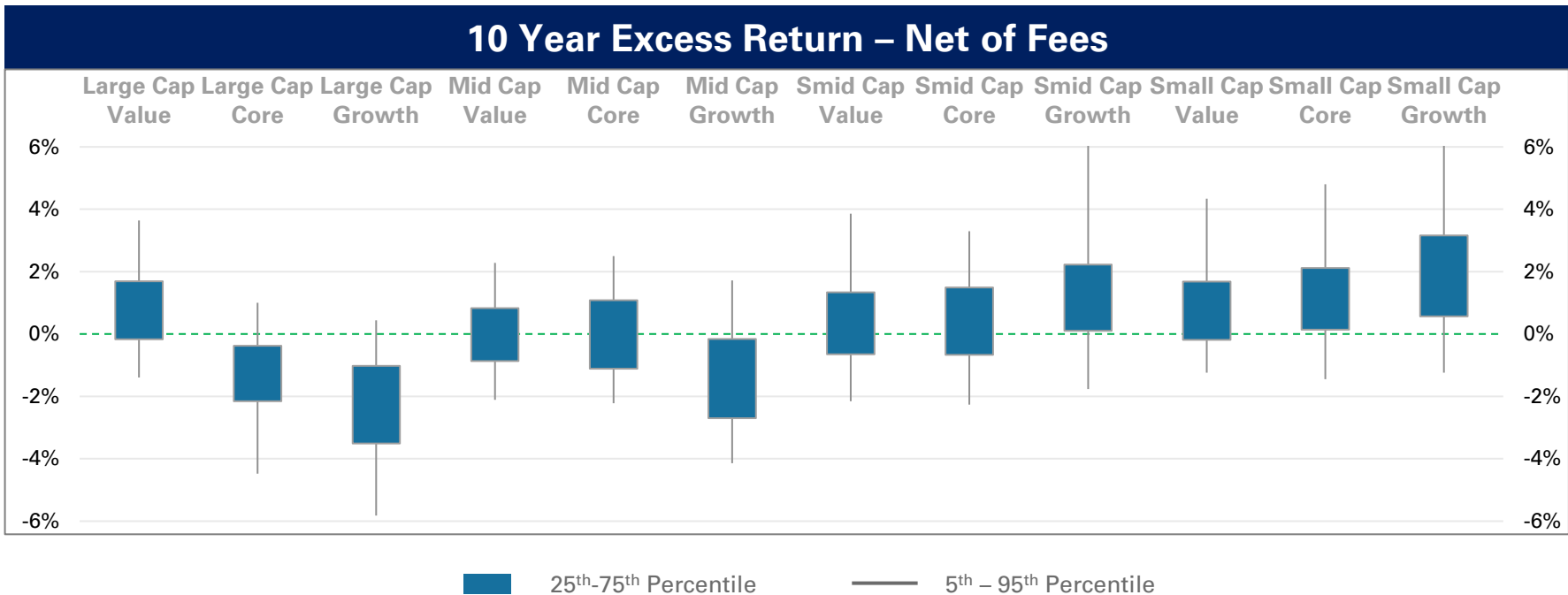


Source: eVestment. Data as of 06/30/2025; **Test 1** considers whether there is wide dispersion between manager returns across the trailing 10-year period and **Test 2** considers whether the median manager outperforms the benchmark, net of fees, on a rolling 3-year basis on average; Benchmarks used in the above analysis are detailed within appendix

US EQUITIES

ACTIVE VS. PASSIVE VIEWS

	Large Value	Large Core	Large Growth	Smid Value	Smid Core	Smid Growth	Small Value	Small Core	Small Growth
Test 1 (Dispersion)	Pass	Pass	Pass	Pass	Pass	Pass	Pass	Pass	Pass
Test 2 (Rolling Outperformance)	Pass	Fail	Fail	Fail	Pass	Pass	Pass	Pass	Pass
Efficient Passive Option	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes

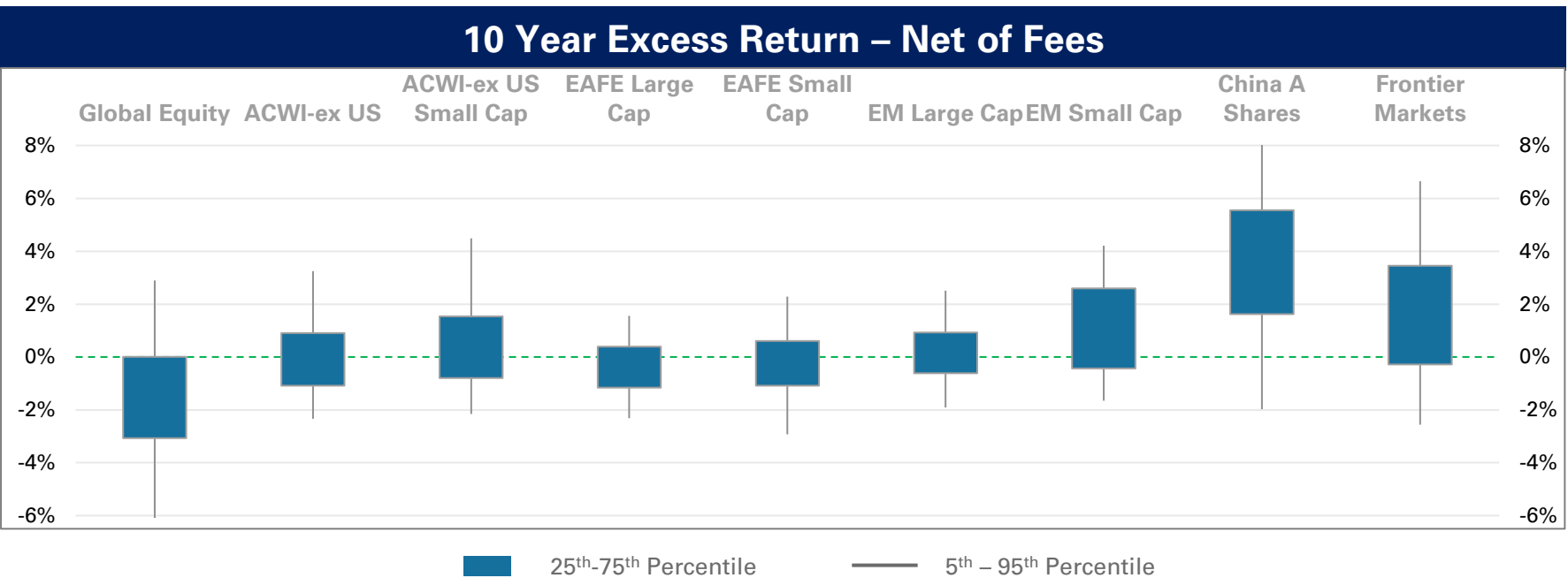


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NON-US EQUITIES

ACTIVE VS. PASSIVE VIEWS

	Global Equity	ACWI ex US	ACWI ex US Small Cap	EAFE Large Cap	EAFE Small Cap	EM Large Cap	EM Small Cap	China A Shares	Frontier Markets
Test 1 (Dispersion)	Pass	Pass	Pass	Fail	Fail	Fail	Pass	Pass	Pass
Test 2 (Rolling Outperformance)	Pass	Pass	Pass	Pass	Pass	Pass	Pass	Pass	Pass
Efficient Passive Option	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes



Source: eVestment. Data as of 06/30/2025; **Test 1** considers whether there is wide dispersion between manager returns across the trailing 10-year period and **Test 2** considers whether the median manager outperforms the benchmark, net of fees, on a rolling 3-year basis on average; Benchmarks used in the above analysis are detailed within appendix



DETAILED ANALYSIS

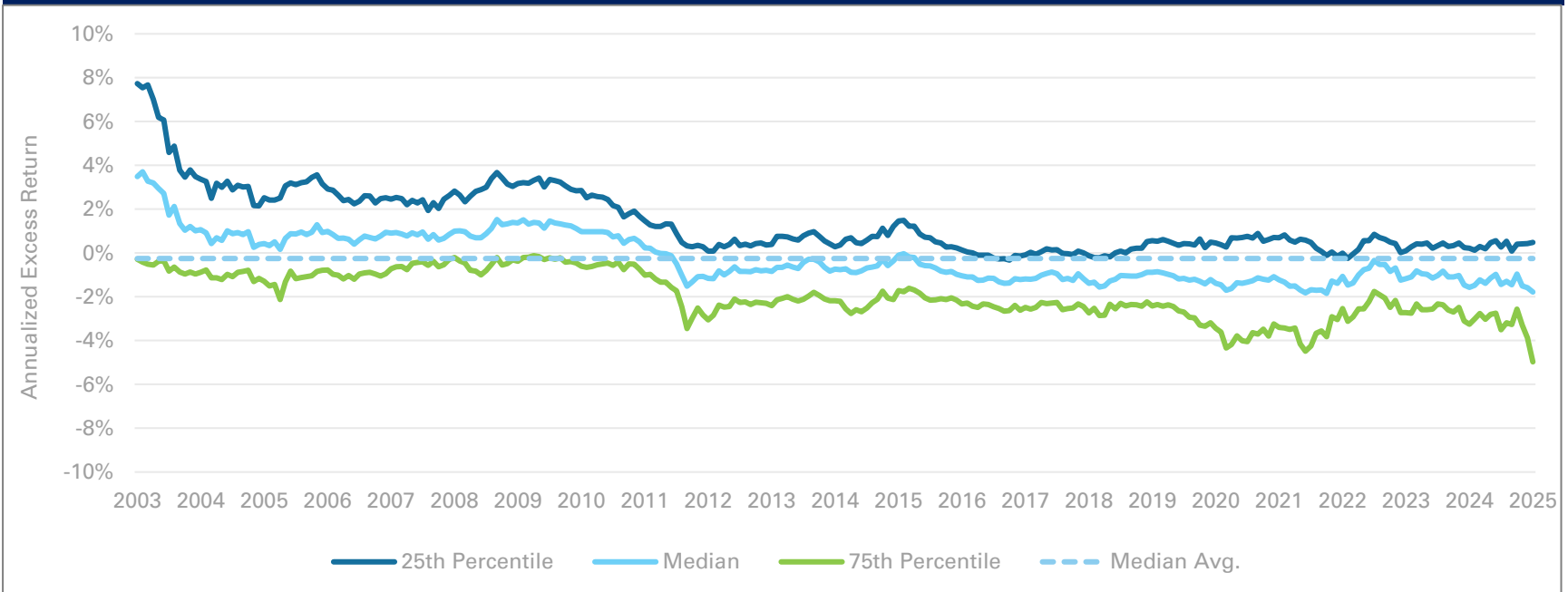
EQUITIES

US LARGE CAP CORE

NEPC Active Management Views

Asset Class	Median Fee	Test 1 Dispersion	Test 2 Median Outperf	Efficient Passive Option
US Large Cap Core	0.48%	Pass	Fail	Yes

Rolling 3 Year Excess Returns



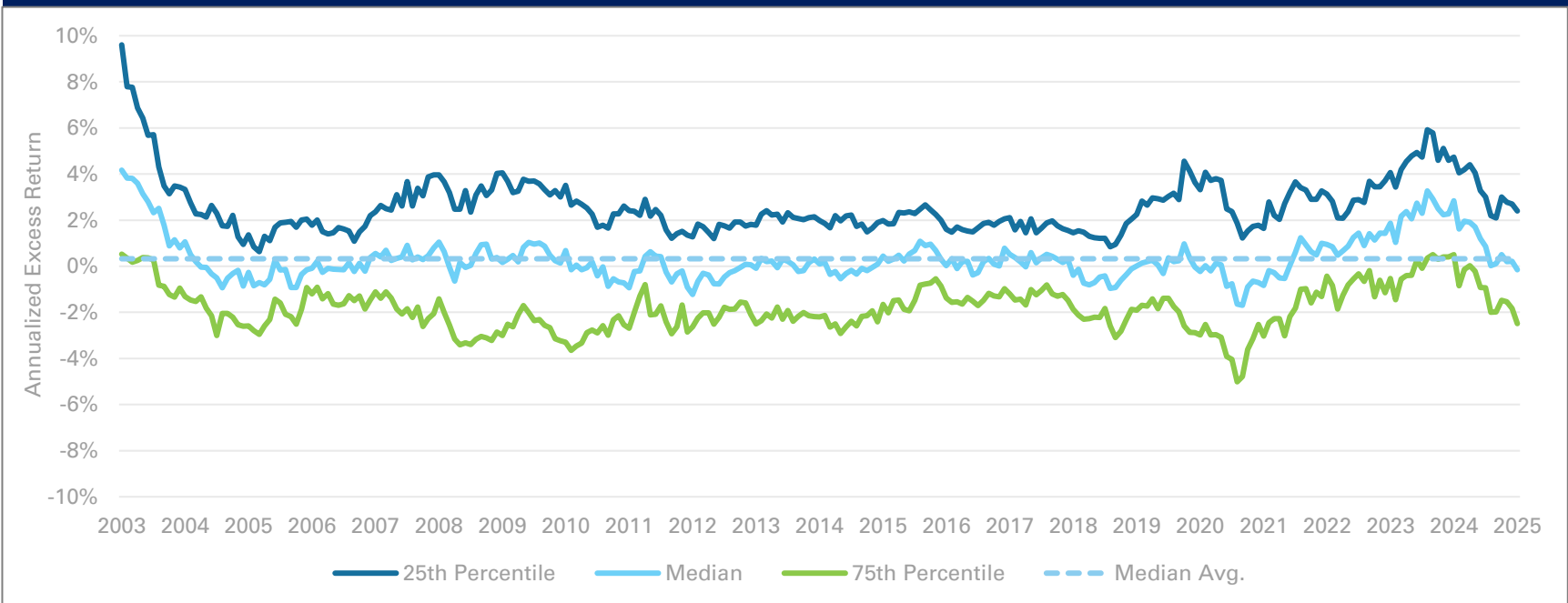
Source: eVestment. Data as of 06/30/2025; **Test 1** considers whether there is wide dispersion between manager returns across the trailing 10-year period and **Test 2** considers whether the median manager outperforms the benchmark, net of fees, on a rolling 3-year basis on average; Data is Net-of-Fees. US Large Cap Core Universe vs. S&P 500 Index.

US SMID CAP CORE

NEPC Active Management Views

Asset Class	Median Fee	Test 1 Dispersion	Test 2 Median Outperf	Efficient Passive Option
US Smid Cap Core	0.75%	Pass	Pass	Yes

Rolling 3 Year Excess Returns



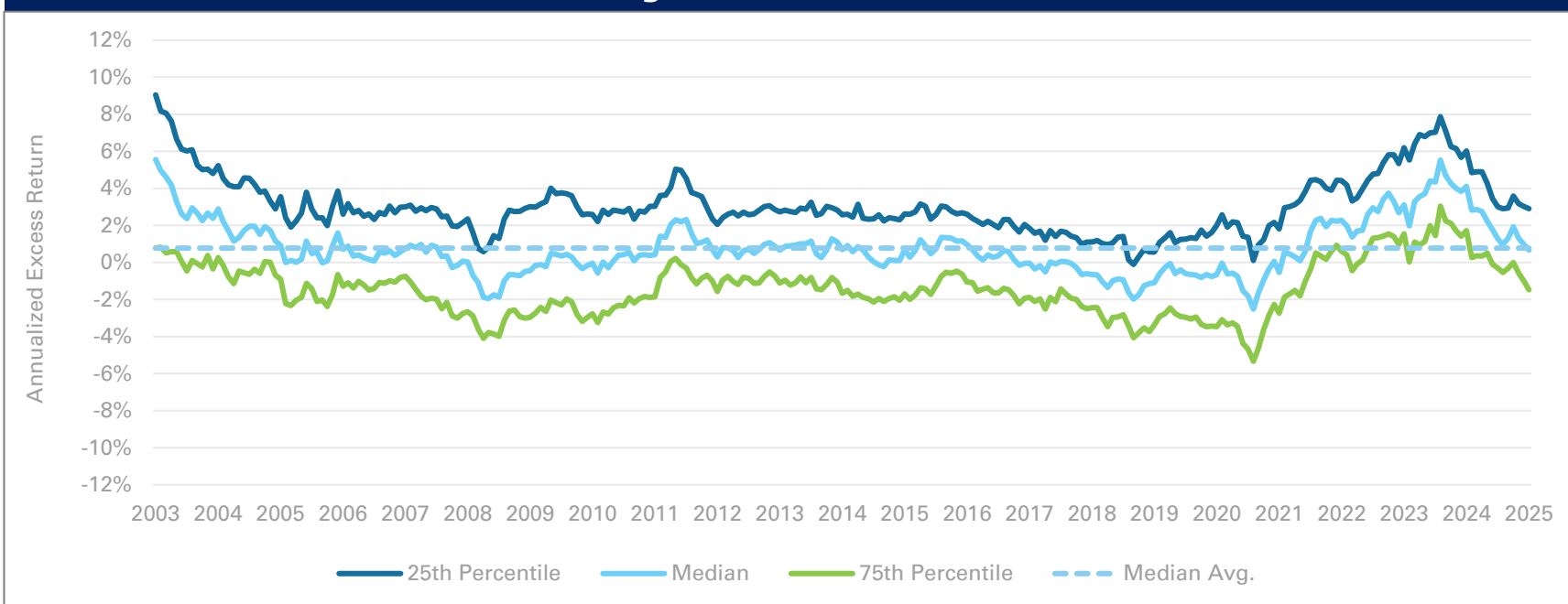
Source: eVestment. Data as of 06/30/2025; **Test 1** considers whether there is wide dispersion between manager returns across the trailing 10-year period and **Test 2** considers whether the median manager outperforms the benchmark, net of fees, on a rolling 3-year basis on average; Data is Net-of-Fees. US Small-Mid Cap Core Universe vs. Russell 2500 Index.

US SMALL CAP CORE

NEPC Active Management Views

Asset Class	Median Fee	Test 1 Dispersion	Test 2 Median Outperf	Efficient Passive Option
US Small Cap Core	0.76%	Pass	Pass	Yes

Rolling 3 Year Excess Returns



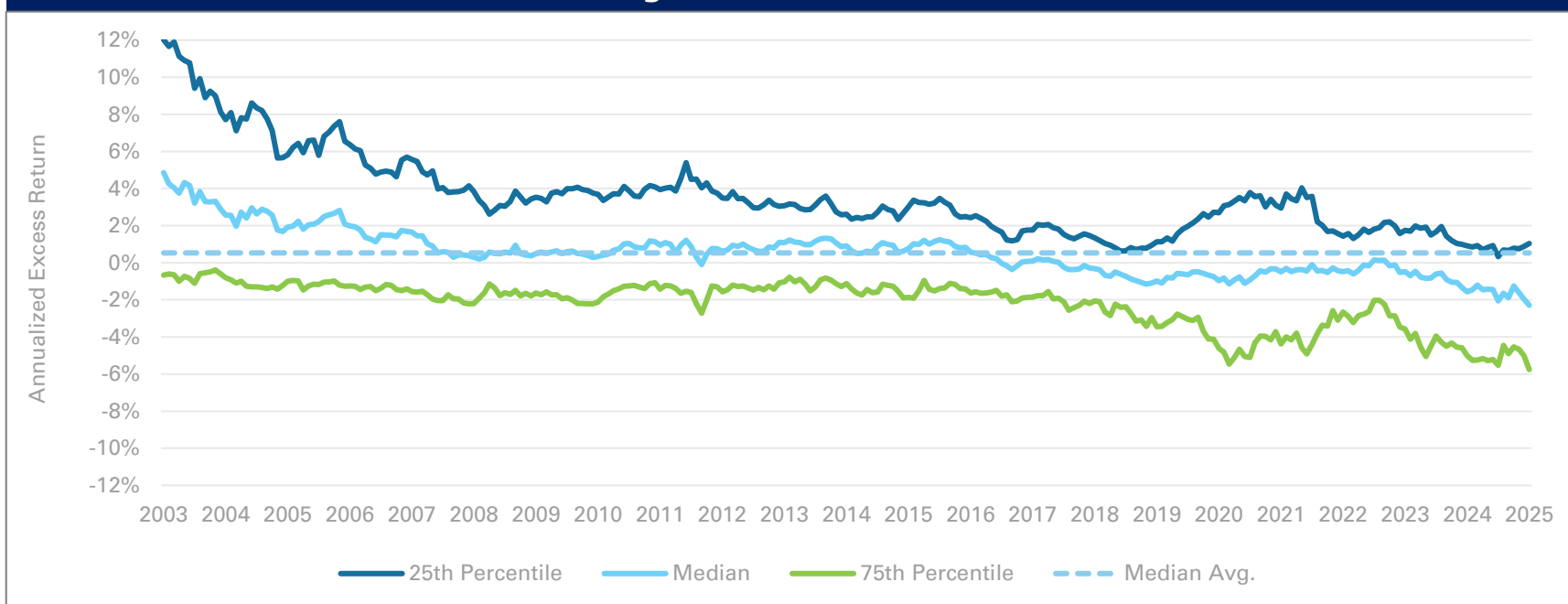
Source: eVestment. Data as of 06/30/2025; **Test 1** considers whether there is wide dispersion between manager returns across the trailing 10-year period and **Test 2** considers whether the median manager outperforms the benchmark, net of fees, on a rolling 3-year basis on average; Data is Net-of-Fees. US Small Cap Core Universe vs. Russell 2000 Index.

GLOBAL EQUITY

NEPC Active Management Views

Asset Class	Median Fee	Test 1 Dispersion	Test 2 Median Outperf	Efficient Passive Option
Global Equity	0.70%	Pass	Pass	Yes

Rolling 3 Year Excess Returns



Source: eVestment. Data as of 06/30/2025; **Test 1** considers whether there is wide dispersion between manager returns across the trailing 10-year period and **Test 2** considers whether the median manager outperforms the benchmark, net of fees, on a rolling 3-year basis on average; Data is Net-of-Fees. All Global Equity Universe vs. MSCI ACWI Index.

ACWI EX-US

NEPC Active Management Views

Asset Class	Median Fee	Test 1 Dispersion	Test 2 Median Outperf	Efficient Passive Option
ACWI ex-US	0.70%	Pass	Pass	Yes

Rolling 3 Year Excess Returns



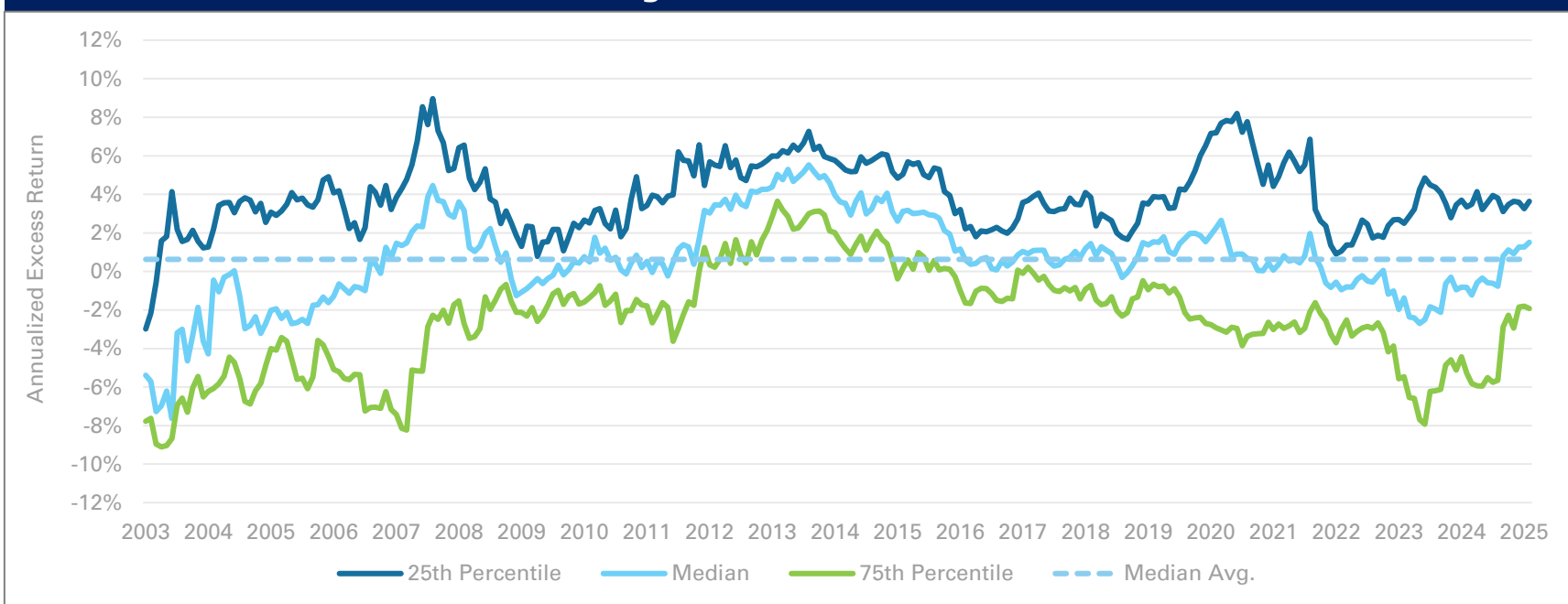
Source: eVestment. Data as of 06/30/2025; **Test 1** considers whether there is wide dispersion between manager returns across the trailing 10-year period and **Test 2** considers whether the median manager outperforms the benchmark, net of fees, on a rolling 3-year basis on average; Data is Net-of-Fees. All ACWI ex-US Universe vs. MSCI ACWI ex US Index.

ACWI EX-US SMALL CAP

NEPC Active Management Views

Asset Class	Median Fee	Test 1 Dispersion	Test 2 Median Outperf	Efficient Passive Option
ACWI ex-US Small Cap	0.90%	Pass	Pass	Yes

Rolling 3 Year Excess Returns



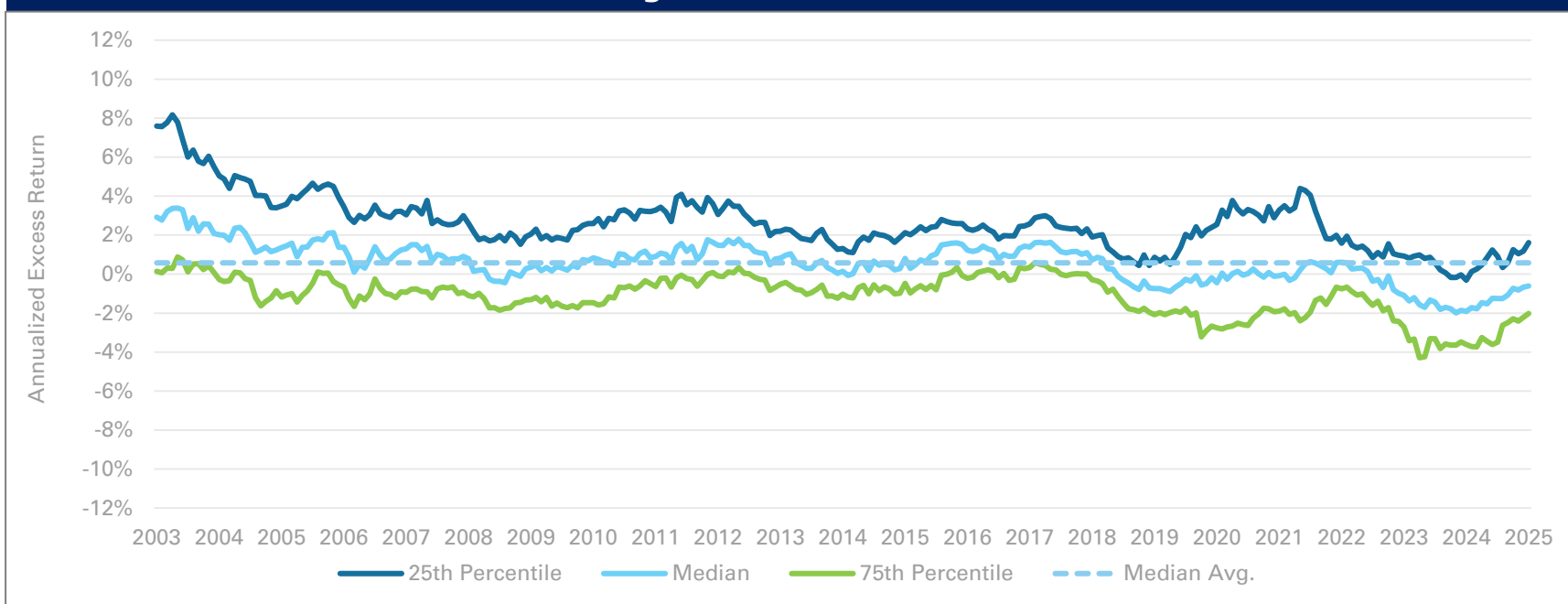
Source: eVestment. Data as of 06/30/2025; **Test 1** considers whether there is wide dispersion between manager returns across the trailing 10-year period and **Test 2** considers whether the median manager outperforms the benchmark, net of fees, on a rolling 3-year basis on average; Data is Net-of-Fees. All ACWI ex-US Small Cap Universe vs. MSCI ACWI ex US Small Cap Index.

EAFE LARGE CAP

NEPC Active Management Views

Asset Class	Median Fee	Test 1 Dispersion	Test 2 Median Outperf	Efficient Passive Option
EAFE Large Cap	0.63%	Fail	Pass	Yes

Rolling 3 Year Excess Returns



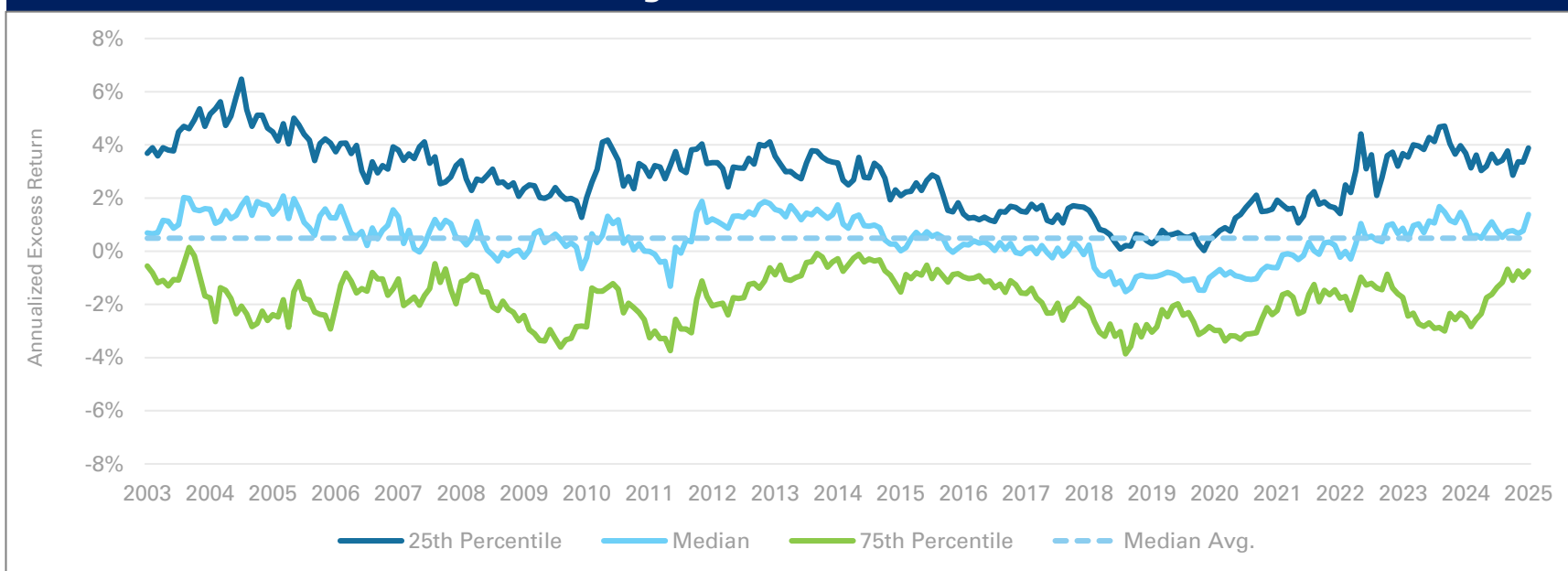
Source: eVestment. Data as of 06/30/2025; **Test 1** considers whether there is wide dispersion between manager returns across the trailing 10-year period and **Test 2** considers whether the median manager outperforms the benchmark, net of fees, on a rolling 3-year basis on average; Data is Net-of-Fees. EAFE Large Cap Equity Universe vs. MSCI EAFE Large Cap Index.

EMERGING MKT. LARGE CAP

NEPC Active Management Views

Asset Class	Median Fee	Test 1 Dispersion	Test 2 Median Outperf	Efficient Passive Option
Emerging Mkt. Large Cap	0.78%	Fail	Pass	Yes

Rolling 3 Year Excess Returns



Source: eVestment. Data as of 06/30/2025; **Test 1** considers whether there is wide dispersion between manager returns across the trailing 10-year period and **Test 2** considers whether the median manager outperforms the benchmark, net of fees, on a rolling 3-year basis on average; Data is Net-of-Fees. All Emerging Mkt. Equity Universe vs. MSCI Emerging Mkt. Equity Index.

APPENDIX

BENCHMARK DISCLOSURE

ACTIVE VS. PASSIVE TEST: EQUITY

Asset Class	Index	eVestment Universe
Large Cap Core	S&P 500	US Large Cap Core Equity
Smid Cap Core	Russell 2500	US Small-Mid Cap Core Equity
Small Cap Core	Russell 2000	US Small Cap Core Equity
Global Equity	MSCI ACWI	All Global Equity
ACWI-ex US	MSCI ACWI ex US	All ACWI ex US
ACWI-ex US Small Cap	MSCI ACWI ex US Small Cap	All ACWI ex US Small Cap
EAFE Large Cap	MSCI EAFE Large Cap	EAFE Large Cap Equity
EM Large Cap	MSCI Emerging Mkt. Equity	Global Emerging Mkt. Large Cap Equity

MORNINGSTAR ASSET CLASS DISCLOSURES

Equity: this asset category consists of Morningstar funds categorized under Equity

Fixed Income: this asset category consists of Morningstar funds categorized under Fixed Income and Convertibles

Alternatives: this asset category consists of Morningstar funds categorized under Alternatives and Commodities; Morningstar defines “alternatives” as Funds which invest in some form of alternative strategy. These strategies can include but are not restricted to global macro, long/short credit, market neutral, multialternative, and options trading

Multi-Asset: this asset category consists of Morningstar funds categorized under Allocation and Other; Morningstar defines “Allocation” as Funds which invest across a mix of different assets. These strategies include but are not restricted to aggressive allocation, cautious allocation, moderate allocation. flexible allocation, and target date funds.

Other: this asset category consists of Morningstar funds categorized under Miscellaneous, Unclassified, Property, and Money Market

DATA DISCLOSURES

Universe performance data is shown on a net-of-fee basis

The universe data shown includes only actively managed portfolios

Rolling 3-year annualized excess returns and benchmark rankings have a one month rollback

The median fee shown for each asset class is for a commingled fund at an assumed \$50 million mandate size

To account for survivorship bias, eVestment includes inactive accounts in any historical universe calculations. eVestment does not allow for products/vehicles to be deleted from its database.

eVestment classifies universes using a tiered approach so that products can be found in data screens of differing levels of granularity. eVestment offers universe tiers at three levels: Primary, Secondary/Specialty, and Roll-Up.

Primary Universes are typically the most granular and are commonly used as the default comparison peer group in eVestment's analytics modules. A product can only be classified into one Primary Universe. Example: US Large Cap Core Equity and US High Yield.

NEPC DISCLOSURES

Past performance is no guarantee of future results.

All investments carry some level of risk. Diversification and other asset allocation techniques do not ensure profit or protect against losses.

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