APRIL 26, 2013

# Actively Pursuing Outperformance: How Active Managers Can Make a Difference

**For many, the question of "active" versus "passive" management is no longer even a debate:** Many academics and passive proponents have simply proceeded on the assumption that passive management rules the day. However, this assumption is likely premature for many reasons. In practice, some managers who claim to be active invest in a very similar way to their market benchmark, calling into question the validity of the many empirical comparisons. Furthermore, passive management can have limitations: A customary way of investing passively is through exchange-traded funds (ETFs), and these products carry many risks that we believe are often overlooked, including market, liquidity and counterparty risk. Finally, as stock correlations and volatility have generally declined over the past few quarters and global equity markets have begun to move more on fundamentals, active managers may have a greater opportunity to exploit market inefficiencies. Looking both within and outside the US, this paper will seek to make the case for active management in today's marketplace, with a focus on two key areas of the active versus passive debate:

1. Putting the performance figures of active versus passive solutions into context, particularly the limitations of traditional ways of identifying active managers and highlighting how "true" active managers can potentially outperform less active players;
2. Re-examining some of the commonly known risks of passive ETF investing, and discussing some of the less well-known limitations of such strategies as well.

## PART 1: PUTTING THE ACTIVE VS. PASSIVE DEBATE IN CONTEXT

In recent years, many have made emphatic claims that passive investing is the proven winner over active management. At least from a flows perspective, those claims appear true. As illustrated in Charts 1 and 2, passive global equity ETFs have seen sizeable inflows in the US fund market over the past several years and notably outpaced the growth rate of active mutual funds in the same space. Furthermore, the equity ETF business overall has grown exponentially, now representing nearly a quarter of the active equity space: In 2006, there was approximately $385 billion under management, but at the end of 2012, passive equity ETF assets came close to $1 trillion. Proponents of passive investing cite the potential for better short-term returns and lower fees than actively-managed solutions as part of their rationale. However, these factors may not tell the whole story. It is true that in more recent, shorter-term time periods, US-domiciled equity mutual funds have tended to underperform the market, as a high-correlation environment has limited the benefits of fundamental investing. Despite these challenges, many actively managed portfolios with compositions unlike market indexes have still performed well. Furthermore, although there is no guarantee that an active investment manager's investment technique or decisions will produce the desired results, over longer time frames, we believe the potential benefits of real active management still hold true.

**Chart 1: Passive Flows Have Grown at a Faster Pace Than Active Managers**

As of January 31, 2013

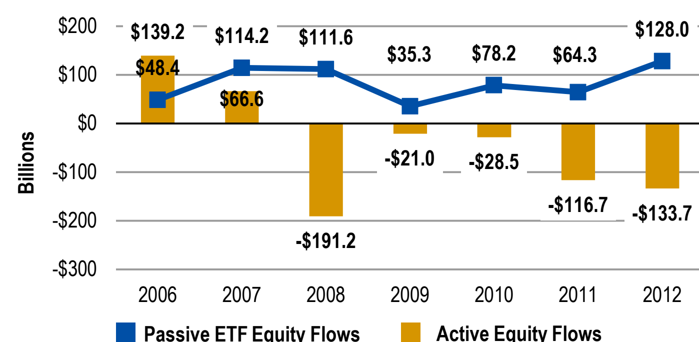



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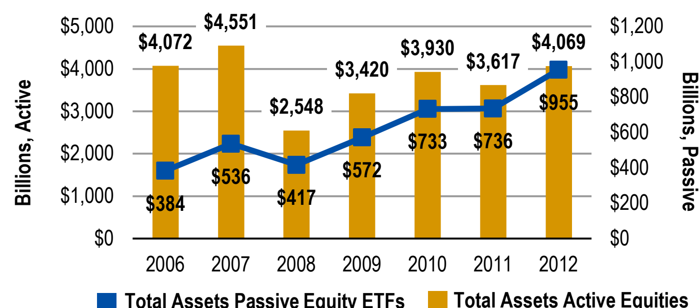
**Chart 2: Passive ETF Assets Are Now Almost 25% of the AUM Under Active Management**

As of January 31, 2013





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## WHEN "ACTIVE" INVESTING IS NOT SO ACTIVE AFTER ALL

Many mutual funds claim to follow an active philosophy. Accordingly, their returns are reflected in databases that track the active funds category and are applied toward the results that encompass active funds in general. Yet some of these managers appear more passive in nature: When compared to their respective benchmark indexes, some managers who claim to be active invest in the same holdings, and at a similar weighting. Even open-ended mutual funds that are specifically designed to mirror an index—and that display other active characteristics such as multiple managers or higher expense ratios—can sometimes be included in active mandate groupings.

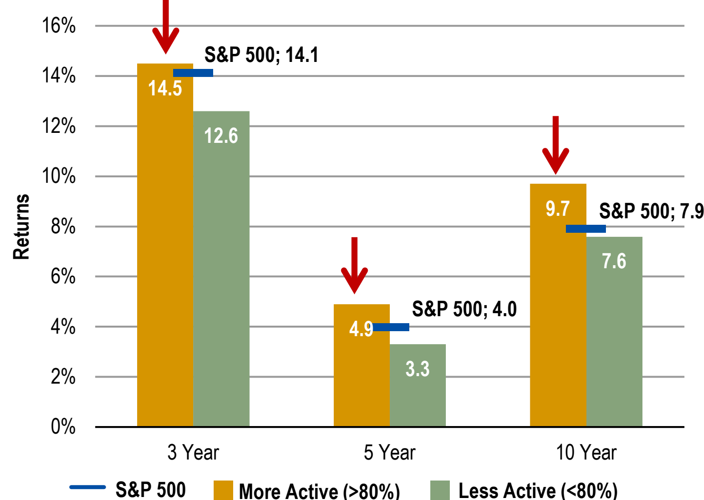
*Active Share*, a statistic that measures the percentage of a given portfolio's holdings that is different from its respective benchmark index, is a relatively new tool that can help to identify "true" active managers. Managers that tend to look and perform similar to an index tend to have a lower *Active Share* score, and can be detrimental to an investor's overall portfolio, particularly when that fund has active-manager-level fees. As illustrated in the following section, analysis suggests that those managers who have a higher *Active Share* have tended to perform better on average than those with a lower *Active Share* over select time frames. Past performance does not guarantee future results.

## "TRUE" ACTIVE MANAGERS HAVE THE POTENTIAL TO OUTPERFORM THE MARKET

While the typical active-versus-passive comparison might simply highlight Morningstar or Lipper category returns relative to the passive ETF returns or market index for a similar investment style, such results can be misleading. Morningstar and Lipper categories contain both "true" active managers and active managers who invest similarly to the benchmark—the latter often called "closet indexers." When "true" active managers are broken out from the closet indexers, the true players have tended to do better. This concept can be illustrated by conducting a screen of Morningstar's US equity managers. As shown in Chart 3, when the group was organized by *Active Share* score, (using the standard 80% score as a threshold for "active") the active group outperformed less active peers and the S&P 500® Index on average over the period indicated. Keep in mind that passively-managed ETFs that are designed to follow the S&P 500 Index will generally mirror the performance of this benchmark, so the active group outperformed these ETFs as well. Furthermore, those funds with an *Active Share* score below 25% returned 7.4% on average over 10 years ending January 31, 2013, underperforming the index, even though they looked very similar to it.[1] The crucial point: While active managers can have a greater range of performance versus passive players, on average, the "true" active funds have tended to outperform. Often, the less active managers can pull down the results of the entire category making it appear that active managers underperform ETFs, while in reality, the "true" active managers outperformed.

**Chart 3: US Equity Managers with Higher Active Share Score vs. Less Active Share Score of S&P 500**

As of January 31, 2013

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## A DEEPER DIVE INTO US EQUITY

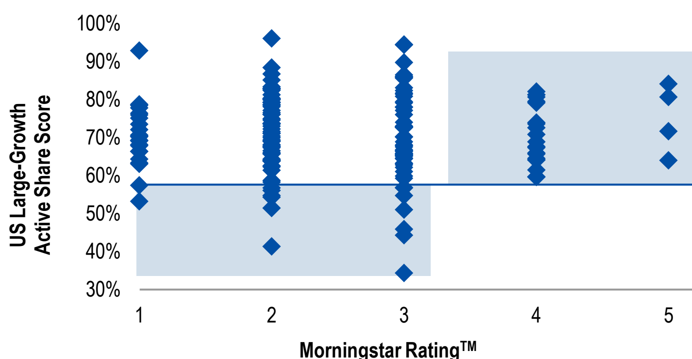
On initial review, the data appear to offer a strong case in favor of "true" active managers (those with a score of 80% or higher). However, a critic of active management might argue that in the US equity category, the most active funds tend to be small-capitalization strategies. These small-cap funds generally have very different underlying holdings than those of the S&P 500 Index, which is generally weighted more toward larger-capitalization names. However, even filtering out small- and mid-capitalization focused funds—thereby leaving just actively managed large-capitalization equity funds—produced these results: As of January 31, 2013, the "true" active large-cap managers (based on 80% threshold) outperformed, on an annualized basis, the less active managers over five and 10 years, and the S&P 500 Index over the annualized 10-year period.[1]

1. Morningstar Direct; 12/31/12.

On an even more granular level, the results were similar for US large growth managers (source: Morningstar Inc., as of January 31, 2013). When the group was split into two, those that offered the "true" active portfolios (based on 80% threshold) outperformed, on an annualized basis, the less active over three, five and 10 years ending January 31, 2013. Furthermore, the "true" active funds outperformed the appropriate index over the same 10 years, returning 8.9% compared to the Russell 1000® Growth Index's 8.2% annualized return, and the less active funds' 7.7%. Another notable point: In terms of Morningstar ratings ending January 31, 2013, all 4- and 5-star ratings were earned by managers that achieved an *Active Share* score of 60% or higher, including several in the 80% or higher category. Most of the less active managers had 2- and 3-star ratings, suggesting that more active managers may have better risk-adjusted results.

**Chart 4: Overall Better Ratings Assigned to More Active Managers**

As of January 31, 2013

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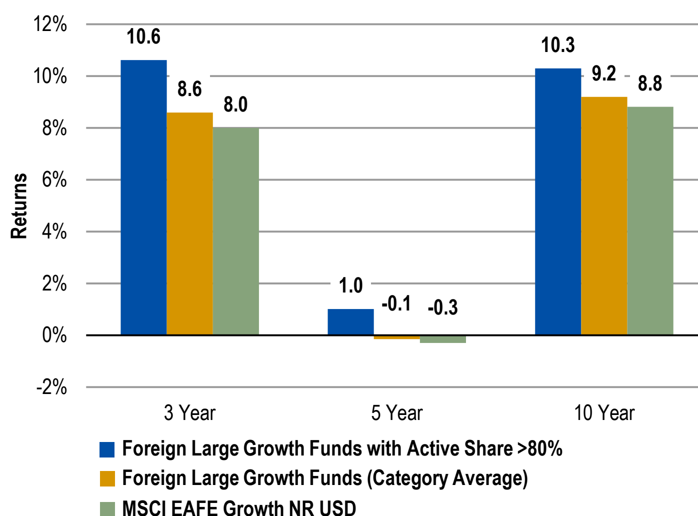
Other data points further showcase the potential benefits of investing in active managers. For example, when comparing large value funds to the Russell 1000® Value Index, we found that over three years no fund with an *Active Share* score below 65% was able to outperform. In addition, no 5-star fund within the large value screen had an *Active Share* score below 70%, suggesting that to beat an index, a fund cannot look much like it (Morningstar Direct, 2013).

## BEYOND THE US; THE CASE FOR ACTIVE MANAGEMENT APPEARS EVEN STRONGER

Foreign large growth and foreign large value funds tend to be more active than many US equity managers possibly because the larger investment universe makes it less likely that any one fund would invest very similarly to a relevant international benchmark. With an average *Active Share* score of 77%, the foreign large growth managers trended slightly more active than value managers, and as a whole outperformed the MSCI EAFE Growth Index benchmark over three, five and 10 years ending January 31, 2013. Those funds that had an 80% *Active Share* or higher outperformed by even more. On the foreign large value side, "true" active managers also beat less active managers (as measured by the 80% threshold) and the MSCI EAFE Value Index benchmark over three, five and 10 years during the same period. (Morningstar, 2013).

**Chart 5: Foreign Large Growth Managers Beat the Index over Three-, Five- and 10-Year Annualized Periods; Active Managers Did Even Better**

As of January 31, 2013

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## PART 2: PASSIVE ETFS MAY HAVE HIDDEN RISKS

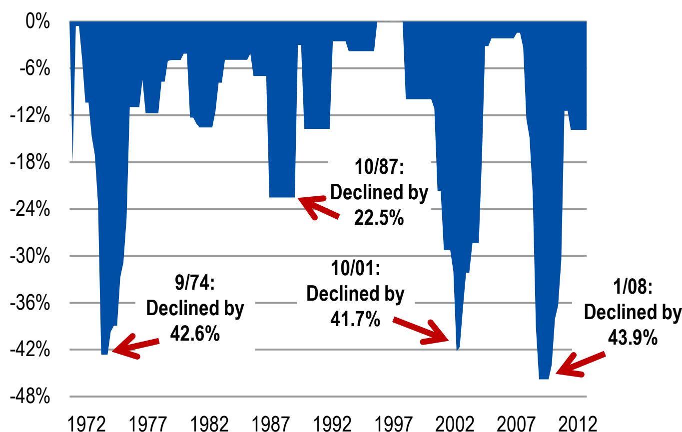
The growth of interest in passive ETF investing may be resulting in investors overlooking the possibility of certain negative consequences. Although active managers can have a broader range of results, either outperforming or underperforming the market more dramatically than passive ETFs, passive investments can still struggle. In fact, tracking error risk and fees can still cause passive ETFs to underperform the very benchmark they are supposed to follow. Even though global equity markets have generally done well over the past year, that does not mean risk was not present. Ultimately, it is not correct to assume that a given index is safely constructed for the future just because it has done well in the recent past—after all, past performance cannot guarantee future results. Furthermore, a number of other risks exist, as highlighted in the following discussion.

### Passive ETF Risk 1: Market Risk

Passive investments do not consider market outlook or macroeconomic conditions. As a given market struggles, passive ETFs for that market typically feel the entire brunt of the downward movement. An entire sector could be on the brink of failure and a passive ETF would still stoically maintain exposure there. Unlike with an active manager, where responsibility for rebalancing or reallocation rests on an investment team—that presumably uses its time and expertise to monitor market implications—a passive portfolio is completely dictated by market movements. Such a risk presented significant challenges in 1974, 1987, 2001 and 2008, when the US market's downward movements would have likely exposed a passive investor's portfolio to losses.

**Chart 6: Risk of Losses Is Not Avoided by Passive Investors: Those in an S&P 500 Index Fund Could Have Been Exposed to the Worst of the Market's Downward Movements**

As of December 31, 2012

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### Passive ETF Risk 2: Sector and Selection Risk

Passive investments can find themselves following a market-capitalization weighting process that ultimately allocates more investment dollars to potentially overvalued stocks and less investment dollars to potentially undervalued stocks. This can lead to an inefficient risk/return profile. In fact, passive ETF investors may mirror momentum investors without realizing it. Most active managers try to buy low and sell high—few will want to do the reverse—yet, by the very nature of many ETF products, passive investors will tend to buy more of the stocks and sectors that have increased in price the most, and less of those sectors or stocks that have decreased the most. This can have favorable implications in periods of rapidly rising prices, or in an emotion- or trend-driven market, but in markets where fundamentals drive results, passive ETF investors could suffer. In fact, there are times when sectors that experience tremendous appreciation can become a disproportionately large part of an index or ETF portfolio; unfortunately, such a scenario can lead to potentially dramatic falls in a subsequent bear market. For example, in 2000, heading into the "tech bubble crash," more than 21% of the S&P 500 Index's total exposure was in technology names; similarly, heading into 2007 (before the US financial crisis), more than 22% was in financials. At the end of 2012, the total information technology weight for this index was back up to about 19%, with a significant portion of that exposure coming from its top 10 holdings.

**Table 1: S&P 500's Sector Weights Expose an Investor to More Sector Risk Than Perhaps Recognized**

| S&P 500 Sector Weights Over Time | Before the Dot.Com Crash | | Before the Financial Crisis | | Today |
|---|---|---|---|---|---|
| | 12/31/99 | 12/29/00 | 12/30/05 | 12/29/06 | 12/31/12 |
| Consumer Discretionary | 11.40 | 8.89 | 10.20 | 10.44 | 11.77 |
| Consumer Staples | 9.67 | 10.13 | 9.21 | 9.03 | 10.20 |
| Energy | 5.74 | 6.90 | 9.34 | 9.80 | 10.93 |
| Financials | 13.31 | 17.54 | 21.45 | 22.44 | 15.73 |
| Health Care | 9.70 | 14.76 | 13.41 | 12.10 | 12.01 |
| Industrials | 8.76 | 9.45 | 11.69 | 11.15 | 10.13 |
| Information Technology | 28.49 | 21.09 | 15.42 | 15.02 | 19.01 |
| Materials | 2.80 | 2.33 | 2.93 | 2.97 | 3.71 |
| Telecommunication Services | 7.94 | 5.46 | 3.00 | 3.50 | 3.06 |
| Utilities | 2.03 | 3.44 | 3.35 | 3.54 | 3.44 |

Sources: FactSet; S&P Index Data Services; annually through 12/31/12. Index information is historical and subject to change. For illustrative purposes only. An index in unmanaged, and one cannot invest directly in an index.

**Passive ETF Risk 3: Counterparty and Derivative Risk**

Many ETFs use swaps—a type of derivative—as an instrument to replicate the returns of an index and offer investors synthetic exposure to a given market or sector. These swaps work when a counterparty (the other side of the transaction) exchanges the return on the underlying holdings of the ETF with the return on the desired index; this is done in an attempt to provide results that mirror the results of that index. Generally, the derivative contract is not collateralized or not otherwise guaranteed, and the returns for the ETF and its investors are dependent on the creditworthiness of the counterparty to ensure payment, should it be owed. Alternatively, the contract may be collateralized, but with assets dissimilar to the index being replicated. In a case where the counterparty fails, the impact on the ETF in question could be significant. Furthermore, some passive ETFs use leverage to enhance the returns of a given index; in some cases, these funds borrow assets to increase their ability to make purchases. Should the market decline, these funds can experience much greater losses than expected.

**Passive ETF Risk 4: Liquidity Risk**

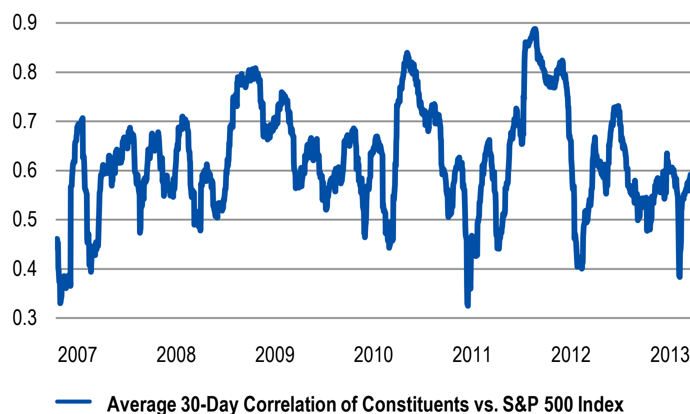
ETFs are purchased on an exchange with a bid price and an ask price. Should demand increase for a particular ETF, it could push the price of the ETF up. An investor attempting to purchase shares or units in this ETF could experience challenges as a result, as the increased price could be a misstatement of the value of the underlying assets it represents. On the other hand, if demand declines, the price may decline to below its underlying value, which can be a problem for an investor who needs to sell shares. In fact, should an investor attempt to sell a thinly traded ETF, the price quoted may be much lower than the price paid at the initial investment, negating any returns earned.

## CONCLUSION: NOW IS A GOOD TIME TO CONSIDER ACTIVE INVESTING

We believe current market conditions present a good environment for active managers. Heading into 2008, markets were arguably driven downward by emotion-based investor sentiment. In 2009, momentum on the upside moved the US equity market up. In those types of environments, it can be difficult for active managers to benefit from stockpicking and other fundamental analysis, as the difference between winners and losers is typically narrow and not driven by facts. However, in today's equity markets, correlation appears to have been on the decline. This phenomenon can be seen in Charts 7 and 8, which display varying levels of correlation between the S&P 500 Index and the various US stocks that it contains. The decreasing correlation levels present potential opportunities for active managers to benefit from stockpicking. Furthermore, historical data indicate that in periods when stocks trade on fundamentals, growth in the reported earnings-per-share (EPS) of corporations tends to move ahead of share price appreciation, as seen in the US equity market example (Chart 8). Currently, we are seeing markets exhibit some traits of fundamentals-based trading again, which can lead to an environment that rewards good companies and presents good opportunity for stock selection.

**Chart 7: S&P 500 Correlations Decline**

January 3, 2007–March 28, 2013




Sources: S&P Index Data Services; FactSet; data as of 3/28/13.
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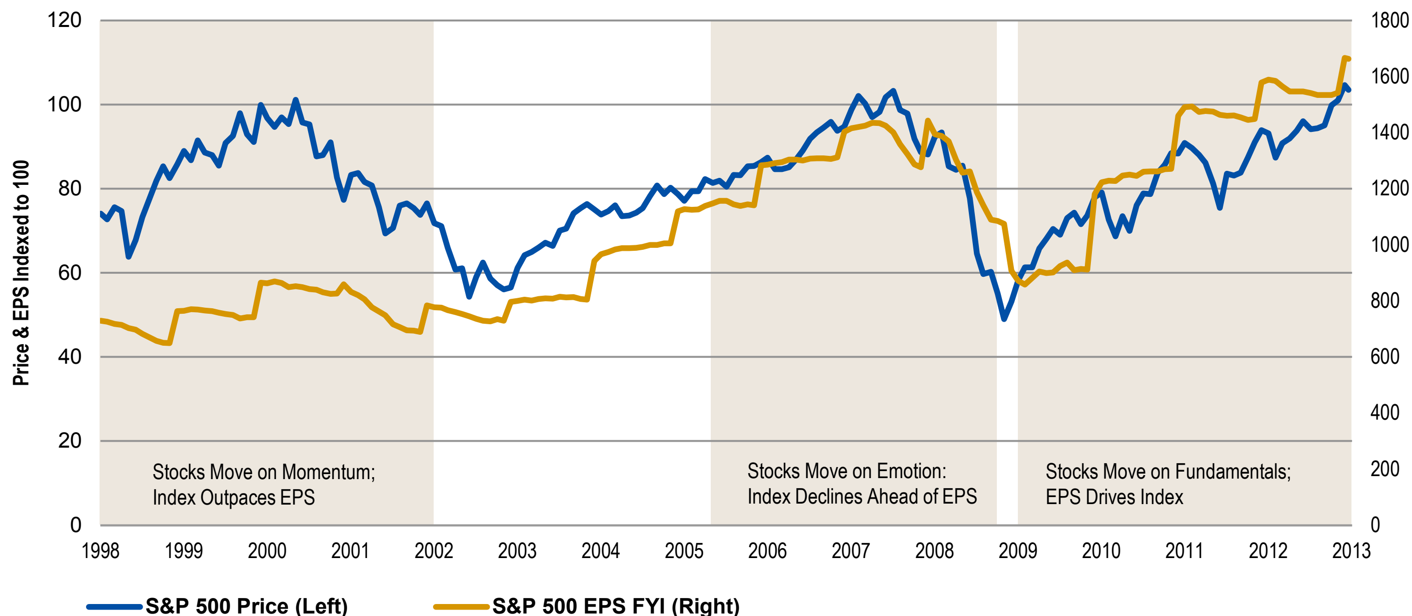
**Chart 8: Stocks Appear to be Moving on Fundamentals, Not Emotion**
As of April 15, 2013




Source: FactSet; data as of 4/15/13.

As has often been said, a portfolio cannot beat an index if it looks exactly like it. The reverse is true as well: that same portfolio cannot be protected from the worst of the market's downward movements if it looks exactly like the market. "True" active managers can offer a wider range of potential results, including more potential upside. With hidden risks and the uncertainty over the long-term benefits of passive investing, we believe now is an ideal time to critically examine the active versus passive debate, and to take a close look at investing in actively-managed strategies.



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## WHAT ARE THE RISKS?

All investments involve risk, including possible loss of principal. Actively managed strategies could experience losses if the investment manager's judgment about markets, interest rates or the attractiveness, relative values, liquidity or potential appreciation of particular investments made for a portfolio, proves to be incorrect. There can be no guarantee that an investment manager's investment techniques or decisions will produce the desired results. Additionally, legislative, regulatory or tax developments may affect the investment techniques available to an investment manager in connection with managing a portfolio and may also adversely affect the ability of the investment manager to achieve its investment goals. Stock prices fluctuate, sometimes rapidly and dramatically, due to factors affecting individual companies, particular industries or sectors, or general market conditions. Special risks are associated with foreign investing, including currency fluctuations, economic instability and political developments.

## APPENDIX

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