Investment Insight

Darkest just before dawn: why it's not the time to abandon active management

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"The active versus passive debate has been reinvigorated by recent poor returns from active global share managers."

The pros and cons of active management versus passive management is an age-old investment debate. In the last year, it's been reinvigorated by the poor returns recently generated by many active managers. Some investors have been asking, Why bother with active managers? As a result, a lot of money has flowed into passively managed products.

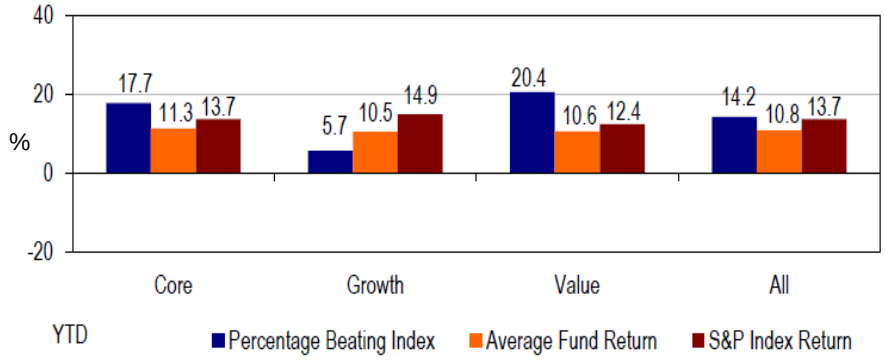
So are the poor results last year from active managers, in a period of strongly rising markets, indicative of a broader problem with active management? Is now the time to move to passive management? In this article, we explain why, on the contrary, we believe it's the time to stay with active management.

How did active managers perform in 2014

While the analysis below is for active managers of US shares, it's also representative of global share managers.

Chart 1 shows investment results for calendar year 2014 for managers with different active investment styles (core, growth, value and all of these managers). For each type of manager, it shows the percentage that beat their index (the dark blue bars), the average fund return (orange bars) and the relevant Standard & Poor's index return for that approach. It demonstrates that, regardless of investment style, a small percentage of managers outperformed their index last year. Across all managers, less than 15% outperformed, with the average fund lagging the index by 2.9%.

Chart 1: Performance of US shares managers in 2014

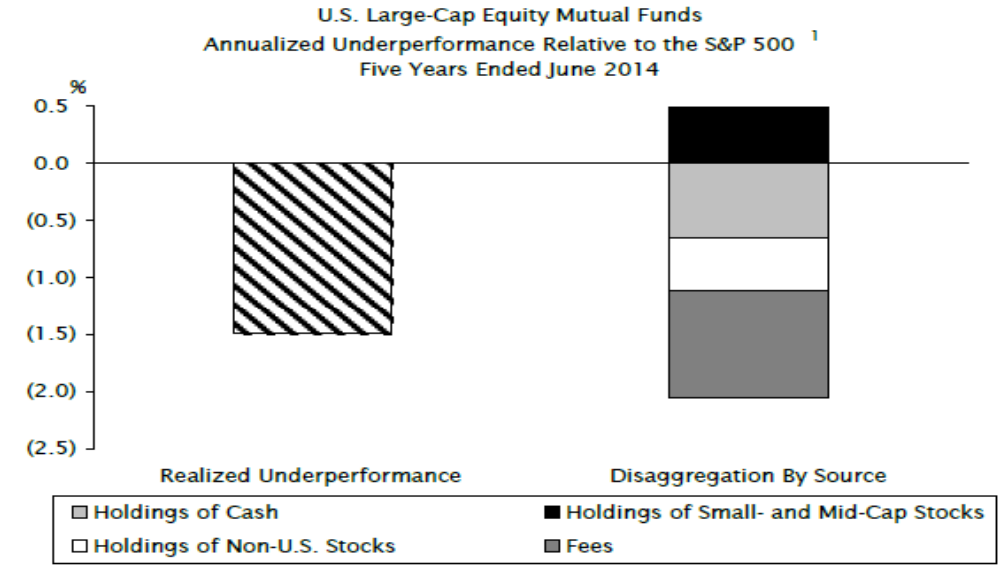


Manager and index returns are to 31 December, 2014. Manager data is net of fees.
Source: Lipper Analytical Services; BofA Merril Lynch US Quantitative Strategy.

Why did so few active managers outperform?

Chart 2 breaks down the reasons for US active managers' underperformance over the five years ending June 2014. On average, active managers underperformed the S&P 500 index by 1.5% (the striped bar on the left). The right hand bar shows the components of this percentage. Together, the biggest drivers of underperformance were investments in non-US stocks and cash holdings. Of course, management fees also contributed to underperformance.

Chart 2: Contributors to underperformance in US active funds

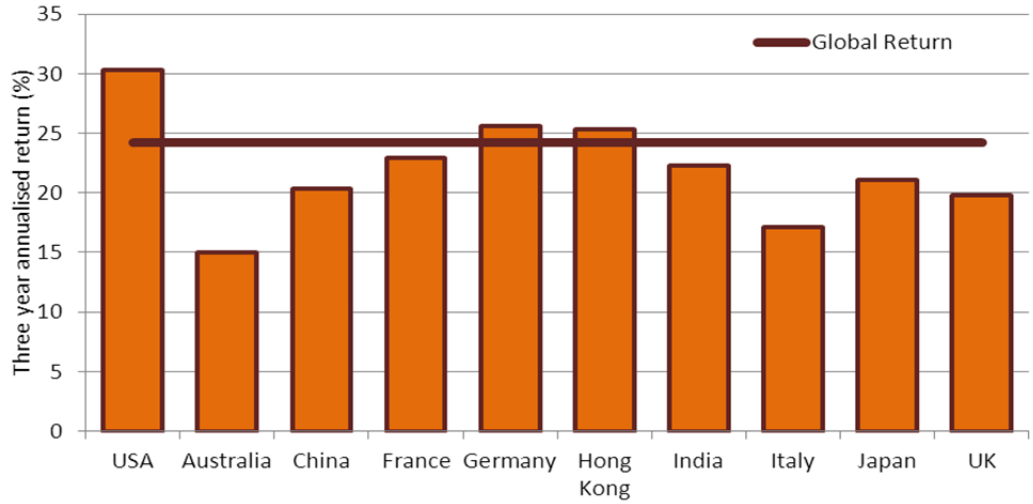


Source: Strategic Insight Simfund, Bloomberg L.P., Investment Company Institute, Empirical Partners Research Analysis. Data is net of fees.

[1]Asset-weighted returns of live and dead funds

So having investments outside the US was a significant factor that held back the performance of many active managers. Chart 3 helps to explain why, as it shows how the US share market has outperformed other major world share markets over the last three years.

Chart 3: MSCI country returns for three years ending 31 January 2015

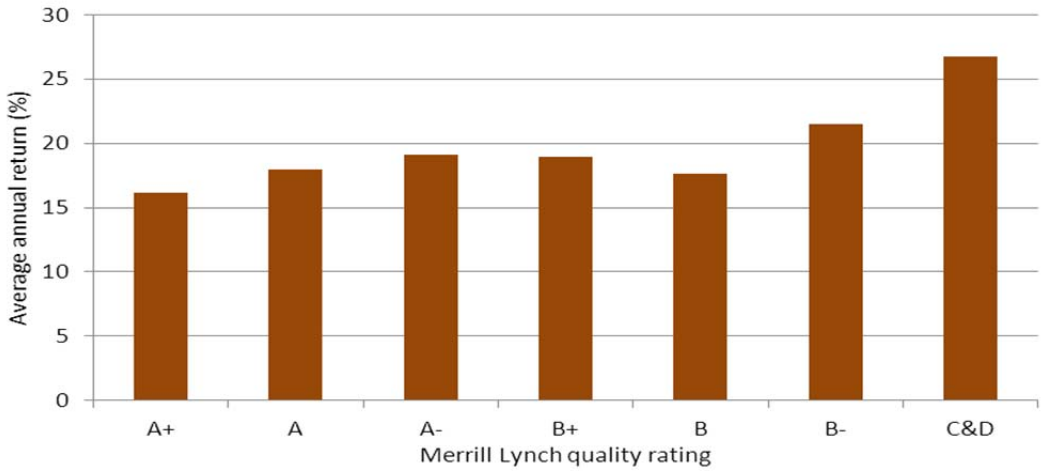


Source: Factset, JANA Corporate Investment Services Limited

What made it even more challenging for active managers was that most of the market's strength came from lower quality stocks. This was unexpected: in uncertain investment environments like the one we've experienced in recent years, investing in higher quality companies is usually the more prudent way to grow wealth.

For Chart 4, Bank of America Merrill Lynch attached a quality ranking to each stock, from "A+" for the highest quality to "D" for the lowest. The chart shows that for the last three years, the stocks with the lowest quality ratings performed best.

Chart 4: Price performance of US shares of different qualities, three years ending 31 January 2015



Source: Bank of America Merrill Lynch, JANA Corporate Investment Services

So, active managers have faced two headwinds: a US share market that kept outperforming other countries' share markets and within the US, lower quality stocks that performed unexpectedly strongly.

Why didn't most active managers take these factors into account?

Shouldn't active global shares managers have been skilful enough to position their portfolios to be overweight, rather than underweight, the US, and to anticipate the strong performance of lower quality stocks?

When you choose an active over a passive manager you're relying on the skill of the manager, rather than simply hoping markets will move in your favour. Active managers generally aim not just to deliver long-term returns above an index, but also to manage risk so that investors aren't at the mercy of all market fluctuations.

So active managers invest where they think there are opportunities to make returns or manage risk. Generally, this means they are early to sell out of investments that have performed well and are relatively expensive, and early to buy into investments that are underperforming and relatively cheap. In our view, this has been a successful approach over the long term for high quality active managers, but in the short to medium term, it may not have time to work.

As the US market kept rising strongly and rapidly, many active managers balanced their search for less expensive return opportunities and their need to manage risk for investors by moving into other countries' markets. As it turned out, this shift was premature – even now, the US share market is continuing to rise and becoming increasingly expensive.

Many active global shares managers saw the investment environment as increasingly risky: the longer share markets kept rising, the more likely it became that there would be a correction. When selecting companies for investment, they didn't want to expose their investors to lower quality companies that might be at higher risk of losses. And it was these companies, in the US, that turned out to deliver the high returns.

Active managers' cash allocations were another factor that detracted from their returns. In the recent strongly rising markets, holding back even a small amount of cash negatively affected returns.

Why stay with active management now?

The US share market is now the most expensive developed market in the world. Due to its rally in recent years, it makes up a larger proportion of global share indices than ever. So if you invest in global shares through a passively managed product that replicates an index, more and more of your investment will be allocated to the US market. Investing on the assumption that the US share market will continue strongly may not be a sensible idea given that the market has already performed well over several years and is relatively expensive, the US Federal Reserve has ended its quantitative easing program and US interest rates are expected to rise later this year.

Different active managers have varying potential for outperformance

What are some of the guiding principles for choosing an active manager? The first and most important is that the manager has a clear investment philosophy and a disciplined investment process, consistently executed by a capable team. However, if a manager meets these qualitative requirements, there are also quantitative measures that can help indicate how well an active manager will perform.

Many people use an active manager's tracking error as a good proxy for their 'alpha' potential – that is, their ability to outperform a benchmark. However, tracking error is simply a measure of the variability of these excess returns. It measures the *consistency* of the excess returns, not the alpha potential of the strategy.

A more relevant measure is 'active share'. This measures how different a manager's investment portfolio is to the index. The higher the active share, the more different the portfolio is to the index. A passive manager has an active share of zero, as the manager replicates the index. An active manager that holds only stocks that aren't in the index has an active share of 100%.

A recent study[1] looked at the relationship between active share and alpha outcomes and found that to outperform the benchmark, a manager's portfolio needed to have quite different investments to those in the index. The study also concluded that while the average active manager underperforms their benchmark after fees, a manager with high active share adds value after fees.

At MLC, when selecting active global share managers for our portfolios we look first for those with careful, disciplined investment processes that they don't deviate from. If we are satisfied on this front, another important factor we look for is that their portfolios are significantly different to the index and that the non-index stocks are delivering good returns. We frequently review our managers to make sure they maintain these characteristics.

Conclusion

Global share markets have produced extremely strong returns in recent years. Many active global share managers have underperformed, mainly due to their exposure to stocks outside the US and cash. This doesn't reveal a general problem with an active approach to investment management, but is more about how they tried to manage risk in a period when the US market continued to outperform other major markets for much longer than expected.

Now isn't the time to lose faith in active management. In fact, the sheer amount of money moving to passive products is an indicator that active management is due to perform well – these things tend to go in cycles. Investors don't make money by following the crowd, and investing with active managers makes a great deal of sense right now, particularly if you choose those who invest quite differently to the index.

One of the hardest things to do in investing is nothing. If you had confidence in your active strategy a year ago or three years ago, then if your circumstances haven't changed, it usually pays to stay the course. Investing is a marathon, not a sprint.

[1] Antii Petajisto, "Active Share and Mutual Fund Performance", Financial Analysts Journal, 2013, 69(4):73-93.