

New Research Affirms Benefit of Patient Adherence to “Truly Active” Management

Before feeling too smug about the highs that certain stock indexes have reached in the past month, investors in index funds (“passive investors”) should consider the results of new research that confirms the superiority of truly active management in building client wealth. Likewise, investors in those active funds that have recently lagged their benchmark indexes would also benefit from this research and a second study that explains why patience is required to reap the rewards of active management.

We favor active management but are extremely selective in the managers we recommend for our client portfolios. This approach is grounded on our experience of using active managers who outperform benchmark indexes over the long term by staying committed to a focused investment discipline, rather than adhering slavishly to an index. We also like taking advantage of the variability in manager returns to increase portfolio performance through measured adjustments. And, as described further below, we dislike the excessive market risk that a purely passive approach imposes on clients. Still, there are times when this perspective is tested.

Now comes new research from the Yale School of Management¹ and from one of our proprietary sources that significantly informs the passive vs. active debate. Together, these studies find:

- ◆ Managers whose portfolios are significantly different from their relevant benchmark indexes tend, over the long run, to outperform the index and other managers who are less “active;”² and
- ◆ Such top-performing managers almost always experience sustained periods (say, three or more years) where their returns are significantly below the index (typically by 5% or more).

In summary, the research confirms our experience that carefully selecting thoughtful, truly active managers—and staying with them as they execute their strategies—yields results superior to index investing, even after fees.

¹ See Cremers, Martijn & Antti Petajisto, “How Active is Your Fund Manager? A New Measure That Predicts Performance,” Yale School of Management (2006) (the “Yale Study”).

² A manager is “active” to the extent that some or all of the stocks in the manager’s portfolio are not component stocks in the relevant benchmark index or the manager holds a component stock in his portfolio in a proportion that is different from the weight that such stock has in the index.

Snapshot of the Active vs. Passive Debate

As passive investors experienced so painfully in 2000, index funds suffer from the drawback that if the market climbs up on a high wire of risk and irrationality, index investors climb up there with it. This occurs because most indexes are capitalization weighted so that over short-to-moderate periods these indexes reflect a sort of popularity contest.³ For example, in 1999 the ten largest stocks in the S&P 500 Index accounted for 25% of the index's value and performance. And technology stocks accounted for 85% of the index's return. The risk inherent in that situation was realized in 2000 when those leaders stumbled and the S&P 500 lost 38% of its value over the ensuing three years—by many measures, the worst stock market environment since the Great Depression. In contrast, many of the active managers our clients used in 1999 avoided this concentration in their portfolios and, consequently, missed much of the downturn that soon followed.

While avoiding excessive risk is important, most investors are focused on achieving superior long-run returns. Passive investors believe that active managers fail to deliver sufficient performance to offset their higher expense ratios. True enough, passive funds hold a very narrow advantage in average annual returns over active funds by delivering returns as a group that lag the relevant index by 0.23%, while active funds, as a group after all expenses, lag by 0.33%.⁴

To Outperform Indexes, Choose Truly Active Managers

The Yale Study lays bare the reason why the typical “active” mutual fund delivers disappointing returns. To do this, the researchers develop a new measurement tool called “active share” to quantify the difference between the composition of a fund's portfolio and the relevant benchmark index. Using this tool, the researchers show what many of us have suspected all along: A large majority of equity managers who claim they are active are really “closet indexers.” This means their portfolio positions are not significantly different from the composition of their respective benchmark indexes, giving them a slim chance of outperforming the index, especially after deducting the manager's fee.

By contrast, managers with high “active shares” (i.e. those whose portfolios are composed markedly different from the index) on average outperform the closet indexers and the relevant benchmarks.⁵

³ For example, if Company X has a market value (computed by shares outstanding multiplied by the share price) five times greater than Company Y, Company X will have five times the weight of Company Y in the index.

⁴ Yale Study using returns data from 1990 to 2003. See Tables 3 and 8. The performance lag for index funds is based on the value-weighted average expense ratio for the bottom quintile of all funds ranked by “active share.”

⁵ While trying to avoid too much detail in this newsletter, it is important to distinguish between types of active managers. Managers who rotate through industry sectors without making concentrated bets on individual companies may exhibit moderate or even high “active share” readings, but they also tend to be identifiable by greater volatility of returns relevant to the benchmark index (known as “tracking error”) and, as a group, have perhaps the worst overall record of returns among the studied managers.

Specifically, managers in the top 20% of “active share” readings (think of them as “truly active” managers) on average outperform their benchmark indexes by 1.39% per year after fees.⁶ This impressive incremental return, when compounded over a typical equity investor’s horizon, will contribute handsomely to the patient investor’s wealth.⁷

But Expect Volatility . . . And Sustained Periods of Underperformance

Of course, by constructing a portfolio that differs substantially from his benchmark index, a truly active manager will tend to perform differently from the relevant index, often substantially so. One-third of the time, a typical truly active manager will underperform or outperform the benchmark index by more than 8% for the year.⁸

Furthermore, a second, proprietary study shows that a sustained—and sometimes surprisingly deep—period of underperformance is highly typical of top performing managers. The study focused on all equity funds that beat their respective benchmarks by at least 1% per year annualized over the 10 years ending in 2005.⁹ Among this select group, 92% of them had at least one rolling three-year period where they underperformed the benchmark by at least 2% for the period. For a majority of the group, the underperformance was at least 5%; for about a third of the group, the underperformance was at least 10%!

Patience and Diversification are Essential to Success

While perhaps disconcerting in the abstract, this phenomenon of temporary but sustained underperformance is both logical and readily observable in client portfolios. Moreover, volatility in manager returns, when part of a client portfolio composed of multiple managers, allows for greater long run portfolio returns through tactical shifts toward managers that have recently underperformed.

The truly active manager is making a judgment about a collection of stocks that differs from the judgment reached (at least initially) by the overall market segment as represented by the benchmark index. It typically takes years and not months for the overall market to recognize (and reward) the value in that judgment.

⁶ The second 20% of managers by the active share measure delivered average annual returns that were 0.39% above their benchmarks. The bottom three quintiles all underperformed, with the worst quintile performing -1.41% below their benchmarks.

⁷ For example, over a 30-year period, a \$1.0 million portfolio would grow to \$10.1 million using an 8.00% compounded annual return, but would grow to \$14.8 million with a 9.39% compounded annual return.

⁸ According to the Yale study, the majority of truly active managers have a standard deviation of annual returns (representing the difference from the return of the index) that exceeds 8%. A single standard deviation represents the outer boundaries of two-thirds of all potential outcomes.

⁹ Although the second study did not utilize the “active share” measure in selecting top managers, we can confidently surmise from the observed relationship between performance and active share that the managers in the second study were overwhelmingly “truly active” managers.

Maintaining loyalty to a proven manager during a period of deep and persistent underperformance is difficult, but terribly important. The financial industry is rife with examples of skilled institutional investors firing a portfolio manager after a long spell of poor returns just in time to miss out on gains that would have more than made up for the performance drought. Missing out on these “get back” years damages an investor’s long-term portfolio returns.¹⁰

Knowing that temporary underperformance is virtually inevitable, we try to temper the effect by employing two or more managers in major equity segments.¹¹ Even so, there will be times when both managers underperform (although hopefully not for three years in a row!).

All of the above reinforces our view that volatility, when prudently undertaken, is the price of good returns, certainly at the level of a particular fund and even at the portfolio level. By committing to a multi-class, multi-style, multi-manager approach, an investor will diminish volatility of portfolio level returns and have the opportunity occasionally to tilt the portfolio toward asset classes and managers that have recently underperformed. In the long run, this approach yields returns that significantly exceed a static commitment to indexes. To reap these rewards, investors need to remain patiently committed to their discipline.

¹⁰ The impatient investor doesn’t just miss out on a good gross return; he also forfeits the opportunity to make greater use of the “get back” years by increasing the portfolio’s allocation to the manager, incurs greater trading expenses and, in taxable accounts, realizes capital gains earlier than an investor with more patience.

¹¹ It should go without saying—but we’ll say it—that investors need exposure to all equity styles and asset classes in order to obtain the benefits of true diversification. We are focused here on diversifying within each sub-category.