

Viewpoints

March 2011

The value of active management

“I’d be a bum on the street with a tin cup if markets were efficient.” So said Warren Buffett, the billionaire investor who built his fortune buying stocks overlooked by the majority of his peers.

Despite his success, there are many who do not regard Buffett’s impressive track record as proof that active investment management works. Indeed, for the growing number of those who subscribe to passive investing, Buffett is the exception to the rule that it is impossible to systematically and consistently select securities that will outperform the market.

Much of this thinking has been rooted in two notions. The first is that markets are efficient, reflecting the sum of all knowledge on individual companies. The most recent bear market and subsequent rebound, however, have largely discredited that idea. It has also further validated behavioural finance research that supports the obvious: markets are often held in the grip of fear and greed.

The second notion is that the average manager cannot muster the returns to beat a market index, especially after fees. Why engage in a costly pursuit of market-beating investments when the return from an index fund for any given year usually lies above that of the average actively managed portfolio?

It is a fact that the average manager often has not beaten the benchmark for the most recent one-year period. But to focus on average active manager returns over only short-term periods misses the bigger picture. Data consistently illustrate that results for most active managers have indeed exceeded their benchmarks for time periods of five years and longer. It has not been a “lost decade” for the median manager as it has been for passive portfolios. Buffett is not an anomaly: there exists a large pool of active investment professionals who have consistently beaten the market and delivered relatively superior results over the long term.

Even when the annualised excess return delivered by an active manager appears to be modest, compounding excess returns over a period of years can add up to significant gains. Investors should therefore take the time and effort to seek out active managers with a proven investment process. Settling for a passive investment such as an index fund may mean foregoing significant investment gains and can expose investors to unwanted risks.

Skillful active management can add value to portfolio returns

- Mature markets are not perfectly efficient, creating opportunities for active managers
- The median active manager has consistently beaten broad market benchmarks over time
- Replicating an index can expose portfolios to unintended risks

Figure 1: Median active manager excess returns before fees

eVestment Alliance U.S. Equity Universe Median vs. S&P 500 Index with income reinvested and eVestment Alliance Global Equity Universe Median vs. MSCI World Index with gross dividends as at 31 December 2010.

Figure 2: Top quartile active manager excess returns before fees

eVestment Alliance U.S. Equity Universe first quartile vs. S&P 500 Index with income reinvested and eVestment Alliance Global Equity first quartile vs. MSCI World Index with gross dividends as at 31 December 2010.

Figures 1 and 2: Returns for periods greater than one year are annualized. The U.S. universe contains 352 investment managers for the one-year period, 344 investment managers for the three-year period, 320 investment managers for the five-year period and 236 investment managers for the 10-year period. The global universe contains 104 investment managers for the one-year period, 93 investment managers for the three-year period, 77 investment managers for the five-year period and 31 investment managers for the 10-year period. Source: eVestment Alliance

Active managers have typically beaten the index over the long run

Data show that a significant proportion of all active managers in the major equity markets have consistently beaten their benchmarks over the medium and long term. Figures from eVestment Alliance's database of active investment management results reveal that the median active manager return — the minimum return achieved by the top-performing 50% — has beaten the index by a large margin over the long term.

As Figure 1 illustrates, the median annualised return for active investment managers in global equity markets in the 10 years to December 2010 was 227 basis points above the MSCI World Index. (Figures quoted are before fees.) This outcome is remarkably consistent across manager universes and asset classes — even in the U.S., which is regarded as the world's most efficient equity market. The median annualised return of active U.S. equity managers over the same period was 150 basis points above that of the S&P 500 Index. Results for the active median Morningstar Domestic Large Cap Commingled Investment Trust similarly show excess returns, even after fees, for the three-, five- and 10-year time periods.

The returns of the best active managers — those in the top quartile — have meanwhile been exceptional, as shown in Figure 2. These managers have exceeded global and U.S. benchmarks by 285 and 317 basis points, respectively, annualised over the past 10 years, making a strong case for seeking out a reliable active manager. Looking toward the other end of the spectrum, even third-quartile managers managed to beat the global index for five and 10 years and the U.S. index for 10 years.

Survivorship bias may play a role in the consistency of greater excess returns for longer time periods. The barriers to entry in the asset management industry are low and the costs of setting up a business have fallen. The manager universe for short periods includes organisations whose fragile investment processes and poor results drag average active returns down. Successful investment managers are more likely to survive and populate the manager universe for longer periods. Due diligence in the manager selection process is therefore key in pursuing superior long-term results.

The premise of efficient markets is difficult to defend

That a large number of active managers are able to achieve such excess returns is not only a reflection of the strength of their investment methods but also a testament to the inefficiency of the market and its susceptibility to speculative excess. The passive investment approach is founded on the idea that markets

are efficient and that asset prices are always fair and fully reflect all known information. In such an environment, it should be impossible for any investor to gain a sufficient competitive edge to beat the index. But as numerous studies in behavioural finance have shown, investors are far from rational. Market participants are prone to deep-rooted psychological predispositions that often cause asset price anomalies.

Among these is a cause-and-effect bias: a tendency among investors to overbuy stocks in companies based on their earnings histories, extrapolating past results into the future. Investors are also highly averse to selling shares at a loss. The emergence and subsequent bursting of numerous asset price bubbles in recent decades is a testament to such irrational behaviour.

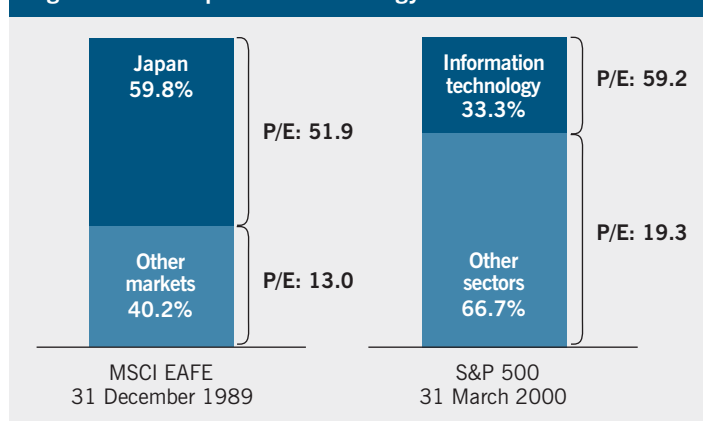
These biases can prove costly for passive funds during severe market declines. Though index trackers gain when stocks rally, they offer no protection against sharp and sustained market falls — in contrast to their active counterparts. In other words, an index tracker mitigates relative risk — or the deviation from the market return — but not absolute risk, the risk of losing money. The losses suffered during bear markets are difficult to recoup — a 20% loss, for example, requires a subsequent 25% gain to break even, often leading to the erosion of capital. (Of course, active managers are not immune from picking stocks that can lose value.)

Index funds expose investors to unintended risks

Indexes can be useful tools in gauging market activity and helping keep managers accountable for their results. In fact, in 1969 Capital Group International created and began publishing what is known today as the MSCI series of indexes. (We are no longer directly associated with these indexes.) But when the goal of meeting client objectives becomes eclipsed by the goal of matching a benchmark, clients are often excluded from new growth areas or become exposed to risks because of market distortions rather than an investment thesis that seeks to provide future gains.

Most equity indices are market-capitalisation weighted. Therefore, index funds are most heavily invested in stocks that have done well in the past, with no consideration given to which companies and stocks might do well in the future. It is by definition a rear-view-mirror approach, which has time and again provided significant volatility to investor portfolios. To illustrate this, consider these examples.

Figure 3: The Japan and technology bubbles



Sources: Morgan Stanley Capital International Perspective, Vestek
 Note: The MSCI EAFE (Europe, Australasia, Far East) Index is designed to measure equity returns in developed markets, excluding the U.S. and Canada. Standard & Poor's 500 Composite Index is a broad measure of the U.S. equity market.

Japan, 1989

As shown in Figure 3, funds tracking the MSCI EAFE Index at the tail end of the 1980s were heavily invested in Japanese stocks, which made up almost two-thirds of the benchmark. This unhealthy concentration of risk left them painfully exposed to the subsequent 50% slump in the Japanese market.

U.S., 2000

Looking more closely at the shifts in the weight of the technology sector within the S&P 500 Index over the period July 1997 to July 2002, the passive investor's exposure to volatility becomes clear. U.S. index trackers encountered a problem as the emergence of the technology bubble in the late 1990s left them fully exposed to the slump in the value of the tech sector that followed. During the first half of 2000, technology stocks accounted for 30% of S&P 500 index trackers' holdings, as shown in Figure 3. This was more than twice their combined weight in 1997–1998 and more than four times their weight in 1990–1993. By the end of 2002, the technology sector comprised just 15% of the index.

Attributes of successful active managers

While market inefficiencies create opportunities for active managers to exploit, producing relatively superior results over the long term is invariably the fruit of a vigorous investment process. Successful asset managers possess a number of attributes that set them apart.

Such managers tend to benefit from a research advantage, which

allows them to develop investment opinions that differ markedly from the market consensus. The payoff arrives when new information comes to light that validates their views and steers the consensus opinion in their favor.

Successful active managers also appreciate that investment must be a forward-looking endeavor. Research is harnessed to anticipate future trends and to understand how these might affect prospects for companies, industries, sectors or entire economies. Focusing on the future gives investment professionals the necessary perspective in a transitioning market, in contrast to the backward-looking process behind passive investing and benchmark construction.

Successful active managers also build portfolios that reflect their strongest investment convictions, and go to great lengths to prevent the dilution of their research advantage by defaulting to a benchmark.

Research has shown that the further a manager deviates from a given benchmark, the greater the potential for above-market gains. A study conducted by two finance professors at Yale School of Management found what they describe as active share — the proportion of an active fund that differs from the portfolio's benchmark index — to be a key determinant of long-term market-beating returns. Examining the returns of U.S. equity funds from 1980 to 2003, the Yale researchers found that funds in the highest quintile for active share beat their benchmarks by to 2.4% per year on a gross basis and by 1.5% per year after fees.* Funds in the next-highest quintile for active

share also beat their benchmarks after fees while the other three quintiles did not.

Active managers can ultimately add value

Investors do not want average returns. But to dismiss active strategies simply because average active manager returns lag those of the market, especially over shorter time frames, makes such an outcome all the more likely. Just as Warren Buffett does not fit into the average category, neither do the large number of active investment professionals who have consistently delivered market-beating returns over recent decades.

Though passive strategies can be a useful, low-cost method of investing in the financial markets, they suffer from shortcomings that can undermine returns and erode capital, particularly during market declines. Even after factoring in management fees, successful active managers — those that are forward-looking, benefit from research experience and are true to their strongest investment convictions — have typically achieved relatively superior long-term returns. ■

**How Active Is Your Fund Manager? A New Measure That Predicts Performance*, Martin Cremers and Antti Petajisto, 2007.

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