March 2017

ACTIONABLE INSIGHTS

GETTING THE MOST OUT OF ACTIVE MANAGEMENT

> ARE YOUR ACTIVE MANAGERS ACTIVE ENOUGH?

The investment community has spent considerable time and effort reviewing the merits of active and passive management styles over the years. Despite a trend toward passive in recent years, active management still holds a 76% market share as of January 2017 according to Morningstar. This indicates that the attraction of active management remains high, especially for those concerned that future returns on major market indexes may not be adequate to meet their financial goals. Given the importance of this issue, we have reconsidered the range of available active management strategies. Looking at the data, we can reframe the debate. Perhaps the important question is, "Are your active managers active enough?" as research shows that high active share/low turnover managers have had greater success than their more benchmark-oriented peers.[1]

THE ACTIVE MANAGEMENT CONTINUUM

By its most stringent definition, active management would refer to any portfolio that deviates from the broad market. Almost every investor's portfolio is in some ways active. Even the highly publicized S&P 500 Index is itself active; it is not just, as some investors believe, "the largest 500 stocks listed in the United States." Similar to an active manager, Standard & Poor's has an investment committee that evaluates stocks based on their "representation" to the U.S. market.

Beyond traditional index funds, a host of investment options are available, all of which can be identified as "active" even if their managers avoid that term. In fact, we believe it is useful to place the whole array of investment styles on a continuum [Figure 1]. We believe investors may be disenchanted with their choice of management because they did not consider where that manager was on the continuum. They did not ask, "is this manager active enough?"

Perhaps the best way to understand this concept is to look at the ends of the continuum. On the left, we place index-oriented investments, which are often identified as passive. From there we move to the right, and place highly quantitative investment strategies (often called "smart beta") that are often as much engineered as they are managed. These strategies tend to hold many stocks and generally try to maintain returns relatively close to an index, but may try to increase returns by targeting specific factors like earnings, cash flow, or similar metrics.

1 Cremers, M., and Pareek, A. "Patient Capital Outperformance: The Investment Skill of High Active Share Managers Who Trade Infrequently." Journal of Financial Economics (JFE), Forthcoming, December, 2015.

Active management involves risk as it attempts to outperform a benchmark index by predicting market activity, and assumes considerable risk should managers incorrectly anticipate changing conditions.

On the far right, we have the most active of managers, alternative investments. Most investors consider alternatives a separate asset class, however, many types of alternatives are properly viewed as just the ultimate active manager. For example, long-short hedge funds engage in the same strategy as equity mutual funds with one key difference—the restriction on going short is removed. Similar arguments can be made regarding other hedge fund styles. The removal of just one constraint, going short for equity managers, or removing restrictions on liquidity for many bond managers, is often the major differentiator between an active manager and an "alternative" investment manager. Please note that "alternative" investment managers may have higher fees than traditional active managers.

TRADITIONAL ACTIVE MANAGEMENT

The more traditional definition of active management makes up the "messy middle" of our continuum. This is where investors have most of their assets, and also an area that some have questioned in recent years as overall returns have had a tough time keeping up with passive strategies based on an index such as the S&P 500.

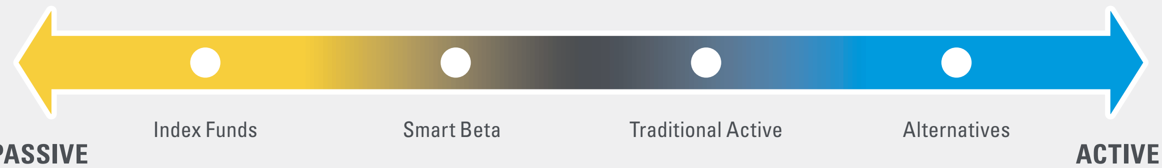
Many hours and dollars have been spent trying to determine how investors can choose the best managers ahead of time—not surprising given that there are thousands of management firms (which frequently offer more than one strategy). But lumping all active managers together in a single bucket can lead to ignoring important distinctions in management styles, such as differentiating closet indexers from managers holding differentiated portfolios.

TEST CASE AND TRENDS

As a test case to illustrate this point, we looked at a smaller slice of the overall market—the most commonly held funds in the Morningstar U.S. Large Cap universe. Though there are hundreds of funds in this category, we removed any fund that had less than $5 billion in assets (in order to focus on the most commonly held funds), those that were less than 20 years old (to ensure they've been through a wide range of economic environments), and those that didn't benchmark themselves to the S&P 500 (to ensure the managers have the same objective). This left us with a total of 27 funds, seven of which were passive funds tracking the S&P 500 index. Admittedly, this is a small sample size, and the study ignores survivorship bias (meaning it doesn't include any funds that closed or merged with others over the 20-year period), but we do feel it offers insight into a widely held segment of the market.

1 INVESTMENT OPTIONS ARE OFTEN LUMPED INTO ACTIVE AND PASSIVE BUCKETS, BUT IN REALITY THERE IS A CONTINUUM OF PRODUCTS

Product Continuum by Managment Style



Source: LPL Research 03/03/17

We created several equal-weighted portfolios based on these funds (rebalanced annually), and some interesting trends showed up as we evaluated different types of managers, namely:

1. Some Active Managers are More Active Than Others
2. Active Outperformance Tends to Be Cyclical...
3. ...But Over Longer Time Periods This Subset of Active Managers Showed the Ability to Outperform

TREND #1

Some Active Managers are More Active Than Others

The concept of "active share" was developed in 2009, as a systematic way of determining how much a fund deviates from its benchmark. A study conducted by Cremers and Petajisto found that historically, "funds with the highest active share significantly outperformed their benchmarks, both before and after expenses, and they exhibited strong performance persistence."[2]

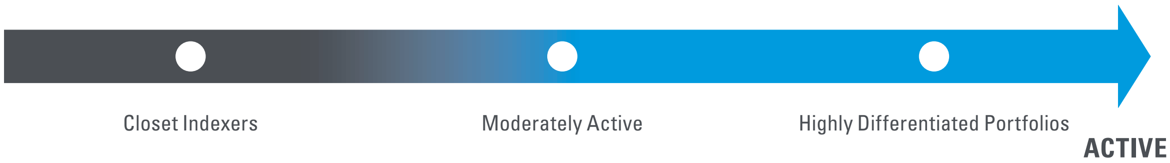
Active share is best used when evaluating managers within a specific peer group. For example, consider a large cap blend manager that only purchases stocks held in the Russell 1000 Index. If over time, that manager had a high active share figure and produced fairly consistent excess returns with moderate tracking error, these quantitative indicators may indicate true stock selection skill and aid in the decision to use this manager over others. However, if that manager has a consistent growth tilt, they will likely outperform when growth does well and underperform when it doesn't. Measuring this manager against a more balanced manager doesn't make sense, given that returns will be driven by other factors (here, exposure to growth stocks).

We don't believe active share on its own is a silver bullet that can guarantee outsized returns for a fund, but when used appropriately, active share does serve as a useful tool to differentiate traditionally actively managed funds from one another along our passive/active continuum, based on how active they are in practice. Research has also shown the combination of managers with low turnover (meaning they hold positions for a longer period of time) and high active share may be more likely to outperform their benchmarks.[3]

Just as we can visualize the entire active management universe as a continuum, there is also a continuum within traditional active management [Figure 2]. The left side represents strategies that

2 TRADITIONAL ACTIVE MANAGERS RANGE FROM CLOSET INDEXERS TO HIGHLY DIFFERENTIATED PORTFOLIOS

Range of Active Managers



Source: LPL Research 03/03/17

2 Cremers, M., and A. Petajisto. "How Active is Your Fund Manager? A New Measure That Predicts Performance." International Center for Finance at the Yale School of Management, March 2009.

3 Cremers, M., and Pareek, A. "Patient Capital Outperformance: The Investment Skill of High Active Share Managers Who Trade Infrequently." Journal of Financial Economics (JFE), Forthcoming, December, 2015.

appear active but in fact have a portfolio and return stream that seem largely undifferentiated from the benchmark. These so-called "closet indexers" have a relatively low probability of outperforming their benchmarks, as their portfolios in general do not have enough deviation from their benchmarks to overcome the funds' fees and operating expenses.

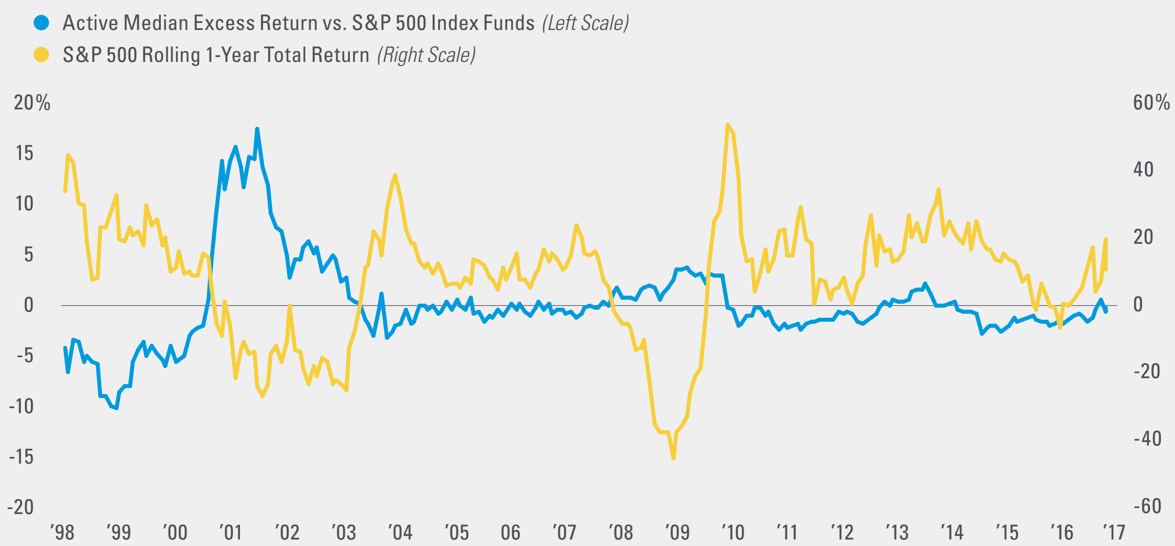
As we move further to the right on the spectrum we see portfolios that are more differentiated from the benchmark, giving more opportunity for performance deviation. Typically managers accomplish this by holding more concentrated portfolios—with a smaller number of stocks comprising the bulk of the portfolio—but this is not always the case.

TREND #2

Active Outperformance Tends to Be Cyclical...

When we segmented our large-cap blend funds between active and passive managers, we found some other interesting trends. One is that active management outpeformance tends to be cyclical. Most of the outperforming periods corresponded with negative one-year returns for the S&P 500, indicating that active managers may be able to help to protect in down market environments. Importantly, outside of a few time periods such as the late 1990s, when tech stocks were shooting higher, active management has managed to keep up relatively well, alternating between slight outperformance and slight underformance over most time periods [Figure 3].

3 LARGE CAP ACTIVE MANAGERS* HAVE OUTPERFORMED DURING MAJOR PULLBACKS



Source: LPL Research, FactSet, Morningstar 03/03/17

*The above analysis consists of the 20 funds identified in the methodology described on page 2. The performance is hypothetical; had different funds been selected the results of this analysis would have been different.

TREND #3

...But Over Longer Time Periods This Subset of Active Managers Showed the Ability to Outperform

Though active management has underperformed over the past five years (a time when markets have moved higher with few significant pullbacks), when looking at a longer time frame of 10- and 20-year horizons, active managers have actually outperformed their passive counterparts in this slice of the market (even after fund-level fees are accounted for) [Figure 4]. They have also done so without taking additional risk, as the standard deviation of returns is the same for both active and passive over a 10-year horizon, and is actually less for active mangers over a 20-year horizon. Sharpe ratios (return per unit of risk as measured by standard deviation) were higher for active managers over both time periods as well. This makes sense given that active managers tended to see smaller drawdowns during big market pullbacks such as the Tech Bubble (early 2000s) and Financial Crisis (2008). This potential downside loss mitigation is one of the key reasons managers in this study outperformed their passive peer group.

Analyzing the active share of these funds versus the S&P 500 over the past 20 years shows how impactful management style can be on performance. Funds with higher active share have underperformed those with lower active share and passive index funds over the past five years, but over longer periods of time higher active share has proven beneficial. This is most clear in looking at the difference in the growth of $10,000 over the past 20 years. A portfolio made up of higher active share funds (80%+ active share) accumulated more than $20,000 more than a similar portfolio of passive funds, while taking less risk per unit of return. Over longer periods of time, even a little active management in a portfolio can make a big difference on overall returns and risk levels.

4 **ACTIVE SHARE CAN BE A USEFUL TOOL TO SEPARATE TRULY ACTIVE FUND MANAGERS FROM CLOSET INDEXERS**

	Total Return (Annualized)			Return per Unit of Risk (Sharpe Ratio)			Growth of $10,000		
Portfolio	5-Year	10-Year	20-Year	5-Year	10-Year	20-Year	5-Year	10-Year	20-Year
S&P 500	14.09%	6.99%	7.46%	1.33	0.47	0.41	Not Directly Investable		
Passive Large Blend Funds	13.93%	6.85%	7.28%	1.32	0.47	0.40	$19,198	$19,400	$40,797
Active Large Blend Funds	13.26%	7.05%	8.14%	1.26	0.48	0.47	$18,635	$19,762	$47,798
Less Than 60% Average Active Share	13.66%	6.55%	7.31%	1.25	0.44	0.40	$18,970	$18,864	$41,020
Greater Than 60% Average Active Share	13.04%	7.30%	8.54%	1.27	0.50	0.50	$18,457	$20,239	$51,512
Greater Than 80% Average Active Share	13.21%	7.83%	9.52%	1.25	0.52	0.56	$18,598	$21,244	$61,621

Source: LPL Research, FactSet, Morningstar 03/03/17

Monthly returns through 01/31/17.

Indexes are unmanaged and cannot be invested into directly. Past performance is no guarantee of future results.

The above analysis is hypothetical and does not represent any actual account, nor investment. The portfolios considered here were created according to the methodology described on page 2. Had different funds been utilized different results would have been obtained.

CONCLUSION

Our analysis suggests that more variety exists in active management than many realize, and that some important distinctions are often ignored when reviewing manager performance, such as how active a strategy is relative to its benchmark. The main takeaway is not that active management is a panacea that will always win over time — it isn't, it doesn't, and the data we reviewed represents a very small slice of the overall investment landscape. Instead, we want to point out that many investors have a skewed idea of what active management actually is, and that focusing on managers who are truly active may offer a better opportunity for longer-term investors than popular opinion would suggest. ■

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