Investment Insights

The Case for Active Management

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The Model Wealth Program
Principle-Based Investing

"Principal-based investing means we focus on investment principals that have stood the test of time rather than basing our decisions on short-term market predictions. Our goal is to identify a small number of experienced managers who offer the potential to outperform their peers over a long period of time. Our approach is to combine a well-defined quantitative and qualitative due diligence process with proprietary construction tools to build, manage and monitor our client's portfolios."

The Model Wealth Program is a managed fee-based investment program, available through Cornerstone Wealth Management, LLC. The MWP investment team has developed sophisticated long-term strategies in an effort to manage and control risk, to help investors pursue their financial goals. For more information about the program, contact your Cornerstone Wealth Management representative.

Key Points

- While most professional investment managers do not outperform the market in any given year, there are a small number who have outperformed their respective benchmarks over the long-term.
- Research from prominent investment managers and academics has identified eight characteristics of successful managers who may have a higher probability of generating above-benchmark, long-term results.
- In our view, very few investors have the time, willingness and resources to identify superior managers on their own.
- Creating portfolios of managers who have the potential to outperform their peers and their respective benchmarks over a long period of time is the focus of the Model Wealth Program.

The Active versus Passive Debate

One of the longest and most intense debates in the investment world concerns the value of active management – where an investment manager attempts to select securities that may outperform an appropriate benchmark, like the S&P 500 Index. Much of the argument centers around the fact that, in any given year, a high percentage of active managers underperform the benchmark. Passive managers make no such effort but, instead, simply seek to match the performance of the benchmark. While it is true that most active managers underperform their benchmark in any given year, a small number of active managers

have outperformed over long periods of time.[a] According to research conducted by prominent investment managers and academics,[b] this group of strong managers share some common characteristics.

What the Research Shows

According to Morningstar, 61 U.S. large-cap active equity managers have outperformed over the past 20 years, out of a universe of 310 equity managers that have 20-year performance data[c]. The median outperformance by the 61 managers was 0.8 percentage points per year, with a high of 4.0 percentage points. While the outperformance may not seem impressive, the power of compounding can make even modest outperformance lead to substantial cumulative outperformance over the long run.

Choosing the Right Active Manager

Academic research and prominent investment managers have identified eight key characteristics of successful active managers.[b] The first is high "active share".

High Active Share

An active manager usually adds value by owning securities that deviate significantly from the benchmark. In other words, if there are 500 companies in the S&P 500, many of the most successful managers would not own the same stocks in the same proportions as the S&P 500. These managers are said to have high "active share". Active managers that own securities that are the same as the benchmark are said to have low active share.

A number of studies show managers with high active share are more likely to generate returns in excess of the benchmark. One paper concluded "Funds with the highest Active Share significantly outperform their benchmarks, both before and after expenses, and they exhibit strong performance persistence. Non-index funds with the lowest active share underperform their benchmarks."[d]

Low Fees and Expenses

Several prominent managers, including Vanguard, Dodge & Cox, and American Funds provide research to show that the level of fees and expenses is a major factor in determining an active manager's ability to beat its benchmark.[b] Academic research supports this view. In one study, "On Persistence in Mutual Fund Performance,"[e] Mark Carhard concluded, "Although the top-decile mutual funds earn back their investment costs, most funds underperform by about the magnitude of their investment expenses." Morningstar analyzed the top 20 mutual funds by assets to illustrate that there is a clear negative relationship between fees and performance: Generally, firms with low fees have a higher likelihood of above-average performance, while firms with high fees have below-average performance.[f] Vanguard states, "low cost continues to be the quantitative filter proven to most effectively predict relative performance."[g]

Low Turnover

Low turnover is another characteristic of the most successful managers. Turnover is the percentage of a manager's investments that are traded each year. A low turnover means a lower level of trading costs, which include commissions and market impact because a large transaction can significantly affect the price of the stock being bought or sold.

Research by Roger Edelen [h] found a strong negative relationship between aggregate trading costs and portfolio returns. According to the author, "Sorting funds on the basis of their aggregate trading-cost estimate yields a clear monotonic pattern of decreasing risk-adjusted performance as trading costs increase." Managers in the lowest quintile of aggregate trading costs in Edelen's study had average annual returns 1.78 percentage points higher than the highest quintile, highlighting the negative affect trading costs can have on performance.

Risk Management

A fourth characteristic of successful active managers is strong risk management. Critics of active management often point to the average return of all active managers, pointing out that index funds have experienced higher

average returns than the universe of active managers after fees. However, we are not limited to selecting the "average manager". For example, with 7,800 managers to choose from, even if two-thirds of all managers underperform their respective benchmarks, that would still leave over 2,600 capable managers to choose from.[i] In addition, total return is not the only consideration for the prudent investor. For investors who are investing nest eggs that have been accumulated over a lifetime, risk is equally important. According to research conducted by Dodge & Cox, active managers who are very focused on managing risk have generated higher risk-adjusted returns than indices or benchmarks when risk is measured over long time horizons.[n]

It is also worth pointing out that for the 40 years ended 2018, there have been 18 market corrections (S&P 500 declines of 10% or more). During those corrections, active managers outperformed passive (index) managers 14 times (78 percent of the time).[i]

Focus on a Core Competency

Research conducted by Dodge & Cox has shown that firms with long-term success tend to have a focus on specific strategies or approaches to the market.[n] In his paper, "Why Focus? A Study of Intra-Industry Focus Effects,"[j] Nicolaj Siggelkow found that U.S. mutual funds with focused product offerings had higher returns than firms who did not. Research by Vikram Nanda and his colleagues found that firms with a smaller number of offerings outperformed those with a broad array of offerings by 2.5 percentage points per year.[k]

Experienced, Talented People

Research from Vanguard shows that successful firms also employee people that are experienced, talented, and have passion for their work.[b] These people often have the courage to have an independent view and the humility to correct mistakes quickly. Successful investment firms often have investment teams that are broad and deep, rather than relying on one person's judgement.

Consistent Process

Successful investment firms often have a consistent process which focuses on rigorous investment research and a strict buy-sell discipline. Their process also emphasizes investment principles such as long-term investing and diversification rather than trying to predict movements in the financial markets or economy over the short-term.[b]

Alignment of Interests

Research conducted by Vanguard, American Funds and Dodge & Cox shows that another attribute of successful active management firms is a high degree of alignment of interests between portfolio managers and clients. That alignment is measured by a number of factors including analyst and portfolio manager compensation, and the degree by which these individuals invest their own money in the portfolios they are managing.[b] We feel it is very important that investment professionals have their own money on the line.

In "Portfolio Manager Ownership and Fund Performance,"[l] Ajay Khorana and his colleagues used reported ownership ranges to conclude that managers who are personally invested in the portfolios they are managing outperform their peers by an average of 1.44 percentage points per year. Their research also showed that "for every basis point of managerial ownership, excess performance of the fund improves by 3-5 basis points."

The Characteristics of Successful Managers	
High Active Share	Focus on Core Competency
Low Fees and Expenses	Experienced, Talented People
Low Turnover	Consistent Process
Risk Management	Alignment of Interests

The Value of Full-Time, Professional Investment Management

In our view, investors today do not want to be sold investments for a commission, they want their portfolio to be professionally managed with a simple annual fee that is straightforward, clear and transparent. The Cornerstone Wealth Management Model Wealth Program offers professionally-managed investment portfolios for a broad range of investor preferences. The program seeks to offer:

Consistently Strong Investment Performance

We believe identifying truly skilled managers is a highly labor intensive process which requires a great deal of skill, experience and judgement. Our goal is to identify a small number of superior managers who offer the potential to outperform their peers and their respective benchmarks over a long period of time.

Risk Mitigation

We provide a professionally-managed, broadly diversified portfolio of investments. We monitor those investments and make changes when necessary. We also rebalance the portfolio in an effort to maintain a level of risk consistent with the investor's goals.

Low Fees

Our fee structure is very competitive. The cost of investment management is negotiated with your advisor.

Objectivity

Unlike many other advisory programs, we have no financial arrangements, such as revenue sharing, with the firms that are represented in your portfolio. This gives us access to quality managers, not just those willing to pay to be on a buy list.

Don't Settle for Average

Studies that show active management is a futile exercise base their claims on the average results of the entire universe of active managers. These studies make no attempt to distinguish the subset of managers that, on average, outpace the benchmarks over the long-term. The emphasis on average disguises the presence of consistent outperformers.[m] The research described in this report supports the view that there is the potential to achieve positive long-term results by investing with skilled active managers. This is the focus of the Model Wealth Program. By staying focused and disciplined, it is our hope that we will deliver on our goal of helping investors achieve their long-term investment goals. To learn more about our Model Wealth Program, contact your financial advisor.

Sources:

(a) Data was obtained from Morningstar Direct and is as of Dec, 2015. Morningstar calculates active share based on the fund's most recent holdings.

(b) Based on research conducted by Vanguard, "Beat the market long-term? Yes, it can be done." May 27, 2016. American Funds, The Active Scorecard, Don't Settle for Average, Dodge & Cox. "The Case for Active Management" Oct, 2016. Academic research cited in the article.

(c) Morningstar Active/Passive Barometer Year-End 2018.

(d) Cremers, KJ Martijn and Antti Petajusto, "How Active is Your Fund Manager? A new measure that predicts performance." *Review of Financial Studies* 22.9 (2009): 3329-3365

(e) Carhart, Mark M. "On Persistence In Mutual Fund Performance." *The Journal Of Finance* 52, no. 1 (1997): 57-82

(f) Morningstar. "The Top 20 Investment Managers by assets, June, 2016

(g) Daniel W. Wallick, Brian R. Winner and James Balsamo. "Keys to improving the odds of active management success." Valley Forge, Pa.: The Vanguard Group

(h) Edelen, Roger, Richard Evans, and Gregory Kadlec. "Shedding Light on "Invisible" Costs: Trading Costs and Mutual Fund Performance." *Financial Analysts Journal* 69.1 (2013)

(i) Research by Cornerstone Wealth Management using the Morningstar Direct database as of April 30, 2019.

(j) Siggelkow, Nicoloj. "Why Focus? A Study of Intra-Industry Focus Effects." *The Journal of Industrial Economics* 51, no. 2 (2003) 121-150.

(k) Nanda, Vikram, Z. Jay Wang, and Lu Zheng. "Family Values and The Star Phenomenon: Strategies of Mutual Fund Families." *Review of Financial Studies* 17, no. 3

(l) Khorna, Ajayu, Henri Servaes, and Lei Wedge. "Portfolio Manager Ownership and Fund Performance." *Journal of Financial Economics* 85, no. 1 (2007): 179-204

(m) "The Active Scorecard, Don't Settle for Average", American Funds, 2015

(n) Dodge & Cox, "The Case for Active Management" Oct, 2016

Important Disclosures

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. Economic forecasts set forth may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

The examples provided are hypothetical and are not representative of any specific situation. Your results will vary. The hypothetical rates of return used do not reflect the deduction of fees and charges inherent to investing. Stock investing involves risk including loss of principal.

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise and bonds are subject to availability and change in price.

International investing involves special risks such as currency fluctuation and political instability and may not be suitable for all investors.

There is no guarantee that a diversified portfolio will enhance overall returns or outperform a non-diversified portfolio. Diversification does not protect against market risk.

Past performance is no guarantee of future results. All indices are unmanaged and may not be invested in directly.

The Standard & Poor's 500 Index is a capitalization weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

With permission, some portions of this communication are taken from "Understanding the Case for Active Management", Dodge & Cox October 2016.

The Model Wealth Program: The Strategic Portfolio

Our Strategic portfolios seek to maximize returns while minimizing risks by investing with managers who offer the potential to outperform their respective benchmarks over a long period of time. The portfolios are implemented with a three-to-five year time horizon, but changes may take place sooner if market conditions change or if a change in managers is deemed necessary. These portfolios may be preferable for investors who pursue an approach that blends both active and passive investing strategies. These portfolios are properly diversified among managers in the three major asset classes: U.S. equity, international equity, and fixed income. Within the Model Wealth Program, we rebalance the portfolios we manage when market conditions push the portfolio out-of-balance in an effort to maintain a steady level of risk consistent with your long-term goals and objectives.

We offer five different choices for investors with varying risk tolerance and need for current income: Aggressive Growth, Growth, Growth & Income, Income with Moderate Growth, and Income with Capital Preservation. We believe a professionally-managed advisory account can help take the emotions out of the investment decision-making process, and offers an attractive solution for investors with long-term goals, like saving for, or investing in, retirement.

Investments and strategies mentioned may not be suitable for all investors. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. Asset allocation does not ensure a profit or protect against a loss. Tactical allocation may involve more frequent buying and selling of assets and will tend to generate higher transaction cost. Investors should consider the tax consequences of moving positions more frequently.

Cornerstone
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