

Stay Active!

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One of the strongest trends within the investment management industry in the past 20 years has been the growth of passive (or index) investing at the expense of an active fundamental approach. Index investing is where stocks are picked just on the basis of their weight in a given index such as the S&P 500 index or the MSCI World Index. The resulting investment portfolio will reflect and perform like that underlying index after costs.

Active investing, on the other hand, is based on fundamental analysis and judgement around factors which could include forecasts of future earnings, competitive positions of companies, or sustainability of solid dividends. The resulting investment portfolio and performance reflects the quality of that judgement.

Index Management has surged.

According to Morningstar, the data provider, the amount of assets managed on an index basis have grown by 230% over the past six years which is four times faster than traditional active fundamentally managed products.¹ The passive industry remains much smaller than the active sector, but the gap is narrowing. The proportion of equity funds managed on a passive basis has risen from 15% to 35% over the last decade.²

Why has this growth been so spectacular? There's no doubt that part of it is to do with costs. Investors (rightly in our view) have become very focussed on the

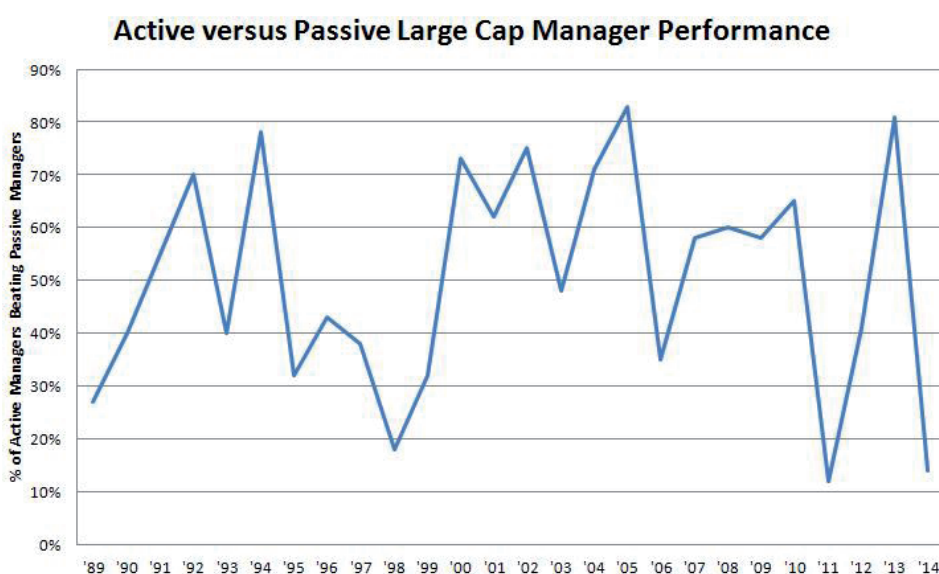
underlying costs in funds and indexed costs, while always lower than active, have come down dramatically in recent years. Management costs in the indexed world are lower as it doesn't bear the research and fund management costs and also index investing is very much a "scale" business dominated by big players such as Vanguard and Blackrock, who can spread reasonably fixed costs over a wider asset base.

Does Active Work?

The other pillar to the growth story for passive investing is the view that active investing hasn't rewarded investors for the extra costs involved and in short it has under-performed the cheaper alternative. Certainly that's what banner headlines in the financial press have been proclaiming for many years. In March of this year, for example, the Financial Times highlighted that 4 out of 5 actively managed funds failed to beat their benchmark in the last 5 years, and this figure was fairly consistent across regions.³ It's a refrain that has been echoed on many occasions.

It's a debate with no middle ground and one it seems of ideological proportions. However, as with all strongly held views it pays to dig deeper into the statistics as both God and the Devil are in the detail.

As investment managers we are aware that there are phases of the market when stock-picking faces tougher headwinds. For example when markets are driven by significant macro events, we see a big jump in the correlation between stock returns i.e. all stocks move together irrespective of underlying differences in company fundamentals or stock valuations. Indiscriminate markets mean fundamental analysis counts for little. Equally there are phases when stock picking can be very rewarding. The chart below focusses on the US equity market and shows in some years active fund managers do very well compared to passive managers while in other years it can be a challenge.⁴



Out of the closet

There is however a deeper and more significant aspect to the debate which is garnering a lot of attention both from investors and indeed financial regulators. There are a number of funds labelled as “active” but in fact are being managed very closely aligned to some underlying benchmark. These funds are in effect “closet indexers”. Because of issues such as asset size or fears around peer group risk there can be a significant overlap between the larger holdings in the fund and in the index. Returns therefore will be very close to the index but the fees will be higher than what a pure index fund might charge. For this cohort of “active” funds therefore underperformance is almost guaranteed. This clearly impacts on those banner headlines about active managers overall failing to make the grade.

Woolley and Vayanos of the LSE in their 2016 paper “Curse of the Benchmarks” actually highlight the issues for those funds not strictly replicating a benchmark but who may use it as a reference and take fixed positions around it, for example being underweight or overweight sectors or stocks.⁵ They run the risk of being captive buyers or sellers of stocks after they have moved.

How widespread is closet indexing? There is no official register but analysis from the European Securities and Markets Authority (ESMA) suggests that up to 15% of active equity funds could potentially be closet indexers.⁶ In some jurisdictions this is much higher with up to 40% or 50% of active funds simply following indices. In the UK, research by SCM indicates that more than a third of UK funds are no more than expensive copies of index funds.⁷ Investors who pay active fees are entitled to get active management. This is an issue being tackled by financial regulators across Europe currently.

The prevalence of closet indexing could be one of the reasons why active managers appear to underperform. The broad statistics do not reflect those “truly” active funds.

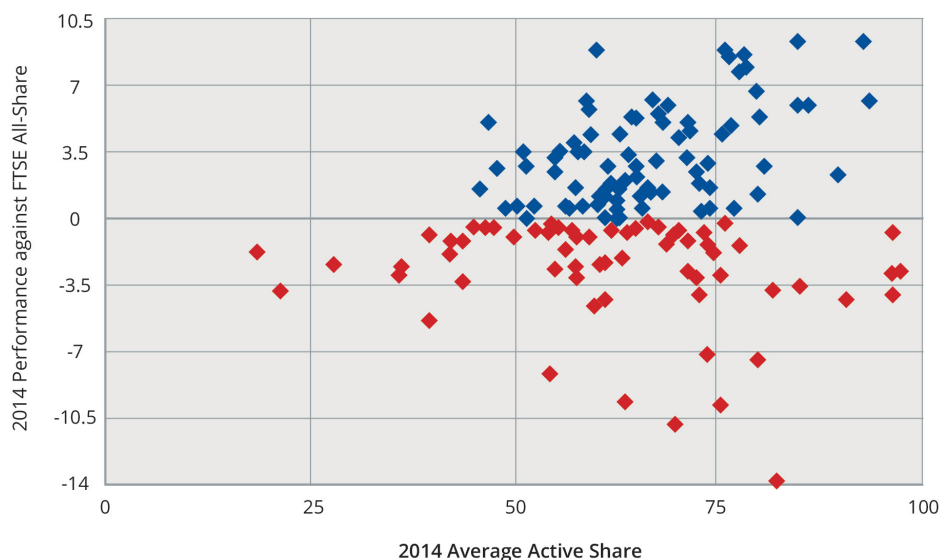
Of course being truly active doesn’t guarantee out-performance but both academic research and fund performance data does point to those funds which have a high active share, that is little overlap with an index but built up with conviction stock ideas, have on balance delivered outperformance. Examining close to 3000 funds over a 20 year period, Yale academics Cremers and Petajisto found that the highest ranking active funds, comfortably beat their benchmarks.⁸

Active is rewarded

In the UK, SCM analysed fund performance compared to active share. The slope of the outcomes shown in the graph below, from their research, supports this view of truly active funds having the potential to do well.⁹

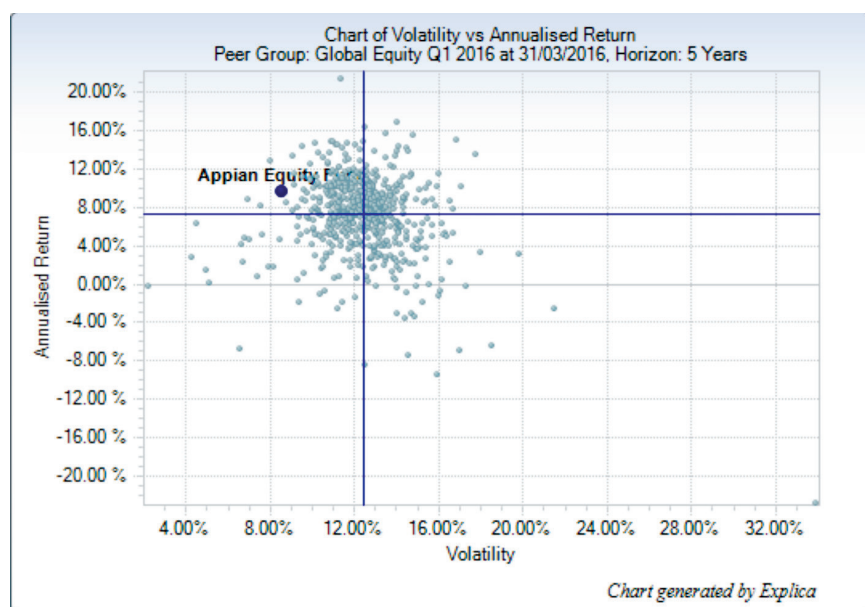
Importantly from the client’s perspective, work by Di Mascio points to strong persistency among active managers who have this measurable skill.¹⁰ Good decision making and strong investment processes can lead to repeatability of outcomes.

Active Share vs Performance in 2014



Appian = Active

At Appian we are strong believers in active management. We believe in meeting with company managements, understanding their strategy and their competitive environment, and assessing their ability to deliver long term returns. Our equity portfolios are quite concentrated in terms of holdings and display high active share percentages. Our focus on quality attributes such as solid balance sheets, strong and sustainable free cash flow and robust business models is designed with the objective of delivering a less volatile outcome while also posting superior performance. As the graph below indicates we have consistently delivered superior performance relative to peers.



Investing on a passive basis will continue, but increasingly is also morphing into so called “smart beta” and factor investing. These are strategies which often boast stellar back-tested results but where it may be still too early to judge true potential.

This in turn puts active investing into focus and there is no doubt we will see greater scrutiny into closet index funds as we have discussed.

Within truly active strategies, research by Bernstein points to several key trends:¹¹

- Among fundamental managers, those with higher active risk and more concentrated portfolios are gaining share.
- The share of fundamental equity strategies accounted for by funds with fewer than 40 holdings has doubled in the past 5 years.
- The proportion of fundamental funds that use stock screens and filters is rising significantly.

These trends are well set to continue.

The growth of absolute return and multi-asset funds shows that for many of today's fund investors, benchmark proxy funds don't really meet requirements. In a world of modest returns, real wealth creation and preservation are what matter and this is where good active managers should focus.

¹ *Financial Times* May 29 2016

² *Bernstein In defence of Active Management* May 2016

³ *Financial Times* March 30 2016

⁴ *Forbes* March 30 2015

⁵ *LSE Working Paper No. 747* March 2016

⁶ *ESMA* Feb 2016

⁷ *SCM Direct* Feb 2015

⁸ *Yale Working papers* March 2009

⁹ *SCM Direct* Feb 2015

¹⁰ *Di Mascio UK CFA Journal* 2015

¹¹ *Bernstein* May 2016



To discuss any of this further please contact:

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