INFORMATION FOR INVESTMENT PROFESSIONALS

COLUMBIA THREADNEEDLE INVESTMENTS

INTELLIGENT THINKING
NOT ALL ACTIVE MANAGERS ARE CREATED EQUAL – WHAT TO LOOK FOR AND WHY.

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FOREWORD

COST V VALUE: REFRAMING THE ACTIVE/PASSIVE DEBATE

In publishing this paper *'Not all active managers are created equal – what to look for and why.'* we hope to add some new perspectives to the ongoing discussion around active and passive management. For my part, I would like to see the discourse move beyond a debate about costs to a more helpful focus on long-term value creation. In this report, we hope to provide investors with additional information that will help them to understand the choices available and will enhance scrutiny, transparency and accountability among those of us entrusted with managing other people's money.

As long-term investors, we at Columbia Threadneedle Investments fundamentally believe that markets are inefficient and that an active approach can benefit investors both in terms of risk and return. In the context of this debate, a look at the last 15 years in which markets have seen a number of "boom" and "bust" periods provides a timely illustration. On 24 February 2015 the FTSE 100 reached its pre-crisis high of 6930.2, a level not seen since January 2000. A passive investor tracking the FTSE 100 over the past 15 years would have fared well. If dividend payments are included (giving a true total return as opposed to just the capital return of the index), a gain of 68% would have been achieved between 31 December 1999 and 28 February 2015. The performance of the FTSE All-Share Index, a more representative measure of the UK economy, was even stronger. A £10,000 investment in the FTSE All Share on 31 December 1999 would have grown to more than £19,000 on a total return basis by 28 February 2015, a gain of 90%.

So investors in a fund tracking either index over the period would have enjoyed healthy returns. However, a well-managed and carefully selected active fund could have delivered significantly more. I'm pleased to say our two flagship UK equity funds provide a strong example. An investment of £10,000 in the Threadneedle UK Fund would have grown to £24,076 (a cumulative return of 141%). The equivalent investment in the Threadneedle UK Equity Income Fund would have grown to £30,007 (a cumulative return of 200%). Importantly, these figures are net of all fees.

I have said before that passive management is not a low cost panacea, but is one tool in an expansive kit available to investors to enable them to achieve their long-term goals. Equally, choosing the right active fund is not a simple matter. I'm pleased that over the past 15 years our two flagship UK equity funds have significantly outperformed other actively managed funds in the UK. But hindsight is a wonderful thing – how would an investor know to expect that outcome 15 years ago?

This paper adds some insightful and useful thinking to the debate. As it indicates, factors such as adherence to a proven investment philosophy and process; the three C's – conviction, contrarian thinking and concentration; and incorporation of ESG considerations play a role. As do less easily measurable factors such as the ability to be open to challenge and to recognise and control behavioural biases.

Given the very real prospect of more modest long-term returns going forward, the ability for investors to effectively increase their chances of selecting exceptional managers who deliver net outperformance is all the more critical. Against this backdrop, and in the interest of investors, we need to shift the emphasis from active v passive to a focus on overall value and outcomes.

Campbell Fleming,
CEO, EMEA and Global COO
Columbia Threadneedle Investments

Fund performance based on institutional share classes. All data in GBP, fund and sector performance net of all fees (1.05% OCF pa and additional costs) and net of tax dividends reinvested (UK Basic Tax).
Source: Morningstar/Factset/Columbia Threadneedle Investments

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SECTION 1:
SUMMARY

Chris Wagstaff, Head of Pensions and Investment Education, Columbia Threadneedle Investments and Senior Visiting Fellow, Finance Faculty, Cass Business School.

This paper challenges the notion that active fund management – in aggregate and after fees – is a negative sum game. Indeed, the reward for selecting exceptional managers who deliver net outperformance can be a significant uncorrelated source of investment return. We investigate the many factors at play that can lead to sustained active investment outperformance. These include adherence to a proven investment philosophy and process, conviction, contrarian thinking and concentration, being capacity aware, a patient investment approach, incorporation of ESG considerations and quite possibly gender. As the paper demonstrates, strong empirical underpinnings suggest these are the key issues to consider when selecting an active manager. And while the task of identifying those active managers likely to outperform over the long-term is not a simple one, given the very real prospect of more modest long-run returns going forward it is arguably time well spent.

KEY POINTS

- For simplicity, our analysis is restricted to equity fund management, although similar considerations apply to many other asset classes.
- We contend that the long running active versus passive debate has been poorly framed with the two approaches to fund management having been incorrectly treated as being mutually exclusive. Both approaches typically comprise the asset mix of most institutional portfolios.
- It is suggested that net value added – delivering sustained outperformance after fees and meeting desired investment outcomes – rather than a focus on cost *per se*, is how the active/passive debate should be positioned.
- While active fund management in aggregate after fees is positioned as a negative sum game, given the prevalence of closet trackers, the potential reward for selecting a genuinely talented fund manager can be a significant and sustained uncorrelated source of investment return.
- The duration of performance persistency among good active fund managers is greatly influenced by the extent to which investor cash inflows constrain their investment approach. The imperative is to differentiate between talented capacity-aware asset managers and simple asset gatherers.
- A combination of luck, skill and investment style determines active fund manager returns in the shorter term. However, in the longer run as luck evens out, any genuine skill will shine through. This skill can, however, take some time to prove statistically – too long for most investors.
- As the quantitative assessment of fund manager performance to determine skill is riddled with practical problems, evaluating fund managers against those key qualitative performance drivers that would appear to point to the ability to outperform over time is arguably time well spent.

KEY POINTS (CONTINUED)

- Although no one factor or quality gives a genuinely skilful manager an edge, the key issues to consider when selecting an active manager, each of which have empirical underpinnings, include:
  - adherence to a proven and repeatable investment philosophy and process that captures the manager's investment insights and value adding processes; an investment approach underpinned by a culture that is dynamic and interactive and by processes that are team-based, performance driven and risk aware;
  - application of the three Cs – high conviction portfolio positions, contrarian/independent thinking and high portfolio concentration;
  - employing an *investing to win* mindset, typically evidenced by a high active share and tracking error;
  - dedication either to a single investment style in which success has been demonstrated, given that each investment style demands a different mind and skill set, or to a stock picking approach which has successfully emphasised particular style traits consistent with the investment outcomes targeted; a patient investment approach – given that this benefits from the greater predictability of asset prices over the longer term; a strong sell discipline – with sale proceeds being invested in new portfolio ideas rather than being spread amongst existing ideas; and a considered approach to portfolio turnover, given the potentially adverse effects of high transaction costs on fund performance;
  - the incorporation of Environmental, Social and Governance (ESG) considerations into the investment process that promotes best practice in corporate governance and sustainable and responsible business and management practices, as ESG factors become increasingly material to company valuations;
  - appropriate manager and team remuneration structures that align interests with the end investor;
  - an ability to:
    - combine proprietary macro and micro insights into investment decision making;
    - clearly articulate how ideas find their way into their portfolio;
    - be open to debate and genuine challenge;
    - recognise and control their behavioural biases, particularly groupthink, misplaced confidence and an aversion to realising loss making portfolio positions;
    - recognise the capacity constraints of their chosen strategy:
    - add value in both rising and falling markets, particularly the latter, and
    - put risk management at the centre of all that they do.
- Although the evidence is sketchy, female fund managers appear to produce more consistent and less volatile performance than their male counterparts.
- Research suggests that once a skilful manager has been identified, a patient approach by the end investor must be adopted for skill to shine through. All too often investors treat periods of poor performance as proof of skill having deteriorated. Even the most skilful of managers will periodically underperform.
- Given the prospect of more modest long-run returns going forward, it is suggested that investors, in applying the requisite due diligence, can increase their chances of finding potentially exceptional managers who more than earn their fees over time and deliver the ultimate uncorrelated source of return. Against this backdrop, and as noted above, net value added – delivering sustained outperformance after fees and meeting desired investment outcomes – rather than a focus on cost per se is how the active/passive debate should be positioned.

SECTION 2:
INTRODUCTION

The active versus passive fund management debate has raged for over 50 years and continues to be a topical subject for discussion amongst investors and academics alike. Although not necessarily mutually exclusive, the two approaches are often treated as such, with the debate typically revolving around relative performance and cost, rather than the more relevant positioning of cost versus value added. By value added, we mean delivering sustained outperformance after fees and meeting desired investment outcomes.

As will become clear, the appropriate active-passive mix for any investor (and it will often be a mix) mainly depends on their investment beliefs – principally around how markets function, how securities are priced and the value of diversification – their investment goals, governance budget and risk appetite.

However, a good place to start is with a definition of the two approaches and the philosophy that underpins each before moving onto their individual nuances, merits and shortcomings. For simplicity, the following analysis will be restricted to equity fund management, although similar considerations apply to many other asset classes.

SECTION 3:
PASSIVE MANAGEMENT

Passive management, or index tracking, as opposed to a buy-and-hold strategy, involves constructing a portfolio of securities that replicates, or tracks, the total return of an equity index, such as the S&P 500, on the premise that securities are efficiently priced. This notion of price efficiency, which originated in the 1930s, is encapsulated in the efficient markets hypothesis (EMH). Developed in the 1960s and 1970s, the EMH states that market prices *continually* reflect all available and relevant information. They therefore move randomly and independently of past prices as investors react rationally and instantaneously to new market news. While the EMH acknowledges that market participants do make random mistakes, it assumes people learn from their mistakes and do not repeat them. Crucially, these random errors are presumed to offset one another. Even if not offset, the contention is that transactions costs would render the opportunity unprofitable. If correct, and it is a big *if*, the EMH has obvious, damning implications for those investors seeking to outperform the market. After all, if market prices continually reflect everything known or knowable about the market's constituent securities, then investors cannot hope to consistently beat the market unless they are very lucky or are prepared to take higher risks, which may or may not pay off. Given this, why devote time and effort to fruitlessly second guessing the market when you can simply track the market's performance?

In seeking to replicate the market, most index tracker funds adopt one of two tracking methodologies: full replication and stratified sampling. Full replication holds every index constituent in accordance with its index weighting, while stratified sampling uses sophisticated statistical techniques to select a subset of index constituents to track the index as closely as possible. The latter technique is typically applied when full replication isn't feasible, whether because of the illiquidity of some of the index's underlying holdings, the sheer size of the index or country specific laws on foreign holdings.

On the plus side, index trackers minimise the risk of underperforming the index before fees and minimise the costs of investing by only transacting when necessary, such as when new money and dividend income is received, to meet investor redemptions and to accommodate periodic changes to the index being tracked. However, on the flip side, once fees, costs and a number of minor technical factors are taken into account, underperformance of the market often results. Moreover, being fully invested in the chosen index means trackers follow the market down as well as up.

Most index tracker funds are based on market capitalisation weighted indices, such as the S&P 500, Dax and Hang Seng, where the largest stocks in the index by market value have the biggest influence on the index's value. This is because only market cap weighted indices (as opposed to price weighted indices, such as the Dow Jones and Nikkei Dow, or equally weighted indices, like the FT30) are easily replicable and perform like an actual investment portfolio. They also automatically rebalance portfolio weightings with changes in the prices of the underlying constituents.

However tracking market cap weighted indices are not without their problems. They cannot be customised to meet all investor objectives – the index chosen is the index tracked – and diversification is often compromised by the index being highly concentrated. Far and away the biggest problem though is that the largest positions in the index are concentrated in those sectors and stocks that the market perceives to be the most successful, even though these may transpire to be last year's winners rather than this year's. Indeed, with rapid product innovation and lower barriers to entry for potential new entrants in many industries, industry pre-eminence can often be a temporary phenomenon. Moreover, the resultant misallocation of capital and subsequent drag on performance is particularly acute in momentum driven equity bull markets as market cap weighted index trackers are forced to allocate more money to, what prove to be, increasingly overpriced market favourites and less to those sectors and stocks likely to be undervalued. This was dramatically illustrated in the dot.com boom and subsequent bust of the late-1990s and early noughties. In addition, as the big became a lot bigger so did the potential for catastrophic corporate failures and so it proved with Enron and WorldCom. Moreover, the big getting bigger was compounded by the overpriced favourites having restricted the amount of issued share capital they made available to investors.

This latter point has since been addressed to a degree by the major market cap index providers introducing free float adjustments to their indices. These dictate a pro-rata index weighting for those stocks which make less than 100 per cent of their issued capital available to investors. In addition, there has been widespread adoption by the major index providers of alternatively weighted, or *smart beta*, indices, principally constructed around those long observed and well documented risk premia, such size, value, momentum and low volatility, whose existence is at odds with the EMH. Principal amongst these are fundamentally weighted indices. These weight each constituent by the size of their real world attributes, such as company revenues, earnings and cash flow, rather than their market cap and result in portfolios very different from those that are market cap weighted. However, despite increased interest in these alternatively weighted index strategies, especially fundamentally weighted and low volatility indices, and their backtested long-run risk-adjusted outperformance of market cap weighted indices[1], the latter remain the dominant index tracking structure.

MARKET EFFICIENCY

While the idea of price efficiency is simple and intuitive, it is arguably based on some highly questionable simplifying assumptions about investor rationality, the capacity to interpret information correctly no matter how it is presented and the ability to learn quickly from past mistakes. Indeed, casual observation suggests that the composition of the investor base is continually changing, as older, more experienced investors leave the market and the less experienced enter the world of money management. As we suggest a little later, one can argue that an investor who has been exposed to several market cycles is probably more in tune with the market and less susceptible to repeating past errors than a less experienced investor. Indeed, there is a considerable body of empirical evidence on the plethora of regularly observed pricing anomalies, patterns and trends – all of which are inconsistent with the EMH – that can be repeatedly and profitably exploited by simple trading strategies.

These phenomena are well documented in both the traditional and the burgeoning behavioural finance literature. The latter, rather than make simplifying assumptions about the way investors approach investment decision making, instead analyses the way in which systematic, or often repeated, cognitive biases – bad heuristics (taking mental shortcuts to simplify decision making) and framing errors (posing, or framing, a decision problem incorrectly) – enter into the process, causing security prices to randomly depart from their fundamental values. Central to behavioural finance is investors' limited cognitive ability, inability to calculate probabilities and slow learning, hence the oft-repeated mistakes observed in financial markets.

[1]See Clare A., N.E. Motson and S. Thomas (2013). An Evaluation Of Alternative Equity Indices. CAMR, Cass Business School, London. All eight alternatively weighted indices generated a higher Sharpe ratio than market cap weighted indices over the period 1969 – 2011 and over the four decades of the 1970s, 1980s, 1990s and 2000s, excluding transactions costs. Most of the alternatives did, however, suffer significant periods of medium-term underperformance and exhibited much higher portfolio turnover than market cap weighted indices.

MARKET EFFICIENCY (CONTINUED)

Although the long running debate between the efficient markets and the behavioural finance schools of thought remains inconclusive[2], Warren Buffett, the world's third richest man, and the living embodiment of successful active management allied to a very patient investment approach (more on that later), sums up the market efficiency debate rather well:

"Observing correctly that the market was frequently efficient, [many academics and investment professionals] went on to conclude incorrectly that it was always efficient. The difference between the propositions is night and day.[3]"

Suffice to say, Mr Buffett has amassed his vast fortune over the past 50 years from those instances when the market has been inefficiently priced and, by implication, from those parts of the market less closely scrutinised. On this latter point, it is worth noting that ironically, market efficiency is as a result of active managers extensively researching the market which they hope to outperform. Essentially index funds take a free ride on the hard work and effort of their active counterparts. Of course, as intimated above, some markets and market segments are more heavily researched than others, resulting in varying levels of market efficiency around the world, with this efficiency varying over time (for reasons that the behavioural finance literature, in particular, seeks to explain). However, rather paradoxically, as money is allocated away from active management towards passive, a point may come (which has yet to be quantified) when a particular market is not being sufficiently well researched, resulting in the market becoming inefficient and active management coming into its own. Currently, just over ten per cent of the US and UK markets is index tracked[4].

Ultimately the relative merits of active and passive management revolve around three key issues: the extent to which markets are price efficient; if inefficient, the ability of active managers to consistently and profitably exploit market anomalies, net of fees, of course, and the ability to deliver desired investment outcomes.

[2]However, Professor Andrew Lo's Adaptive Markets Hypothesis seeks to reconcile the two schools of thought. Lo argues that "markets are neither always efficient, nor always irrational, but are adaptive." This suggests that the EMH and behavioural finance each have merits and can co-exist on the premise that humans are neither fully rational nor psychologically unhinged and each approach captures different aspects of the same "adaptive" system. Drawing heavily on Darwinian evolutionary biology, Lo argues that while markets can remain stable for extended periods of time, this stability can be periodically disrupted by the emergence of new financial "species" and the extinction of others. So investor behaviour that may seem irrational is instead behaviour that has not had time to adapt to a dynamic investment environment which produces new investment products, principles and paradigms. Against this backdrop, humans arguably work best by making guesses and by trial and error until their behaviour adapts to the new environment. According to Lo if one investment strategy works then we stick with it, if not then we try another.

[3]John Kay. Markets after the age of efficiency. Financial Times, 7 October, p.17 (2009).

[4]The Best Thing for Active Managers? Passive Investors. aiCIO, 17 December, 2014.

SECTION 4:
ACTIVE MANAGEMENT

By contrast, the basic premise of active management is that markets are inefficiently priced. That is, securities are not correctly priced, at least not in all markets and not all of the time. Therefore, active managers seek to profitably exploit these mispricing opportunities by taking positions in stocks different to their weight in the index or in off-benchmark positions not represented at all in the benchmark they seek to outperform. In so doing, actively managed equity funds address many of the criticisms levelled at index trackers. Firstly, they can be positioned to meet stipulated investor objectives. Indeed, in addition to requiring strong and sustained outperformance, investors are increasingly looking for asset managers that can deliver outcome-based investment solutions. Crucially, however, active managers can potentially capitalise on prevailing and expected market conditions and provide diversification in varying degrees, as appropriate.

TRACKING ERROR

The extent to which the return on an active manager's portfolio differs from their benchmark is termed their *active risk*. This has historically been measured by their *tracking error*. Usually expressed as an annual percentage, this is the expected, or targeted, standard deviation of the fund's *return* from the benchmark. The bigger the targeted, or *ex ante*, tracking error, the greater is the fund manager's latitude to be benchmark agnostic. The bigger the realised, or *ex post*, tracking error, the more benchmark agnostic the manager has been. While tracking errors of three to four per cent are commonplace, truly active, or high conviction, active managers often target tracking errors up to twice as high. Of course, the higher the tracking error the greater the potential for both significant outperformance and underperformance[5]. By contrast, index tracker funds strive to minimise their tracking errors to as close to zero as possible. Then, of course, there are the closet trackers, or index huggers, the bête noire of the asset management industry. These are they who manage their portfolios on an almost passive basis over prolonged periods, with similarly low tracking errors, while charging active fees.

DOES TRACKING ERROR POSITIVELY CORRELATE WITH PERFORMANCE?

We categorised the 500+ plus global equity funds on the *eVestment* database according to their average *ex post* tracking errors relative to the benchmark MSCI All World Composite Index (MSCI AWCI) over the five years to 31 March 2015 – five years being a reasonable time over which to invest. This was to establish whether tracking error positively correlates with performance in the medium term. The results show the annualised five year performances before fees against the MSCI AWCI.

	Average 5 year *ex post* tracking error			
	0% – 2%	**2+% – 4%**	**4+% – 8%**	**8+%**
Number of funds	53	211	235	42
Minimum annualised return	-1.01%	-2.37%	-10.52%	-9.61%
Mean annualised return	0.96%	1.08%	0.99%	1.13%
Median annualised return	0.89%	0.95%	1.06%	2.10%
Maximum annualised return	2.76%	5.81%	10.13%	8.59%

Source: eVestment and Columbia Threadneedle Investments. May 2015. Data applies to 500+ global equity funds over the five years to 31 March 2015

While it is acknowledged that this analysis has been conducted at the fund rather than at the manager level, we can see that the annualised mean and median performances of these funds before fees not only outperform the MSCI AWCI by around one per cent (two per cent in the case of the median fund with an eight plus per cent tracking error) in all four cases but also correlate positively with the active risk taken.

[5] The consequence of this is that it is difficult to find a highly skilful manager who follows a cautious path.

INFORMATION RATIO

Tracking error is also integral to calculating a fund's *information ratio*. Utilising the fund's realised, or *ex post*, tracking error, the information ratio is an increasingly popular measure of risk-adjusted performance that expresses a fund's performance relative to its benchmark per unit of active risk. So the greater the fund's outperformance and the smaller the tracking error, the higher the information ratio and, by implication, the greater the risk-adjusted value added by the fund manager. Unlike *ex post* tracking error, which provides but one measure of the extent to which an active manager deviated from their benchmark, the information ratio *helps* validate *ex post* an active manager's ability to exploit market anomalies, or at least the extent to which this deviation from the benchmark has been rewarded. However, this isn't a conclusive validation of manager skill, at least not in the shorter term, given the indecipherable role of luck in influencing shorter run performance. This we consider later in the paper.

ACTIVE SHARE

That brings us on to *active share*. Unlike tracking error, active share is not a measure of active risk, and unlike the information ratio, does not help validate manager skill. Rather, active share simply measures the extent to which the composition of a portfolio differs from the benchmark against which its performance is assessed and, as such, acts as a good starting point in assessing how active a fund manager is. Devised in 2009 by two Yale professors, Martijn Cremers and Antti Petajisto[6], active share, by summing the absolute value of the manager's underweight and overweight positions relative to the index, or benchmark, operates on a scale of zero to 100 per cent[7]. The former indicates that the portfolio holds every stock in the same proportion as the benchmark, while an active share of 100 per cent signifies that the portfolio doesn't hold any of the stocks in the benchmark. *Prima facie* the higher the active share of a fund, the more actively managed the fund is, with active shares of 80 per cent and above having become associated with truly active or high conviction asset managers. These are the benchmark aware but not benchmark constrained managers who adopt an *invest to win* philosophy, rather than the *invest not to lose* mindset of closet trackers.

However, active share numbers must be seen in context and, like any other comparator, should never be used in isolation. At the very least, active share should be used in conjunction with both the fund's realised tracking error and its information ratio, if investors are to assess whether they are obtaining the value they expect for the active management fees they pay. Indeed, active share is influenced by several important factors, most of which rail against simply assuming that a high number is good and a low number is bad.

Firstly, the more diversified, or the greater the number of constituents that comprise the benchmark, the higher the fund's expected active share. So, other things equal, a global equity fund, a US equity fund or a smaller companies fund, all of which are typically benchmarked against highly populated and well diversified indices, would be expected to have a higher active share than a single country, ex-US, equity fund, particularly one with a highly concentrated index. So whereas a high conviction global equity fund might be expected to have an 80+ per cent active share, a China fund managed by a similarly high conviction manager might have an active share in the region of 40 to 60 per cent Linked to this is the choice of benchmark used to assess performance. If the benchmark is inappropriate, in that it is mismatched with the fund's objective and/or strategy, then a high, and largely meaningless, active share, will result.

Additionally, active share tends to change with differing levels of market volatility over time. In more volatile market environments[8], when managers can potentially profit from individual stocks moving out of step with one another, as opposed to when markets are calmer and individual stock movements are not so clearly differentiated, active shares would usually be higher. After all, this

[6]Cremers, Martijn and Petajisto, Antti, (2009). How Active is Your Fund Manager? A New Measure That Predicts Performance. Review of Financial Studies, Vol 22, No.9, 3329-65.
[7]For long-only, non-leveraged funds.
[8]More volatile market environments are characterised by increased two-way trading as investors increasingly take on different views of the world.

is when active managers are more inclined to increasingly utilise their active risk, or tracking error, budgets. Indeed, more than five years of quantitative easing by central banks in the UK and US, and that more recently implemented by the European Central Bank, while boosting equity markets, has resulted in stocks tending to move in tandem with one another, as macroeconomic news and central bank policy has overridden stock specific news. Unsurprisingly, this has made stock picking that much more difficult with truly active managers less inclined to use their active risk budgets. However, as monetary policy begins to normalise and equity correlations begin to fall, this should prompt truly active managers to take on more active risk[9]. (That said, in spite of this, according to S&P almost 90 per cent of UK active equity fund managers beat their benchmark net of fees in 2013 by simply tilting their portfolios away from the five largest companies in the index and performed significantly better than their European counterparts over the three years and five years to end-2013[10]).

Active share can, of course, change over time for other reasons. One such reason is if a fund starts to hit capacity constraints and is forced to move away from an outperforming niche strategy to an underperforming, more benchmark constrained, investment strategy. In this regard, the imperative is to differentiate between capacity-aware asset managers and simple asset gatherers[11]. Petajisto illustrates this in a later paper[12], showing how the active shares of the Growth Fund of America in the late-1990s through to the late-noughties and the Fidelity Magellan Fund in the mid-1990s through to the mid-noughties, plummeted as a result of substantial increases in assets under management. In this respect, active share can act as a check on the consistency with which a manager's investment strategy has been applied. Consistency of philosophy and approach matters in asset management. We touch on this when looking at Investment Philosophy and Process and investment style.

Given the relative simplicity of its calculation, active share also fails to differentiate between funds with different performance drivers and risk profiles. So, two funds with vastly different active positions in stocks and/or sectors and, by association, vastly different risk profiles could have similar active shares. For example, a diversified stock picking fund that isn't tilted towards any one sector might have the same active share as one that seeks to derive its performance principally from tilting towards a few sectors. Similarly, stock specific risks are ignored, as a stock picker focused on companies in higher risk sectors might have the same active share as a stock picker focused on companies residing in lower risk sectors.

Despite its shortcomings, the popularity of active share has largely revolved around its association with outperforming funds. This followed from Cremers' and Petajisto's finding, in their original 2009 research, that outperforming funds were typically those with a high active share, concentrated and of a small size. However, that is not the same as saying that active share alone can predict outperformance. No one metric can. Indeed, in his latest research Cremers suggests that active share "...helps to know which funds to consider, or where on the lake to fish", citing those active managers with *both* high active shares and who adopt patient investment strategies as the ones best positioned to outperform[13]. Cremers defines these as managers with stock holding durations of at least two years, ideally longer. Of course, if the manager is underperforming, they may not be given two years to turn their performance around. Indeed, UK consultancy firm Spence Johnson recently found that post-crisis, underperforming managers are only given 12 months by UK pension funds to improve their performance, eight months less than pre-crisis. Suffice to say, a skilful manager also requires patience on the part of the investor if their skill is to shine through[14]. As Nobel Laureate Paul Samuelson once said, "Investing should be more like watching paint dry or watching grass grow. If you want excitement, take $800 and go to Las Vegas." We'll revisit this when looking at the role of luck and skill in performance data.

[9]See Return of the Stock Pickers. Active managers are likely to recapture their lost glory as interest rates rise. Barron's online, 1 April 2015.
[10]Almost 90% of UK active managers beat the stock market, Financial Times, August 3, 2014.
[11]Analysis of the top 10 selling UK actively managed Equity Funds by net cash inflows over one, three and five years to end-February 2015, excluding those run on an absolute return basis, confirms that top performing funds run on a capacity aware basis can continue to outperform.
[12]Petajisto A., (2013). Active Share and Mutual Fund Performance, Financial Analysts Journal 69(4) 73-93.
[13]Cremers, Martijn and Pareek, Ankur. Patient Capital Outperformance: The Investment Skill of High Active Share Managers Who Trade Infrequently. September 19, 2014.
[14]Indeed, poor investor timing was found to largely offset the value added by actively managed funds. Geoffrey C. Friesen and Sapp, Travis R.A.. Mutual Fund Flows and Investor Returns: An Empirical Examination of Fund Investor Timing Ability. Unpublished (2007).

Although partly attributable to lower trading costs[15], patient investment strategies are those that benefit from the greater predictability of asset prices over the longer term. So whereas in the short term, fundamentals such as the level of dividend yield fail to substantially predict subsequent investment returns, over a ten year investment horizon they are a reliable predictor of return[16]. Perhaps unsurprisingly, holding a smaller number of high conviction positions rather than a larger number of stocks was, also found to be a significant performance driver. These points, of course, haven't been lost on Warren Buffett, that most patient of investors, over the past 50 years.

As intimated above, none of the metrics considered so far tell us anything about manager skill – the ability to generate repeated outperformance through systematically and profitably exploiting market inefficiencies. As noted earlier, even the information ratio only helps to validate past risk-adjusted performance, being unable to attribute this performance entirely to skill, unless a sufficiently long time frame is being considered. After all, luck, good and bad, while evening out in the long-run, can influence returns markedly in the short run, with good luck flattering the performance of an unskilled manager and bad luck unseating a good investment process and offsetting genuine skill. As short-term performance can have a substantial random element to it, extrapolating past performance into the future can be particularly dangerous.

With this in mind, let's turn to the issue of active manager performance and what characteristics prospectively define a skilful active fund manager, as opposed to just a lucky one or, worst still, a closet indexer.

ACTIVE MANAGER PERFORMANCE

The main argument for active fund management over passive management is that active managers potentially have the skills to beat the market. Genuine skill is valuable not only because of the obvious value it can add net of fees to investment return, against the probable backdrop of more modest longer-run returns going forward[17], but also because it is an uncorrelated source of return. Arguably, *the* ultimate source. However, as the sum of all fund managers managing a particular asset class *is* the market, they can't all outperform it. Similarly, by definition, every fund manager cannot beat every other fund manager. On average, we might expect half to win and half to lose. So, before fees, active fund management would seem to be a zero sum game. If so, then after fees, by definition, it's a negative sum game. That is, we should expect, at least *in theory*, more than half of all active fund managers to underperform. However, the idea of active fund management being a negative sum game is not clear cut given the increased prevalence of the bane of the active management industry – the low conviction, index hugging, closet tracking, managers.

[15]The attritional effect of trading costs on performance is well illustrated in Barber B.M. and T. Odean. Boys Will Be Boys: Gender, Overconfidence, and Common Stock Investment. Quarterly Journal of Economics (2000) and Barber B.M. and T. Odean. Trading Is Hazardous to Your Wealth: The Common Stock Performance of Individual Investors. The Journal of Finance. Vol 55, No2, pp773 - 806 (2002).
[16]The work of Nobel Laureates Eugene Fama and Robert Shiller, amongst others, in this area is well illustrated in the Barclays Capital Equity Gilt Study. pp. 5 – 10 (2009), using metrics such as dividend yield, price-to-earnings ratios and Tobin's Q.
[17]Based on sub-par sustainable, or trend, economic growth rates, real yields and available risk premia.

SECTION 5:
IS ACTIVE FUND MANAGEMENT REALLY A NEGATIVE SUM GAME?

Although by no means definitive, a recent study into the relative net-of-fees performance of actively managed equity growth funds by Morningstar, the performance data analytics firm, suggests that active funds, particularly in Europe ex-UK, the UK and Asia ex-Japan have, on average, fared better than passive funds over the longer term. Restricting the analysis to those actively managed funds with a growth bias[18], the data shows that the mean active fund performance after fees over 10 years in four of the six countries/regions analysed bettered that of the best performing tracker fund.

The results of the study are shown below.

Country/region	% of actively managed equity growth funds after fees outperforming the best performing tracker fund 3 years (%)	5 years (%)	10 years (%)	Best tracker performance over 10 years (%)	Mean active fund performance over 10 years (%)
US	22	12	33	150	136
UK	70	72	52	115	123
Europe ex-UK	43	65	70	110	130
Asia ex-Japan	41	43	59	193	215
Japan	32	47	37	78	71
Global	15	22	48	123	132

Source: Do trackers beat active funds? The Telegraph. 4 April 2015. Data supplied by Morningstar.

CLOSET TRACKERS

As noted earlier, closet trackers are those managers who manage their portfolios over a prolonged period on an almost passive basis, adopting a benchmark constrained, *invest not to lose* mindset, while charging active fees for the privilege. Typically identified with active shares of less than 60 per cent, sometimes much less, and top ten holdings mirroring that of the index against which their performance is benchmarked, if there was ever a formula destined to underperform and detract value from investors' portfolios, this is it. Despite this, it has been estimated that a gargantuan £58bn ($87bn), or 29 per cent, of investors' money held in UK equity funds is closet tracked. This is the biggest such percentage in any developed market. In the US, it's a little less than ten per cent, in continental Europe a little more than ten per cent, whereas in Japan the figure is a mere three per cent[19]. Crucially, however, it is the immense value destruction by closet indexers overcharging for their lack of active management that is of the greatest concern. In the UK alone, it has been estimated that if the £58bn ($87bn) closet indexed was instead invested in the least expensive UK tracker fund, investors could save themselves in excess of a not inconsiderable £750m ($1.3bn) per annum in fees[20]. Suffice to say the issue hasn't gone unnoticed by regulators in the UK, continental Europe and particularly the Nordics[21], with the Norwegian regulator having recently singled out the country's largest bank for mis-selling a $1bn closet tracker to retail investors. This follows investigations into closet indexing by the Swedish government and the Danish regulator[22], with Sweden's second largest fund manager having had a class action lawsuit filed against it by the Swedish Shareholders' Association over allegations it had mis-sold closet trackers to investors[23].

[18]Please see the section on investment style, below.
[19]Simon Evan-Cook, Premier Asset Management. Kill the Filler: The Costs of Closet Tracking. November 2014.
[20]Premier Asset Management *ibid.*
[21]The future is bleak for closet trackers. Financial Times. 7 December, 2014.
[22]Norway takes action against closet-tracking. Financial Times. 15 March, 2015.
[23]Active share revealed to have feet of clay. FTfm. p.6. 26 January, 2015.

MEASURING ACTIVE PERFORMANCE

For many years, the academic literature has produced successive research papers dedicated to examining the performance of active fund managers, with the aim of understanding whether active managers have the requisite skill to provide investors with value for money. However, with the increasing prevalence of index huggers dragging down the average active performance, it probably comes as no surprise that most, though not all, studies typically find that more than half of funds underperform. Indeed, the general conclusion of most studies is that genuine alpha, or skill, is a rare commodity, with persistent outperformance, or performance persistency, being rarer still. After all, as noted earlier, if a successful manager who, in applying a niche strategy, has consistently outperformed but is not particularly capacity-aware, then they are likely to be overwhelmed with investor cash and forced into a strategy that places larger and more heavily researched stocks at its core, with performance tapering off as a result. Once again, it pays to differentiate a genuine asset manager from a simple asset gatherer.

HOW THE 10 LARGEST ACTIVELY MANAGED FUNDS FARED IN 2014

Again, although by no means definitive, casual observation of the extent to which the 10 largest mutual funds underperformed their respective benchmarks in 2014, suggests that the larger a fund becomes the harder it is for the manager to outperform.

Fund	AuM at 31/12/14 ($bn)	Fund performance 2014 (%)	Benchmark performance 2014 (%)	Benchmark
Pimco Total Return	162.8	4.7	6.0	Barclays US Aggregate Bond
American Funds Growth Fund of America	143.1	9.3	13.7	S&P 500
American Funds EuroPacific Growth	121.4	-2.6	-3.9	MSCI AWCI ex-US
Fidelity Contrafund	109.8	9.6	13.7	S&P 500
American Funds Income Fund of America	96.7	8.4	13.7	S&P 500
American Funds Capital Inc Bldr	96.5	6.6	13.7	S&P 500
Franklin Income	94.2	4.1	13.7	S&P 500
Vanguard Wellington	89.5	9.8	13.7	S&P 500
American Funds Capital World Growth & Income	86.5	4.0	4.9	MSCI World
American Funds American Balanced	79.6	8.9	13.7	S&P 500

Source: Return of the Stock Pickers. Barron's online, 1 April 2015.

However, closet trackers aside, much of the oft-reported poor active manager performance is a consequence of the incorrect methodology being applied to measuring performance. This is because the empirical tests are usually applied to fund performance rather than to manager performance. Quite simply, the former doesn't take account of managers moving between funds and asset management houses. Of course, this isn't helped by manager performance data being less readily available than fund performance data. That said, where research has been conducted at the manager level, it has been shown that manager departures can make a difference to a fund's performance[24]. It also demonstrates the importance of keeping track of manager changes.

[24]A. Clare, N. Motson, S. Sapuric and N. Todorovic. What Impact Does a Change of Fund Manager Have On Mutual Fund Performance? International Review of Financial Analysis 35, 2014, 167-177.

LUCK AND SKILL

Another issue with performance data, alluded to earlier, is knowing the extent to which performance has been generated by skill rather than luck. Even if a manager has had a good run of performance, can the investor attribute this entirely to skill, given that good and bad luck can have a significant impact on performance in the short term? Of course, it is better to have a lucky fund manager than an unlucky one, but it is much better to have a genuinely talented one than a lucky one. After all, manager skill is the ultimate source of uncorrelated return and can be valuable during periods of modest returns.

A simple test of whether an activity involves skill is to ask if one can lose on purpose. While you cannot purposefully lose at the casino wheel because this is a game of pure luck, you could lose on purpose at chess because this is a game of pure skill. However, asset management, as is the case in many human endeavours, involves both skill and luck. The difficulty comes in discerning the contributions of skill and luck, even if analytical tools are available. In sport, for instance, even if a player's skill remains consistent, their results will be affected by changing luck. An exceptional performance is rarely repeated for any length of time as the good luck that boosted this performance will typically be absent the next time around, or certainly the time after that. Conversely, poor outcomes can reflect a lot of skill and a good process being offset by a lot of bad luck. However, over time, as luck evens out, any skill that exists will shine through. Thus luck tends to "mean revert". That is, an outcome that deviates from the average is typically followed by one that is closer to the average. Quite simply, any activity, such as fund management, whose outcomes are determined by a combination of luck and skill, will be subject to this phenomenon. However, to compound the problem, skill is not permanent. Indeed, it can suddenly or progressively deteriorate. In the case of athletes, skill deteriorates with age. However, in more cerebral fields, such as fund management, hitting a peak can take a little longer. Indeed, one can argue that a manager who has been exposed to several market cycles is probably more in tune with the market than a less experienced manager. That said, there is always the danger of applying past principles to a wholly new set of circumstances against the backdrop of the constant evolution of financial markets. What worked in the past may not work in the future, notwithstanding the fact that some anomalies and trends are a seemingly permanent feature of financial markets.

Crucially, the bigger the role of luck in the outcomes we observe, the larger the sample of observations one needs to distinguish skill from luck. Although subject to debate, many finance academics would argue that around 12 years of monthly performance data for a fund manager with an information ratio of 0.5 would be needed to prove skill with 95 per cent confidence, though some would argue that nearer 300 months (25 years) of continuous data is needed to statistically prove the existence of skill. The problem is that very few managers have anything like a 12, let alone a 25 year track record, especially of running the same fund within the same firm. However, those few that do, have proved to be amongst the world's most successful managers with exceptional long-run performance records, albeit punctuated with periods of short-term underperformance. Moreover, these managers are among a select group of active managers who add value in most up *and* down markets. Indeed, given that most investors prefer stable to erratic performance, with no nasty surprises, skilful active managers are those who should add more value in down than up markets.

These managers aside, the inability to separate skill from luck in the short to medium term and skill tending not to be permanent explains why past active manager performance is not necessarily a good guide to future active performance, and therefore not necessarily a good way of choosing an active fund manager. Chance and change really do make past performance difficult to extrapolate. As noted earlier, this is compounded by the inability of some managers to successfully manage capacity constraints following a good run of performance.

SECTION 6:
SO IS SEEKING OUT A GENUINELY SKILFUL ACTIVE MANAGER REALLY WORTH THE TIME AND EFFORT?

Given that the quantitative assessment of fund (manager) performance to determine skill is riddled with practical problems, many investors question whether seeking out skilful asset managers is really worth the governance budget. However, by applying some intelligent due diligence investors can increase their chances of finding potentially exceptional managers who, like Warren Buffet, more than earn their fees over time.

Indeed, there are certainly those who stand out from the crowd, just as Lionel Messi does when he plays football at the highest level and as Usain Bolt does when he competes against the fastest runners on the planet. So, active management when well executed is by no means a lost cause – far from it. The question is, of course, how do we identify the Messi's and Bolt's of the active fund manager world? Or to phrase it differently, what are the attributes, or qualities, that characterise a skilful active manager, one who generates skill alpha rather than lucky alpha, and what exactly gives them that edge? After all, the main problem for active managers is that they are each having to fiercely compete against a set of highly skilled peers. In so doing, they all have to run increasingly faster just to stand still.

However, it certainly isn't just one particular quality that makes a manager skilful or gives a genuinely skilful manager an edge. There are a multitude of factors at play[25]. This should start with an investigation of the manager's investment philosophy and process (IP&P), before moving on to the manager's investment style, the ability of the manager to recognise their behavioural biases and to be in tune with the psychology of the market and the extent of their risk management. Finally, one should not ignore the fund manager's gender. We'll touch on each of these in turn.

INVESTMENT PHILOSOPHY AND PROCESS (IP&P)

Any interrogation of an active manager's capability should begin with ensuring the manager has a clearly articulated investment philosophy. Set out in a statement that captures a manager's investment insights and value adding processes, this should comprise the manager's genuine beliefs about how asset prices become mispriced and the manager's capability and competitive advantage in repeatedly exploiting these pricing anomalies with examples that have borne out these beliefs in practice. This should, in turn, underpin a logical and repeatable investment process, consistently applied through thick and thin, with examples of where this has worked and not worked in practice. Indeed, as even the best fund managers sometimes get it wrong, humility is a worthy characteristic in a fund manager. The key takeaway, of course, is what was learnt from the experience and how this learning has since been applied.

Integral to the effective functioning of an active manager's process is the manager's ability to provide a logical and coherent rationale for why their IP&P works and to ultimately explain their performance with explicit reference to it. As mentioned earlier, the manager should be able to demonstrate whether they have added value in both up and down markets, ideally with a greater emphasis on the latter. Indeed, in gauging whether or not the manager has an edge, the following key aspects to the manager's IP&P should be evident:

- A talented and truly active manager should run a portfolio based on the *three* Cs – high conviction, contrarian thinking and high concentration. As contrarians, or independent thinkers, truly active managers continually challenge the market consensus reflected in market prices. They seek to identify opportunities where their perceived fair value of a security materially differs from its market price. However, only if their analysis presents a view that is clearly differentiated from the consensus, one in which they believe with sufficiently high conviction, is this implemented

[25]Also see Roger Urwin, Identifying Tomorrow's High Performer Today: An Analysis of the Factors which can Help Forecast the Relative Performance of Investment Managers. 2nd AFIR Colloquium 1991, 4: 293 – 315.

into their portfolios. With high conviction comes portfolio concentration. If a high conviction idea warrants inclusion in a portfolio, then it must be implemented in a meaningful manner. Therefore, most truly active equity portfolios typically contain no more than 60 to 80 stocks. Many contain far less. By definition, and as noted earlier, these are managers who, while aware of the benchmark against which their performance is judged, are not constrained by it. They *invest to win*, as evidenced by a high tracking error and typically a high active share[26], rather than not to lose, as evidenced by a particularly low tracking error. Of course, as noted earlier, the higher the tracking error the greater the potential for both significant outperformance and underperformance.

- Talented managers should be free of top down constraints if they are to be given the freedom to exercise creative thinking and individual flair, albeit within a formalised risk management framework.
- The investment approach adopted by a skilful manager should be underpinned by a culture that is dynamic and interactive and by processes that are team-based, performance driven and risk aware. To explain:
  - Talented fund managers rarely operate in splendid isolation. Most typically operate within or have the support of a well incentivised team, with each team member having a genuine stake not only in their own long-term success but also in that of the team. This alignment of interests should, of course, extend to those of the client and is typically evidenced by the manager investing their own funds in a fund, or funds, managed by the asset manager. The strength and depth of the team also matters. The idea behind this collegiate approach is clear: if one of the fund managers moves on, the team's process remains in place for the other managers to carry on from where their departed colleague left off. Just as importantly, these teams should be encouraged not to act as introspective silos but to interact with the asset manager's other research teams so that ideas may be shared and portfolio positions challenged.
  - Indeed, in a genuinely collaborative environment it is absolutely imperative that suitable mechanisms exist that allow team members and other teams to rigorously debate and genuinely challenge a manager's portfolio positions and thinking. Equally important is the manager's willingness to listen to and act upon these challenges, as is disciplined oversight of the process. By working together across asset classes and geographies, in an increasingly interconnected and interdependent world, this pooling and sharing of research and intellectual capital globally generates richer perspectives on global, regional and local investment landscapes, enriches teams' individual investment processes and results in better informed investment decisions.
  - Talented managers should be able to clearly articulate how ideas find their way into their portfolio. These ideas, which should combine macro and micro insights, should principally be generated internally rather than wholly being bought in from sell side analysts. Just as a macro level understanding of economies, markets and themes helps inform investment decisions at the micro level, when conducting fundamental research, the information gathered from companies, government agencies and industry experts helps shape macro views. Suffice to say, these micro insights should have a strong fundamental underpinning based on company visits, ideally conducted on a one-to-one basis with both management and those on the shop floor; an in-depth knowledge of the company and the industry in which it operates – especially if the industry is highly specialised; an understanding of what constitutes a sustainable competitive advantage; and of the stock's fair value.
- Understanding valuation is particularly important. After all, as we noted earlier, there is a very strong inverse relationship between equity valuation and subsequent long-run returns[27]. Moreover, a talented manager is one who doesn't confuse a quality company with a quality investment.
- A good active manager should build Environmental, Social and Governance (ESG) considerations into their investment process. Far from being an altruistic exercise, promoting best practice in corporate governance and sustainable and responsible business and management practices can result in better quality and more sustainable long-run investment returns. Indeed, ESG factors are becoming increasingly material to company valuations and are arguably not fully factored into

[26]Other factors that impact active share notwithstanding, this largely depends on whether the manager's stock picks are spread across a few or a large number of sectors. As a rule of thumb, the fewer the sectors, the higher the active share.
[27]Barclays Capital Equity Gilt Study. pp. 5 – 10 (2009).

market prices. This is as a consequence of the externalities arising from unsustainable activities not being fully internalised and financial markets allocating capital to companies on the basis of incomplete information[28].

- The portfolios of talented active managers should usually exhibit low turnover or at least a considered approach to portfolio turnover. Equally the manager should rigorously apply a sell discipline to stocks that have either breached a pre-determined price trigger or where the original thesis for holding the stock no longer holds. There should also be no evidence of the manager succumbing to loss aversion. That is, selling winning stocks too soon and/or running loss making stocks for too long. Additionally, there should be evidence of positions sold being invested in new portfolio ideas rather than the proceeds being spread between existing positions.

Finally, in conveying their IP&P, a truly talented manager should come across as inquisitive, curious, hard working, ultra competitive and, perhaps most importantly, as an independent thinker – one who demonstrates an ability to balance individual flair with collaboration while recognising the perils of consensus thinking, or groupthink.

INVESTMENT STYLE

Although the choice of stock holdings and sector weights impact portfolio returns, one potentially big driver of active manager outperformance, however, remains investment style. While style investing can be traced back to the 1930s, originating from the pioneering work of Benjamin Graham and David Dodd[29] and since developed by a number of academic luminaries[30], it has only really gained prominence since the mid-1990s, notably in the US, as a means of developing and evaluating investment strategies and stock selection processes.

Active fund managers adopt a chosen style given evidence that particular groups of stocks sharing one of a number of common characteristics, or *style factors*, exhibit a meaningful tendency to move together and so experience long periods of out and under performance of the broader market. Of these styles, the most established and well documented and to which almost all fund managers are deliberately (the good) or unwittingly (the bad) exposed to some extent, are size, growth, value and momentum. Indeed, a whole new subset of the asset management industry has been predicated on the idea of *smart beta*, an active/passive half way house that attempts to almost mechanistically capitalise on style factors, in addition to market anomalies, such as low volatility stocks outperforming high volatility stocks, and fundamental indexing, to which we referred earlier when looking at indexing.

Each investment style demands a different mind and skill set. For example, in the same way that Real Madrid's finest, Sergio Ramos and Cristiano Ronaldo, could never perform at their best by swapping positions on the hallowed turf of the Bernabéu, most value and growth managers (please see the text box below) would find it difficult to successfully emulate their counterpart's defensive and attacking investment styles, respectively. Therefore, it is vitally important that active managers adhere to their chosen investment style and don't succumb to *style drift*. Style drift can be monitored by using the output from multi-factor risk models employed by most fund managers and investment consultants that drill down into the DNA of a portfolio by identifying the extent of the portfolio's investment style bias[31].

That said, many fund managers argue that while growth and value investing have a different focus, they are not mutually exclusive, in that the majority of stocks exhibit, to varying degrees, both growth and value characteristics. Moreover, according to Warren Buffet, growth and value investing are joined at the hip in that investment styles and processes often overlap. For instance, not too many value managers would ignore a cheap stock simply because it looked to have strong growth prospects. In short, no two fund managers will approach any one investment style in exactly the same manner.

[28]Increasingly within continental Europe, active managers are expected to voice their discontent when a company misbehaves as part of being a good societal stakeholder.
[29]Benjamin Graham and David Dodd, Security Analysis, New York, McGraw-Hill, 1934.
[30]See Rolf W. Banz. The Relationship Between Return and Market Value of Common Stocks. Journal of Financial Economics 9 (1981): 3 – 18. DeBondt, Werner and Richard H. Thaler. Does the Stock Market Overreact? Journal of Finance, 40(3) (1985): 793 – 805. Jagadeesh, Narasimhan and Sheridan Titman. Returns to Buying Winners and Selling Loser: Implications for Stock Market Efficiency. Journal of Finance, 48 (1993): 65 - 91.
[31]These multi-factor risk models do this by using traditional valuation measures, such as the portfolio's average price-to-earnings ratio, price-to-book ratio, dividend yield, earnings growth prospects and the size of the stocks held, to quantify the extent to which the characteristics of the stocks held within the portfolio differ from the portfolio benchmark, so pointing to a particular investment style.

Despite this, style matters. Indeed, Nobel Economist Bill Sharpe found that investment returns are more dependent on style factors than on the stock picking abilities of individual managers. In other words, a growth oriented stock picker would find it difficult to outperform in a value driven market.

However, there's one big issue with style and that is no single style outperforms over all time periods and in all market conditions: each periodically outperforms and underperforms other styles and the market. Because of this difficulty in identifying *ex ante* the style that is likely to outperform in the future, some equity fund managers adopt a *style neutral* approach. This can be done by blending sub-funds, each managed according to a distinctive investment style independently of the other, and combining these to form a single fund. When well implemented, this approach should offer returns that are more consistent and less volatile than the returns of the sub-funds in isolation, given the diversification of manager and investment style risk. This assumes, of course, that style drift is being closely monitored. More commonly, a single fund is used with the manager either rotating between styles or adopting a *style agnostic*, or stock picking, approach, given that identifying style inflection points in an attempt to style rotate is beset with practical problems. While style rotation can, at least in theory, be successfully undertaken by observing a multitude of economic and market indicators that collectively signal potential inflection points in the equity market[32], in practice style rotation has proved to be an elusive skill.

INVESTMENT STYLE

Growth versus value investing

Whilst investment styles are many and varied, the most popular are growth and value investing. The growth versus value debate has run as long, if not longer, than the active versus passive debate.

Growth investing originated in the 1960s, emerging as a distinctive investment style during the US *Nifty Fifty* craze of the early 1970s. Growth investing is a relatively aggressive investment style and is typified by a so-called GARP approach. GARP, or buying Growth At a Reasonable Price, centres on those companies that are perceived to offer above average earnings growth potential that has yet to be fully factored into the company's share price. It is also about avoiding those companies most susceptible to issuing profits warnings, as any stock trading on a high valuation that fails to meet consensus earnings expectations can be marked down savagely by the market. Genuine GARP stocks are those companies that are able to differentiate their product or service in some way from their industry peers so as to command a competitive advantage and pricing power and, therefore, an ability to generate high quality earnings and above average earnings growth for a considerable period of time.

Value investing, meanwhile, with its origins in the 1930s, seeks to identify those companies that typically operate in mature markets with little prospect of substantial market expansion or rapid future growth in earnings, but which still produce a stable and relatively high dividend stream – utilities for example. These value stocks typically trade on low valuations and a high dividend yield relative to the rest of the market. Fund managers that specialise in investing in value stocks do so because they believe that in the long run these stocks will outperform other stocks, particularly growth stocks.

So which of the two styles has been the most successful? It is well documented that within developed markets globally value outperforms growth over the very long term by some considerable margin, though this period typically extends far beyond the investment horizon of most institutional, let alone individual, investors. Over shorter horizons, however, the evidence suggests that no one style outperforms in all market conditions; rather each periodically outperforms and underperforms the other and the market.

[33]See Levis M. and N. Tessaromatic. Style rotation Strategies: Issues of Implementation. Journal of Portfolio Management, 2004 Vol. 30, No. 4r, and Quantitative or Momentum Based Multi-Style Rotation, A. Clare, S. Sapuric and N. Todorovic, *Journal of Asset Management* (2010).

Small cap investing

The small cap, or size effect, was first identified by Rolf Banz in 1981[33]. Banz showed that the smallest companies quoted on the NYSE had generated the highest long-run returns. As with value investing, small-caps have outperformed large-caps globally over the very long run by a significant margin but, equally, shorter run outperformance has been less predictable.

Momentum investing

Momentum investing focuses on those stocks that have recently performed well and whose price continues to gather momentum in a self perpetuating manner. Momentum investing, sometimes termed fashion-led investing, appeals to investors' natural tendency to extrapolate trends, as little, if any, attention is paid to the average market valuation of such shares. However, fashions, by definition, soon go out of style – and momentum can turn sometimes dramatically so – often resulting in significant drawdowns. Indeed, investing in last year's top performing stock does not necessarily guarantee a repeat performance the following year. That said, short-term momentum effects are often in evidence for periods of up to about 12 months with the academic literature suggesting momentum investing generates higher than average returns over time. Moreover, the momentum effect is a global phenomenon.

Quite simply, momentum investing is more about gauging short term market psychology and going with the market consensus, whilst employing a shrewd sense of market timing, rather than analysing the more salient characteristics of individual stocks.

Thematic investing

Thematic investing involves identifying an economic or socio-economic trend that will eventually have an impact upon the valuations of underlying securities. For example, if an active fund manager was strongly of the belief that advances in technology would mean that people would have increasing amounts of leisure time available in the future, then the manager might build a portfolio consisting of firms with exposure to the leisure industry, comprising travel companies and companies with an interest in casinos or leisure parks for example. This portfolio might be constructed on a global basis, that is, made up of companies from many different regions of the world, rather than comprising stocks from one particular country.

In practice, many active fund managers adopt investment themes, favouring particular industries and reflect this in their portfolios. However, these themes will change over time as global financial markets evolve. In contrast, thematic investing tends to involve sticking with one or a number of particular themes.

Contrarian investing

Some active fund managers will deliberately position their portfolio so that it is at odds with the consensus view. In particular, managers that apply this approach might be willing to buy the stocks of companies where the stock price has fallen considerably in the belief that it will recover in the future as the consensus eventually comes to the same view about the stock.

All active managers buy or overweight stocks relative to their benchmark that they expect to rise in price in the future. However, these investments are still usually made with reference to a benchmark, whereas a contrarian investment manager will simply seek

[33]Rolf W. Banz (1981) *ibid*.

out stocks that have fallen in value significantly and hold these stocks regardless of the sector in which they trade and without reference to a benchmark index. Most people tend to associate contrarian investing with value investing but contrarian investors can also be growth investors. For instance, a growth investor may also sell a stock after a strong run in performance in the belief that the consensus view has driven the stock's price beyond its fair value. Indeed, just as markets undershoot by overreacting to bad news, to the benefit of value oriented contrarian investors who position themselves against the market consensus, they also overshoot their intrinsic value to the benefit of momentum investors.

Stock picking

Arguably the oldest style of all is that of the pure stock picker. Stock pickers are generally not concerned with larger themes, dedicated styles (), sectors or even a stock's market cap. They simply pick the stocks that they believe will perform well over time. That's not to say stock pickers are style agnostic as their portfolios will show particular style traits consistent with the investment outcomes they target.

This bottom-up, high conviction, concentrated style of investing results in far fewer stocks being held than most equity fund managers, or their investors, would be comfortable holding and typically exhibits both a high active share and tracking error if the manager is sector agnostic.

Valuation spreads

There are times when having the right active manager can really make a difference. For example, when stock valuation spreads – the difference in the valuation of the cheapest 20 per cent of stocks in the market compared to the average valuation of stocks – deviate from their historical average. This was dramatically illustrated at the height of the Great Financial Crisis in 2008, when financial stocks were hit particularly hard, resulting in a marked dispersion of fund manager returns. Unsurprisingly, closet indexers and index trackers felt the full force of these declines. However, as the valuations of the very cheapest stocks returned to historical norms in the first half of 2009, so active management well and truly came into its own, with 70 per cent of active managers in the US outperforming the S&P 500, gross of fees. Crucially though this outperformance was not evenly distributed. While 96 per cent of US large-cap value managers outperformed, only 16 per cent of large-cap growth managers did so, with the most marked outperformance being amongst US small-cap managers who averaged outperformance of 33 per cent[34] – such is the importance of investment style in determining returns, especially under such conditions.

Recognising behavioural biases

No examination of what makes a good active fund manager would be complete without considering the extent to which a manager recognises and corrects their own behaviour for the disparate array of behavioural biases to which investors typically succumb in a systematic fashion. Although most fund managers admit to recognising these biases, because failing to do so would result in sub-

[34]Empirical Research Partners. 8 October, 2009. While it is acknowledged that the S&P 500 is not an appropriate benchmark by which to judge small-cap returns, the point has been made to illustrate the importance of investment style.

optimal investment decision-making, only the very best actually do so in a formalised way. Some of the more commonly cited biases, a number of which were uncovered when looking at the key aspects to a manager's IP&P, are as follows:

- Representativeness: is the manager simply a trend follower, evidenced by subconsciously creating and extrapolating patterns and trends from a series of random events, without investigating the reasons for the apparent trend?
- Confirmation bias (cognitive dissonance): does the manager only seek out evidence that confirms a view they hold, dismissing anything that contradicts it?
- The endowment effect: does the manager pay more attention to and know more about the portfolio's overweight positions than the portfolio's underweight positions and, indeed, those stocks that form part of their universe but are not held[35]. Skilful managers know as much about the latter as the former and are able to articulate scenarios that would challenge these positions.
- Gamblers fallacy: does the manager believe the market is about to change direction simply because longer-term data suggests a correction is due, despite the longer-term not correlating with the shorter term?
- Overconfidence: is there evidence of the manager overestimating their investment knowledge, skill and ability, often resulting in excessive portfolio turnover, to the detriment of investment returns? Does the manager suffer from information overload, gathering reams of information without context, leading to false empowerment, misplaced confidence and compromising the accuracy of their decision making?
- Adjustment conservatism: is the manager overconfident in their forecasting ability and so failing to adjust forecasts for new salient news and being subject to a series of company earnings surprises?
- Anchoring: has too much emphasis been placed on the price paid for a stock when considering the stock's future prospects and the price at which to sell?
- Ambiguity aversion: is there an unwarranted home bias to the manager's portfolios or an emotional attachment to stocks that should otherwise have been sold?
- Loss aversion: has the manager sold their winning stocks too soon and held on to their losing stocks for too long? Have they started doubling up on their loss making positions?

Being prepared to ask questions in this area is crucial if investors are to avoid poor active managers.

Risk management

Risk management and appropriate risk allocations should be central to a manager's investment process. Good active managers are those who not only manage the known and more readily quantifiable risks but also those risks that are not so easily forecasted and calibrated. Indeed, a good manager in seeking to limit the portfolio's downside risk, will constantly evaluate the macroeconomic, company specific, geopolitical, regulatory and environmental, social and corporate governance risks to their portfolio, as well as the extent to which the portfolio is exposed to any one risk.

One of the key elements of risk management is having a disciplined approach to selling securities. This we considered when looking at the manager's IP&P and ability to recognise their behavioural biases. After all, it is much more difficult psychologically to sell a stock than buy one[36]. A good active fund manager is not only one that buys well, but one that sells well too.

Another key aspect of risk management upon which we have touched on several occasions is successfully managing potential capacity constraints. The performance of even the best performing, quite possibly the most skilled, fund managers can be compromised by subsequent inflows of cash from investors chasing performance, as this can force the manager, overwhelmed

[35]Research suggests that confirmation bias compounds the endowment effect in that those managers who succumb to the latter bias also typically seek out confirming evidence that validates, rather than contradictory evidence that challenges, their overweight and underweight positions.
[36]This is captured in the behavioural bias known as loss aversion. Loss aversion is typified by a fund manager, anchored to the price they paid for a loss making stock, running their losses, or even buying more of the stock, in the hope that the price will rise above this somewhat irrelevant anchor.

by the sheer amount of cash, to depart from the strategy which generated that superior performance. A manager's capacity constraints will be determined by both the characteristics of the market in which they operate and the investment style they adopt. For instance, to operate effectively, a successful emerging markets equity or a developed markets small-cap equity fund manager may need to limit the size of assets under management to a fraction of the size of a fund managed by a large-cap developed market fund manager. In addition, given the relatively illiquid nature of emerging market and small-cap stocks and the much smaller free-float of such stocks, the manager should also place a limit on the amount of each stock's free float they own. A two or three per cent limit is not unusual. Good active managers are those who can tell you the optimal size of their portfolio, and the level at which they intend to close their fund to new business. Indeed, investors should always ask about the capacity of a fund before investing.

Gender

Who make the best fund managers – men or women? Well, although the evidence is sketchy, according to the French investment funds association AFG in 2009, female fund managers produce more consistent and less volatile performance than their male counterparts. Although according to the French research, female fund managers are rarely among the top performers, they are less likely to be among the bottom performers[37].

The principal problem with this research, however, is the small sample size. After all, according to the research only three per cent of UK and 12 per cent of US fund managers are female. Despite this however, a greater percentage of female fund managers are highly rated by the fund management rating agencies – and for good reason. The behavioural finance literature seems to confirm that women do not succumb to as many damaging behavioural biases as men. Of course, it is always dangerous to generalise and much depends on the personality of the manager but it would seem that women are arguably more analytical in their decision making. They also appear not to blindly extrapolate perceived trends that more often than not prove to be just a series of random events that look like a trend.

To shed more light on this issue, two US researchers, Brad Barber and Terrance Odean, looked at the trading behaviour of a large number of US investors[38]. They analysed the stocks that 66,000 retail investors bought and sold between 1991 and 1996. The average investor had a portfolio turnover of 75 per cent but the most aggressive had a turnover of 250 per cent. Between 1991 and 1996 the market returned 17.9 per cent and the average active investor 11.4 per cent. They found that the single men in their survey had the highest portfolio turnover, followed closely by married men, while both single and married women had similar low portfolio turnover statistics. Was this because single men knew the most, and were better money managers? Interestingly, they found that the 20 per cent of investors that turned over their portfolios the most – largely single men – after transactions costs, earned an average return of seven per cent over the sample period studied; while the 20 per cent of investors that turned over their portfolios the least – largely single and married women – after transactions costs, earned an average return of 18.5 per cent over the same period.

Separately and more recently, hedge fund research conducted in June 2013 by consultants Rothstein Kass found that women had comfortably outperformed men over the six-and-a-half year period from the start of 2006, with the outperformance appearing strongest during the Great Financial Crisis. That would seem to concur with the fact that given the lower turnover within female fund manager portfolios, these female hedge fund managers would have benefitted from the rebound in risky asset values in 2009. However, once again the data set was small given that only 125 female run hedge funds report to industry databases, with the added complication of self-selection bias[39].

[37]See FTfm, 23 March 2009, p.11 and Mail Online, 28 March 2009.
[38]Barber B.M. and T. Odean. Boys Will Be Boys: Gender, Overconfidence, and Common Stock Investment. Quarterly Journal of Economics (2000).
[39]Is gender a factor in fund performance? Financial Times, 9 February, 2015. Self-selection bias describes when a fund manager has the option of reporting their performance to a performance database.

SECTION 7: CONCLUSION

By way of conclusion, we'll finish on the note on which we started and that is the appropriate active-passive mix for any investor depends on their investment beliefs – principally around how markets function, how securities are priced and the value of diversification – but perhaps more prevalently on their investment goals, governance budget and risk appetite.

What should be emphasised is that taking the line of least resistance and opting for a low cost passive solution every time is rarely the best way forward for all of the reasons considered earlier in the paper. As we have previously articulated, despite the practical problems associated with determining skill, seeking out skilful asset managers really can be worth the governance budget. Given the prospect of more modest long-run returns going forward, in applying the requisite due diligence, investors really can increase their chances of finding potentially exceptional managers who, like Warren Buffet, more than earn their fees over time and deliver the ultimate uncorrelated source of return. Against this backdrop, net value added – delivering sustained outperformance after fees and meeting desired investment outcomes, rather than a focus on cost *per se*, is how the active/passive debate should be positioned.

BIOGRAPHY

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Chris has over 30 years experience of the finance and investment industry and regularly features in the pensions and investment press.

Chris is responsible for raising Columbia Threadneedle's presence and profile in the global institutional market mainly through thought leadership and other generic educational initiatives. Prior to this, Chris was Client Director of Cass Business School Executive Education and Head of Investment Education at Aviva Investors.

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