Capital Markets Brief

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The Case for Active Management: Part I

Recent statistics clearly show that most actively managed investment strategies have underperformed their respective benchmarks over the last decade. Most financial economists and academics have stated for years that, before costs (fees, transactions and taxes), the return on the average actively managed dollar equals the return on the average passively managed dollar. This statement assumes the passive investor's portfolio holds every security from the market and in the same proportion as the market. Conversely, the active investor's portfolio differs from that of the passive investor and to varying degrees. The term "active" comes from the fact that managers act on perceptions of security mispricing.

There are several factors that affect returns for actively managed investments. The most prominent factor is market risk (systematic) and the least prominent is residual risk (active risk). There are other non-market related factors or constraints, such as inflation and taxes, that enable actively managed strategies to beat the benchmarks. In this market brief, we will focus on the investment component of the value added from active management. The investment "valued-added" (residual) component of return is called alpha. Alpha is the return differential between the active approach and the benchmark that is achieved with similar or less risk than the benchmark.

Longer term, the odds are only 50-50 that the average money manager will beat the index before all costs. This calculation does not, however, argue that one should automatically adopt an "all-index" approach to investing. Arguments in favor of active management include: 1) policy mix benchmarks (weighted average market indexes based on client's long-term asset allocation policy mix) are inefficient, meaning that these portfolios are not "optimal" in terms of potential risk-adjusted return (they fall below the efficient frontier of all possible portfolio combinations of optimal risk and return); 2) well-selected active managers give investors the ability to achieve gains not afforded by an all-passive strategy while assuming less risk; 3) the theory behind indexing assumes that markets are efficient and investors are rational (we know both are untrue); and 4) actively managed investment strategies perform well during periods of lower market risk, lower expected market returns and less sector concentration.

Policy mix benchmarks are the benchmark of choice for most investors' total portfolios. These benchmarks do not measure risk under its traditional definition of market volatility. Because the real risk for individuals is the risk of not meeting financial goals over a predetermined time horizon, risk should be measured, not by the volatility of portfolio returns, but rather as a function of the characteristics of the portfolio's liabilities as well as its assets (or the cash flow relationship of the two over time). The best way to meet these liabilities, or mitigate this "real" risk, is to employ active strategies that further reduce asset risk (correlation between active manager's residual risk as well as correlation between asset risk).

Selecting superior managers is difficult, but not impossible. The risks for active managers are known in advance. The burden of proof rests with the active manager. Active managers are able to focus on skill (stock selection) because they can control market risk. The problem with the money management industry is that many do not. Many underperform due to peer

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pressure or regret aversion. Those active managers that understand, isolate and control market risk, while focusing on stock selection, usually end up generating alpha. These managers also tend to avoid market timing and momentum investing, and to focus purely on their known skill set.

Advocates of indexing or passive management usually subscribe to the theory behind the Capital Asset Pricing Model (CAPM). The CAPM relies on two notions (the market portfolio and beta) that link any stock or portfolio to the market. The theory assumes that the expected residual return on stocks and any portfolio is zero. In other words, a portfolio that differs from the market is playing a zero-sum game. In this scenario, the investor has additional risk and additional expected return. CAPM is a theory, and not all of its assumptions are true. Not all investors are rational. Not every investor has access to the same information, and not every one has the same set of expectations. Active strategies can take advantage of gains by holding those areas of the market not in the indexes. Active strategies have also had a superior track record in less efficient, less liquid areas of the stock market (e.g., small cap stocks).

Large capitalization stock index strategies have outperformed nearly 70%-75% of all active strategies over the last 10 years and, to a lesser degree, over the last 20 years. The primary driver behind this performance gap has been concentrated sector risk. Most recently (in the late 1990s), technology stocks accounted for as much as 40% of the total stock market on a capitalization-weighted basis. Most prudent active managers (those with fiduciary responsibility) did not hold 40% of their portfolios in technology stocks, opting instead to diversify their sector risk. Many of these stocks were trading at excessive valuation levels with unrealistic earnings expectations. The same phenomena occurred during the early and middle 1990s when financial services and consumer non-cyclical stocks accounted for over 25% of the stock market's total value. In the early 1980s, the energy and basic materials sectors accounted for over 40%, dominating the market landscape. Currently, no one sector dominates the market indexes as was the case during much of the 1980s and 1990s. Overall market return expectations are also lower than they have been in decades. Given these two factors, active portfolio strategies should now have the opportunity to add value over the market index while at the same time maintaining a reasonable level of asset risk.

In the next market brief (The Case for Active Management: Part II), we will discuss the value-added of actively managed investment strategies on both the fund and manager level after accounting for non-market risks, such as fees, inflation and taxes.