

The Case for Active Management Part 1 - Opportunity

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ACTIVE
VS.
PASSIVE

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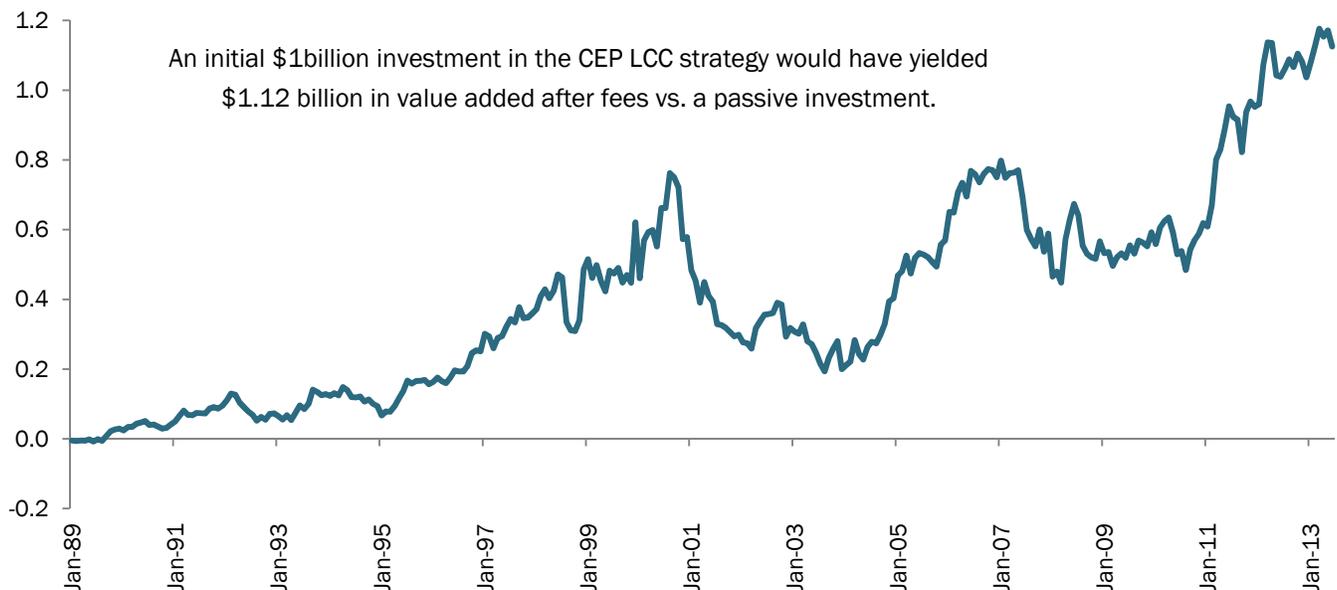
*"When written in Chinese, the word 'crisis' is composed of two characters—
One represents danger and the other represents opportunity."*

- John F. Kennedy

Introduction

The potential benefits of active management are plainly appealing to most investors. When it's successful, the rewards can be considerable. For example, as highlighted below, since its 1989 inception, Chicago Equity Partners' flagship large cap core strategy added significant value, net of fees, compared with a passive investment S&P 500 Index approach. Nevertheless, not all active management strategies have seen such success. Many investors are frustrated by the gap between the promise of alpha (excess return) and the reality of their after-fee performance. Such investors believe the odds are stacked against them, prompting the decision to simply purchase an index fund and call it a day.

CEP Large Cap Core Cumulative Excess Return (Net of Fees)* vs. S&P 500 (January 1989 - June 2013)



*Source: Chicago Equity Partners. Past performance is not indicative of future results. Please see disclosures at the end of this paper for important information.

At Chicago Equity Partners, we believe there is clear evidence that market inefficiencies lead to mispriced securities that can be systematically exploited. These market inefficiencies represent the very reason for our existence. An intelligent application of a disciplined and systematic approach can effectively capture the alpha potential inherent in inefficient markets. We don't blindly follow a "black box" or act only on historic market data or academic research. Implementing a disciplined and systematic approach is critical to avoiding a process that is simply a hostage to emotion or the theme of the day.

Saying we apply our systematic approach intelligently means our investment program is based on a dedicated research process honed through decades of practical experience. Our approach allows us to be disciplined and innovative at the same time—to apply what we believe is relevant from the past to the investment climate of today and tomorrow. This process represents an anchor preventing us from drifting aimlessly. At the same time, we take steps to ensure it doesn't limit our flexibility.

The quote highlighted at the beginning of this discussion, this paper – Part I of a two-paper series on active management – focuses on the presence of "opportunity" in the form of manager alpha and the proof of its existence among institutional money managers. In Part II of the series, we will focus on the "danger" of implementation and the gap between promise and reality.

Arguments for Passive Investing: The Story of the Aggregate

Many academic papers have concluded that the after-fee performance of actively-managed equity funds is below that of passively managed index funds.¹ The majority of such research has been focused on retail mutual funds. The simplest arguments are often the most compelling and hardest to refute. Nobel Prize-winning financial economist William Sharpe posited such an argument in his 1991 Financial Analysts Journal article "The Arithmetic of Active Management:"

If "active" and "passive" management styles are defined in sensible ways, it must be the case that (1) before costs, the return on the average actively managed dollar will equal the return on the average passively managed dollar and (2) after costs, the return on the average actively managed dollar will be less than the return on the average passively managed dollar.

To paraphrase, the returns from active management, in the aggregate, are just the market's return after fees. Therefore, the difference, on average, between active and passive investing is the level of fees paid. In the aggregate, this is undoubtedly true, as illustrated by Sharpe.

The market is quite segmented, though, which is an important qualifier. Individual investors, mutual funds, pension funds and corporations themselves comprise the various segments. Certain segments, such as mutual funds, do have negative excess performance on average, and there is substantial academic research to explain this. This underperformance is partially a function of mutual funds' fee structures. Retail mutual

funds tend to have high embedded management fees that overwhelm any positive excess returns before fees. According to Lipper, the average mutual fund expense ratio was 1.11% as of December 31, 2012. That component of Sharpe's argument certainly holds true and is echoed in later research we will review.

Similarly, economists have examined the choices individual investors make with regard to security preferences and market timing. This includes research into disposition effects "investors sell winners and hold losers"² and attention-driven investing "investors have limited attention, which causes them to chase performance".³ In general, this research concluded investor choices lead to reduced investment values, before fees. Yet, if one segment of the market is actually detracting value consistently with sub-optimal decisions, the same zero-sum math used by Sharpe would lead us to conclude another segment should be consistently adding value. In other words, there should be segments of "smart money." Might we be able to find evidence of that?

Corporations have been among the largest purchasers of stock over the last decade. Companies looking to return cash to shareholders have repurchased billions of dollars of stock. On average, this component of return has been almost as large as dividends in terms of stated yield. Is this smart money? Years ago, various studies showed some evidence of corporate skill in the timing of stock purchases – that is, buying back undervalued stock and issuing stock when it was overvalued.⁴ But, as stock buybacks increased dramatically in the last 20 years, their impact became a greater portion of return yield. The evidence of skill seems to have abated.⁵ Because buybacks are now executed programmatically, it's hard to describe them as "smart money." Companies consistently repurchase their stock regardless of market movements or the underlying stock valuations.

Moreover, passive investing continues to grow steadily, with passive strategies now comprising approximately 25% to 30% of the total equity market value. As the popularity of passive investing increases, the market, by definition, becomes less efficient, thus creating opportunity. It also likely has a hand in increasing volatility, too, as stocks increasingly are priced at the margin. Passive investing simply locks investors into stocks at the exact fixed proportion of their market weightings, regardless of prices. At the extreme of 100% passive, market prices would remain forever fixed (with the exception of de-listings), even as underlying fundamentals changed. This scenario represents the opposite of an efficient market! In this framework, managements would have to take their companies private in order to extract true economic value. If passive investing levels increase substantially, private equity approaches may become more typical.

In summary, the retail fund segment doesn't add value, partially due to its high fee structure and the buying and selling behavior of individual investors. In general, individual investors likely will lose money before fees. Corporate stock demand and passive strategies are indiscriminate and fixed (or semi-fixed). Therefore, we believe the majority of the money isn't "smart money."

Arguments for Active Investing: The Story of the Micro

Classic studies, such as “Performance Persistence,”⁶ “Do Winners Repeat?”⁷ and “Do Winners Repeat with Style?”⁸ demonstrate there has been some persistence in positive, benchmark-relative performance among active retail managers, on the positive side and particularly on the negative side.

More recent studies⁹ show that even in the mutual fund industry, there is some evidence of consistent value added. One current paper, “The Mutual Fund Industry Worldwide: Explicit and Closet Indexing, Fees and Performance,”¹⁰ which builds on the earlier “active-share” framework of Cremers, suggests the problem with most managers with low active share is the fee structure is too high for their lower-tracking-error strategies. In other words, with a lower fee structure, even lower-risk managers could potentially add value.

Therefore, even in the higher-fee retail universe, this latest research finds evidence of consistent value-added after fees for managers with an active share greater than 60%. This research suggests managers can add value over a passive approach, and successful manager selection is possible.

Empirical Evidence - The Institutional Data Set

Most academic research on active management has been based on the retail mutual fund universe. Therefore, we performed our own analysis using institutional data, and we discovered evidence of value added in the aggregate on a gross of fees basis. This analysis presumed no manager selection skill and simply looked at median performance. What we found offers some insights into the difficulties the typical plan sponsor experiences.

Our methodology and approach

We performed our analysis on institutional large cap core, growth and value universes. With the goal of obtaining a data set of institutional large-cap, long-only products for our analysis, we culled the eVestment database of retail-oriented products, such as wraps, SMAs, etc. We also removed strategies, such as 130/30, buy write, covered call, absolute return, specific sector funds, etc.

The eVestment database corrects for the usual survivorship bias that is endemic in many databases that maintain defunct products within their data set. Still, there is the possibility that the initial population of any universe may be impacted by a pre-selection bias, stemming from backfilled returns of successful strategies. While this is a concern in-sample, it poses fewer problems out of sample. We started our analysis a few years after the inception of the database to minimize any potential problems in this regard.

We also employed shorter windows of observation, of 3 years, to correct for any embedded survivorship with long look back windows. Shorter windows results in the least potential for embedded survivorship bias from

selection methodology and maximizes the total number of observations. The 10 year period has a greater potential embedded survivorship bias with only 289 observations versus 510 in 3 year periods, as the 10 year window samples from only those managers that have survived the full 10 year period.

Our Results

LARGE CAP CORE Broad Universe	3 Year Non-Overlapping Periods (2004-2012)				10 Year (2003-2012)
	2004-2006	2007-2009	2010-2012	Average	2003-2012
# of Observations	532	554	444	510	289
Median Excess Return	0.48%	1.09%	-0.415	0.39%	0.40%
Median St Deviation	7.34%	19.81%	15.64%	14.26%	14.84%
Benchmark St Deviation	7.15%	20.33%	15.62%	14.37%	15.06%
Median Tracking Error	2.60%	4.17%	2.66%	3.14%	3.21%

Benchmark: Russell 1000 Index. Returns presented are gross of fees.

Based on our research, in the large cap core universe, which investors generally consider to be the most "efficient," the median manager provided excess returns over most time periods reviewed. Over the full 10-year period, the median excess return was 0.40%, showing solid median value added before fees. The three-year sub-periods, with maximum observations, didn't cover exactly the same time period (excludes 2003) but showed a very similar 0.39% median excess return.

In contrast to the retail universe, the fee structure in the institutional space is negotiable, as it is often a function of asset size. In general, the larger the mandate size, the lower the cost of active management. As an investment manager, we believe anything larger than a 30-basis-point (bp) fee for a \$500 million large-cap mandate would be excessive, and this is a reasonable baseline to judge the observations against. Obviously, substantially lower active management fees are available for such a mandate size. But, assuming 30 bps of fees, more than half the managers with 10 years of performance history provided excess returns compared with a passive alternative net of fees.

Moreover, the median manager in the core universe produced this higher return after fees with less volatility than the passive benchmark. The median standard deviation was at the same level or slightly less compared with the benchmark in the core universe.

One potential element that may generate investor frustrations is the observation that the median manager has detracted value over the latest three-year period. This was true in all three sub-universes, even though the evidence for long-term value-added is clear.

LARGE CAP VALUE Broad Universe	3 Year Non-Overlapping Periods (2004-2012)				10 Year (2003-2012)
	2004-2006	2007-2009	2010-2012	Average	2003-2012
# of Observations	439	439	403	427	274
Median Excess Return	-1.05%	3.49%	-0.44%	0.67%	0.76%
Median St Deviation	7.25%	20.40%	15.82%	14.49%	15.53%
Benchmark St Deviation	6.78%	21.40%	15.73%	14.64%	15.71%
Median Tracking Error	3.03%	5.33%	3.51%	3.96%	4.19%

Benchmark: Russell 1000 Value Index. Returns presented are gross of fees.

The value universe showed slightly more value-add, on average, relative to the core universe, at 0.76% median for 10 years and 0.67% for three-year periods. It's important to note these strategies generated most of their return during the deep value cycle of 2009, as the market rebounded off of the bottom. Many value managers live on periods, such as 2009 and 2003, when valuation spreads are wide. This is evident in two of the three three-year sub-periods producing negative returns (2004-2006 and 2010-2012). This represents a different return pattern than demonstrated in the large cap core universe. Investors pursuing a growth/value construction to their portfolios need to intelligently approach these differences.

Similar to the core universe, value strategies produced overall excess returns with slightly less volatility than the benchmark. Managers tended to take less risk than the benchmark when valuation spreads were not so wide (2004-2006 and 2010-2012) and increase risk when valuation spreads widened, such as during 2007-2009, which makes intuitive sense for value managers.

In contrast to the core universe, the style categories experienced higher median benchmark-relative variation, as measured by tracking error. The median tracking error was approximately 1% higher, on average, than in the core space overall.

Once again, with an assumption of a 30 bp fee, compared with a median 10-year before fee return of 0.76%, there is solid evidence of value-added after fees.

LARGE CAP GROWTH Broad Universe	3 Year Non-Overlapping Periods (2004-2012)				10 Year (2003-2012)
	2004-2006	2007-2009	2010-2012	Average	2003-2012
# of Observations	475	451	370	432	263
Median Excess Return	1.96%	0.05%	-1.09%	0.31%	0.39%
Median St Deviation	9.21%	20.22%	17.01%	15.48%	15.79%
Benchmark St Deviation	8.43%	20.01%	15.88%	14.77%	15.06%
Median Tracking Error	4.19%	5.11%	3.51%	4.27%	4.55%

Benchmark: Russell 1000 Growth Index. Returns presented are gross of fees.

The growth universe showed similar value-added, on average, to the core universe, at 0.39% median for 10 years and 0.31% for three-year sub-periods. The majority of value-added was produced during the economic expansion of 2004-2006 +1.96% for the typical growth manager – as opposed to the inflection period of 2007-2009, when the typical value-style manager excelled. This raises the prospect of combining value and growth styles to smooth out this pattern, although the actual result from this approach was similar to the excess return and volatility of the median core manager. Regardless, it emphasizes a general need for investors in a growth/value framework to recognize their strategies may produce excess returns (or underperform) at different times.

Overall, the returns in the growth universe were generated with slightly greater volatility than the benchmark, in contrast to both the core and value universes. Therefore, the risk-adjusted returns were the lowest in the growth universe, even though there was still median value-added after fees. The benchmark-relative variation, as measured by tracking error, was also the highest among growth managers.

Conclusion

If the median institutional manager outperforms after fees, there is the potential for significant value-added for investors who select above-average managers and/or efficiently construct their portfolios.

Pursuing this effort likely would be a better approach for pension funds than investing the bulk of their assets in passive strategies and aggressively pursuing returns from peripheral investments.

Despite what many people believe, indexing is not on the rise because of increasing evidence against the value of active management. To the contrary, there is solid evidence actively managed strategies can add value, with fees being the largest swing factor in determining outperformance. With appropriate plan design and reasonable fees, substantial value-added is possible. Passive investing simply protects investors from their own self-defeating tendencies, which will be our focus in Part II of this series.

Disclosures

The opinions expressed herein are those of Chicago Equity Partners and are for informational purposes only. The information contained within this paper should not be considered investment, legal or tax advice.

Past performance is not indicative of future results. Returns reflect the reinvestment of dividends, gains and other earnings. Net returns are computed by subtracting the highest applicable fee (30 bps on an annual basis) on a monthly basis from the gross composite return.

The S&P 500 is an index of 500 widely held common stocks that measures the general performance of the market. The Russell 1000 Index measures the performance of the large-cap segment of the U.S. equity universe. It is a subset of the Russell 3000® Index and includes approximately 1000 of the largest securities based on a combination of their market cap and current index membership. The Russell 1000 Value Index measures the performance of the large-cap value segment of the U.S. equity universe. It includes those Russell 1000 Index companies with lower price-to-book ratios and lower expected growth values. The Russell 1000 Growth Index measures the performance of the large-cap growth segment of the U.S. equity universe. It includes those Russell 1000 Index companies with higher price-to-book ratios and higher forecasted growth values. Index returns reflect the reinvestment of dividends; however, they do not include management fees, brokerage commissions or other expenses incurred as a result of investing. It is not possible to invest directly in an index.

The Chicago Equity Partners Large Cap Core Strategy represents a composite of accounts having similar investment guidelines and objectives.

Endnotes

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- ¹⁰ Cremers, Ferreira, Matos and Starks. "The Mutual Fund Industry Worldwide: Explicit and Closet Indexing, Fees and Performance," *SSRN Working Paper*, (2013).