The Case for Active Equity Management - Part 2
Implementation

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> *"We have met the enemy…and he is us."*
> - Pogo Comic Strip by Walt Kelly

Introduction

The potential benefits of active management are quite clear. The frustration for many investors, however, is the gap between the 'promised land' of alpha and the sobering reality of realized performance after fees.

The epigraph above from the classic American comic strip Pogo is a parody of the 1813 quote from U.S. Navy Commodore Perry, "We have met the enemy, and they are ours." The gap between promise and reality is often the result of our own failings—we become our own worst enemies. This tends to be true both in the micro-world with investment managers seeking alpha unsuccessfully; and in the macro-world, with investors allocating their assets among investment managers.

Chicago Equity Partners has demonstrated over decades the ability to generate alpha. We have done so through both a commitment to understanding what drives security prices, as well as striving to take into account the wisdom to not become our own worst enemy. As shown in Part 1 of our Case for Active Management, the empirical evidence for alpha exists at both the micro and macro level. We believe, therefore, that the right question is not so much whether alpha exists, but what are investors doing (or not doing) that prevents them from finding it?

The Enemy Is Us

In our previous paper," The Case for Active Management: Part I – Opportunity", we performed an empirical analysis of a large data set of institutional large cap managers. We demonstrated that even in the segment of the market perceived to be "efficient" as defined by the Efficient Markets Hypothesis (EMH), and over a difficult time period that encompassed a largely sideways market, there is solid evidence of active management adding value. In other words, the conventional wisdom of the primacy of so-called passive approaches is not necessarily true; to the contrary, there is opportunity to add value over a passive benchmark.

If empirical results show that the median manager usually adds value after fees for sizable mandates, or at least presents equivalence to a passive approach—regardless of whether one pursues a core approach, a growth/value approach or a combination of the two—what, then, is the problem? Shouldn't about half the plans out there actually be experiencing above median performance? If the evidence shows that there is some performance persistence, why do plan sponsors sometimes not find value in active management?

We contend that the answer lies partly in investors' misunderstandings of the pattern of returns generated by active managers. This includes both the cyclical quality of performance for many strategies, and the tendency toward mean reversion in excess returns. We have also often observed plan designs that sabotage their intended goals by failing to capitalize on low correlation among managers, or investors that could not stay the course (for behavioral or organizational reasons, or both) over a full cycle in order to capitalize on available alpha.

For instance, we saw in our previous results (shown in the table below) that the alpha generated by the typical value manager is cyclical, relying on brief, extreme periods to produce their excess returns. In other words, they are home-run hitters that strike out a lot—not high percentage singles hitters. Having such "players" in one's "line up" can make a lot of sense in an overall portfolio, if how those players add value are understood and utilized appropriately.

Large Cap Value Universe

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%

Source: eVestment. Benchmark: Russell 1000 Value Index

Many investors buy these cyclical, deep value managers following junk-rally periods like 2003 and 2009, when their recent absolute returns are most attractive. But if an investor buys the manager after the 2003 run-up, then endures underperformance for several years, they can be easily tempted to sell that manager before 2009, thus missing out on the true source of excess returns across the market cycle.

This dynamic can be aggravated if the periods between deep value return cycles are even longer. In fact, as we saw in previous decades, two big value cycles in a decade such as we saw in the 2000s is actually uncommon. Can investors stay the course with a deep value manager long enough to fully capitalize? It might make sense to combine this type of strategy with a low risk manager approach that more consistently produces excess return in the space.

Some investors may test the idea of pairing a deep value manager with a deep growth manager, the kind that did well in the expansion phase of 2004-06. That plan structure is not uncommon. Certainly, the median excess return pattern in the eVestment tables indicates a predominance of managers with a cyclical bent. Unfortunately, that can produce a vicious cycle where managers are hired after outperforming and then fired before they can rebound. This

triggers a wave of value manager searches in one period and then growth manager searches in another, as the managers outperform and underperform in different parts of the cycle. Anecdotally, this pattern does seem to fit the waves of search activity rather well.

Large Cap Growth Universe

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%

Source: eVestment. Benchmark: Russell 1000 Growth Index

It certainly mirrors frustrations that we have heard on the part of plan consultants who carefully design plan structures intended to capitalize on manager diversification that are at times undermined by investors in practice. Most investors realize that investment managers can't outperform all the time, but knowing that and having the discipline to adhere to an intelligently designed plan structure are two different things.

The Psychology of Investor Behavior

In fact, there is a body of empirical work that documents this very problem. One of our favorites is an excellent paper entitled "The Selection and Termination of Investment Managers by Plan Sponsors."[1] The authors build a unique data set of private and public plan sponsors that tracks hiring and firing decisions of investment managers over a 10-year period. They arrive at three general conclusions: (1) Plan sponsors hire managers that had large excess returns in the three years prior to the hiring decision, but post-hiring excess returns are not significantly different from zero; (2) Plan sponsors fire managers after underperformance, but the post-firing returns are often positive. (3) Plan sponsor post-decision excess returns on average would have been better by retaining the fired managers than with the newly hired managers.

Our interpretation is that investors tend to chase returns. There is value-added and performance persistence in the institutional universe on average, but it requires proper analysis and systematic discipline to capture. Different approaches can work, but some are tougher to adhere to then others. For instance, combining deep value and growth managers might make good strategic sense, but if this is the sum total of the plan structure, it may also be the most difficult to adhere to.

For example, let's return to the value universe data set discussed earlier. Cyclicality of performance is the norm. A manager that is top quartile in one period (i.e., a rolling three year period) can easily be bottom quartile in another period. What are the odds of that? The odds are greater than 42% across all of our observations in the value universe. The percentage of managers who have at least one three-year period excess return above 50 bp and another 3-year period excess return below -50 basis points is 70%. Meanwhile, 61% of managers have at least one three-year period excess return above 100 basis points and another 3-year period return excess return below -100 basis points.

Chasing returns can lead to the frustration, both on the part of investors, as well as the investment managers they employ. For instance, if cyclical, deep value managers are paired with similar growth managers, will the plan sponsors utilizing such an approach adhere to the structure? While many plans do pursue managers with higher tracking error and a more cyclical style, the apparent hiring and firing behavior of managers may indicate that investor risk tolerances are better suited to a different plan structure. Incorporating strategies that are not as cyclical, such as lower tracking error core managers in the mix, along with less tail-oriented growth/value managers is one logical alternative.

Conclusion

If a typical plan design is exposed to the cyclicality of excess returns, and if it is typical human nature to chase performance, then it is not surprising that institutional investment experience is often disappointing. Indeed, in that case, it is not puzzling why there is an increasing trend toward passive investing.

Though understandable, going passive forgoes the real opportunity to capture alpha. Passive investing simply mitigates investors' own self-destructive tendencies. Indexation is not on the rise because increasing evidence against the value of active management. To the contrary, there is solid empirical evidence for the value-added by the median manager. With appropriate plan design, substantial value added is within reach. In a world of underfunding and the quest for scarce returns, is passive investing the best investors can do?

If the median manager outperforms, there is the potential for significant value-added if one can select better than median managers. Accomplishing that feat, plus constructing a more efficient portfolio, would do more to counteract pension expenses than would indexing the bulk of one's allocations and then aggressively pursuing outsized returns through niche strategies.

Endnotes

1 Goyal and Wahal. "The Selection and Termination of Investment Managers by Plan Sponsors," *Journal of Finance*, Text selection garnered from earlier working paper version (2008).