STONEHAGE FLEMING

KNOW HOW BULLETIN

THE ROLE OF ACTIVE MANAGEMENT IN A MODERN PORTFOLIO

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Most investors will be well aware of the increasing popularity of so called 'passive', 'index' or 'tracker' funds in modern investment portfolios. This is a trend that has been much discussed in the press and has implications for the future role of more traditional active managers.

In short a passive fund seeks to replicate the relevant market index, rather than select individual stocks, so that the performance of the fund will be in line with that index, less any management or transaction costs, which are generally small. It could be one of the main stock market indices, such as the S&P 500 for US or the FTSE 100 for UK companies, or one representing a smaller subset of the investment universe based on a particular sector or investment style.

Passive funds have been around for over 50 years (Vanguard being the original market leader), but have gained in popularity over the last decade for four main reasons:

1. **New technology** has made it easier and more cost effective to accurately track the relevant index;
2. Investors now have access to such extensive **on line information and analysis** that they are more confident of making their own asset allocation decisions, whilst they also have greater access to trading markets through online investment platforms;
3. They offer investors the **purest exposure to the "market" return** without them having to engage in extensive research into individual companies;
4. Crucially, **active managers have had a difficult period** and it is argued that the median active manager significantly underperforms the indices, partly because of their fees.

For an investor, the detailed arguments of active versus passive can become complex, and the purpose of this paper is hence to assess the continuing role of active managers within a broader portfolio. For most investors, performance is of course the major issue, but there are other factors which need to be considered. These arguments are also relevant to wealth managers with a mandate to advise across the entirety of their clients' affairs.

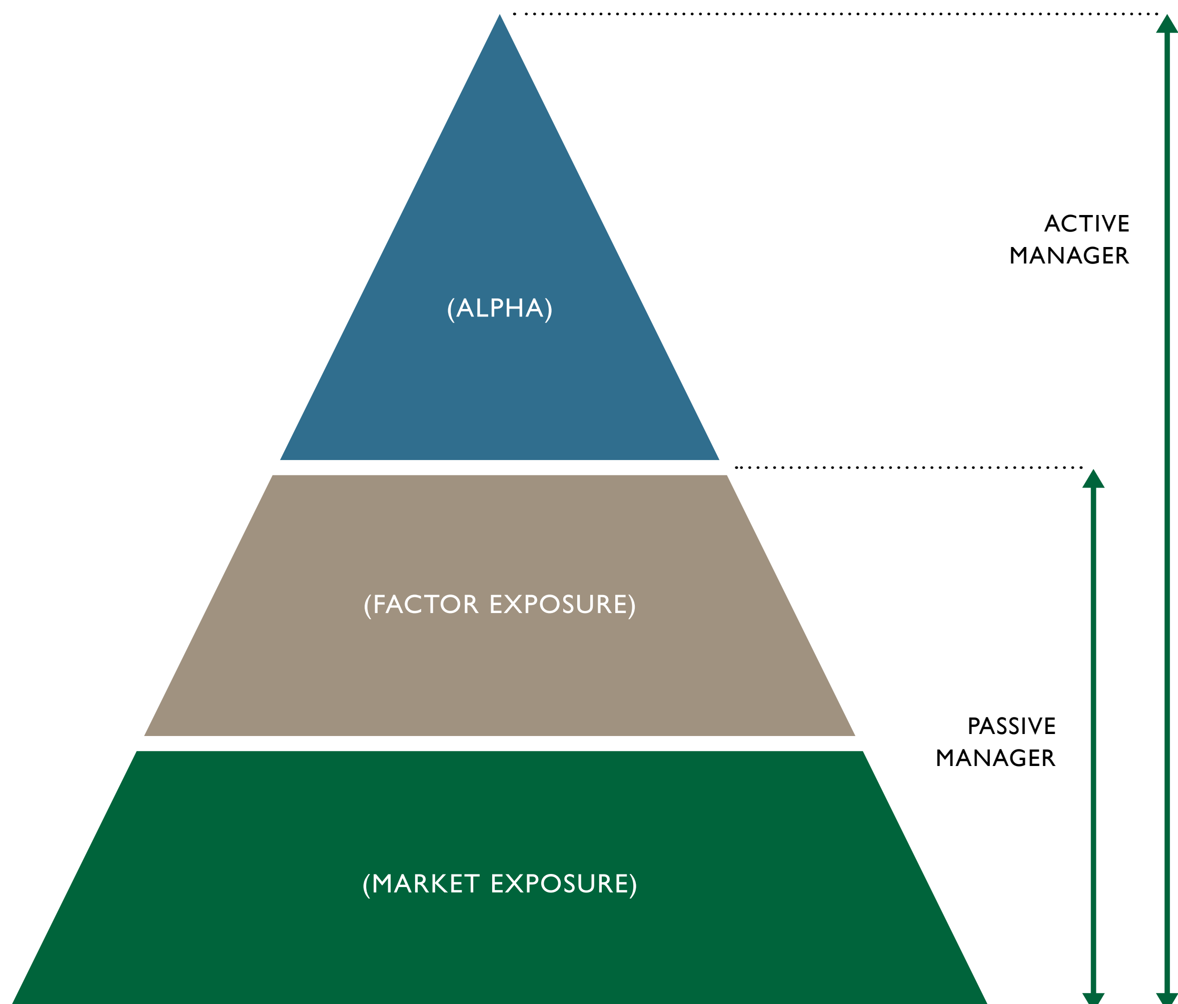
PASSIVE INVESTING

In a sense one would expect that a passive fund will inevitably outperform the median active fund operating within the same market. This is because the market return essentially approximates to the average of all portfolios managed by active managers, BEFORE CHARGES; the median active manager thus underperforms that average AFTER CHARGES. The cumulative impact of these charges over time has been substantial.

Furthermore, within the universe of active funds there can be quite a wide dispersion of returns, creating a significant risk of further underperformance caused by selecting the wrong manager. By contrast the return on passive, index or tracker funds will almost precisely reflect the index, less the fees, which are significantly smaller than those of active managers.

This is not a new argument and as long ago as 1991, Professor William Sharp asserted in his essay 'The Arithmetic of Active Management' that the underperformance of the median manager was a 'mathematical certainty'. Even the legendary investor Warren Buffet challenged investors in 2008 to construct a portfolio of hedge funds which would outperform the S&P 500 over ten years, a bet he won with ease.

Passive management does not restrict the investor's asset allocation decisions, as there are more and more indices which enable the investor to target their particular preferences for sectors or asset classes, gaining so called 'factor exposure'. It is well known that asset allocation contributes far more to absolute investment performance than individual stock selection, so it could be argued that the use of passive funds helps the investor to focus on the issues which matter most.



Source: Stonehage Fleming Investment Management, 2017

Whilst the case for passive funds is therefore quite compelling, there are many investors who have an instinctive dissatisfaction with investing in this way for several quite legitimate reasons:

- They are more comfortable investing in 'businesses', to which they can relate, rather than in 'markets' and nebulous indices;
- They believe an active investment manager is more closely engaged with the real economy through monitoring the performance of businesses, rather than simply following markets which can become detached from reality;
- They have a sense that passive managers are followers rather than leaders and price takers rather than makers;
- The fewer the number of active managers, the more prices depend upon a smaller number of people conducting fundamental analysis of the companies comprising the indices, creating the potential for instability and market bubbles, as momentum drives market prices far beyond their fair values.

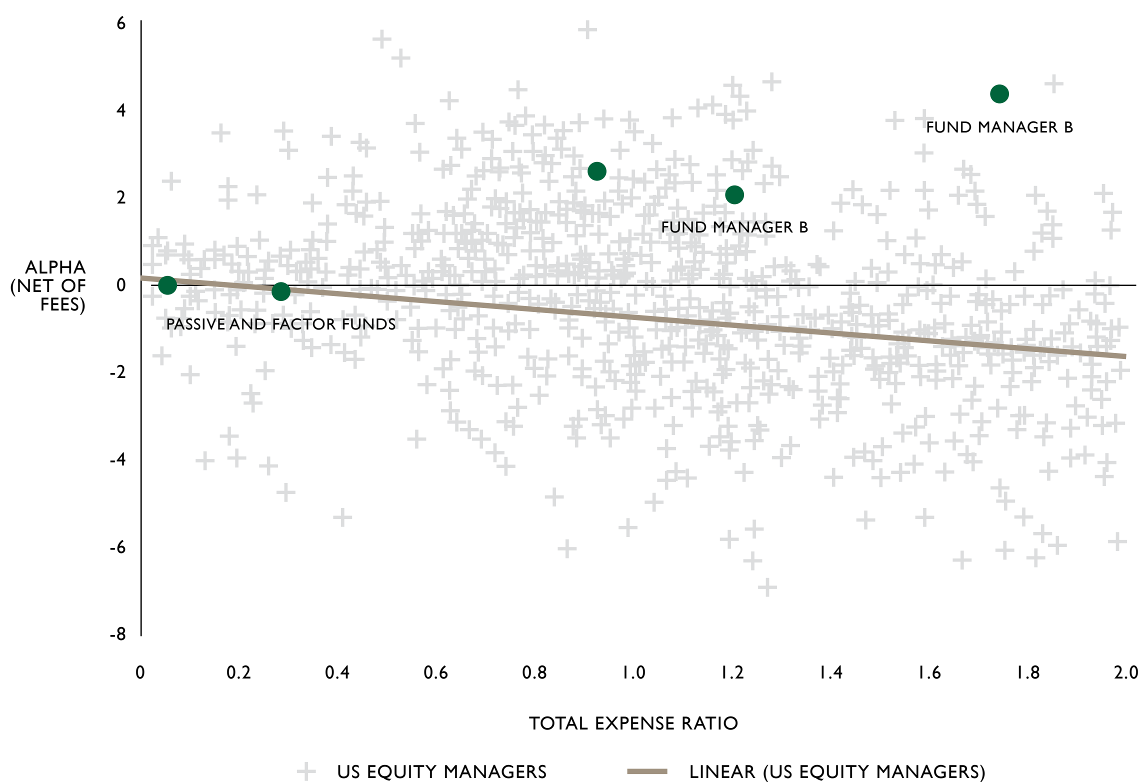
ACTIVE INVESTING

Firstly it is worth mentioning that recent press commentary has been focused on the underperformance of active managers since the 2008 Global Financial Crisis, a period in which market returns were dominated by a subset of large companies within certain sectors such as technology.

Historically active managers have performed better in periods when market leadership has not been as concentrated and when smaller companies have performed better. Any reversion to a more normalised environment is hence likely to see an uptick in the fortunes of the active management industry.

In performance terms, the case for active management depends on picking the managers who are most likely to outperform the market return over and above the fees they charge. In many sectors there is quite a wide dispersion, some managers outperforming handsomely, others underperforming dismally, with many apparently being close to index trackers themselves.

US EQUITY FUNDS TEN YEAR RETURNS AGAINST FEES



Past performance is not a guide to future performance.
Source: Stonehage Fleming Investment Management, Bloomberg, Lipper

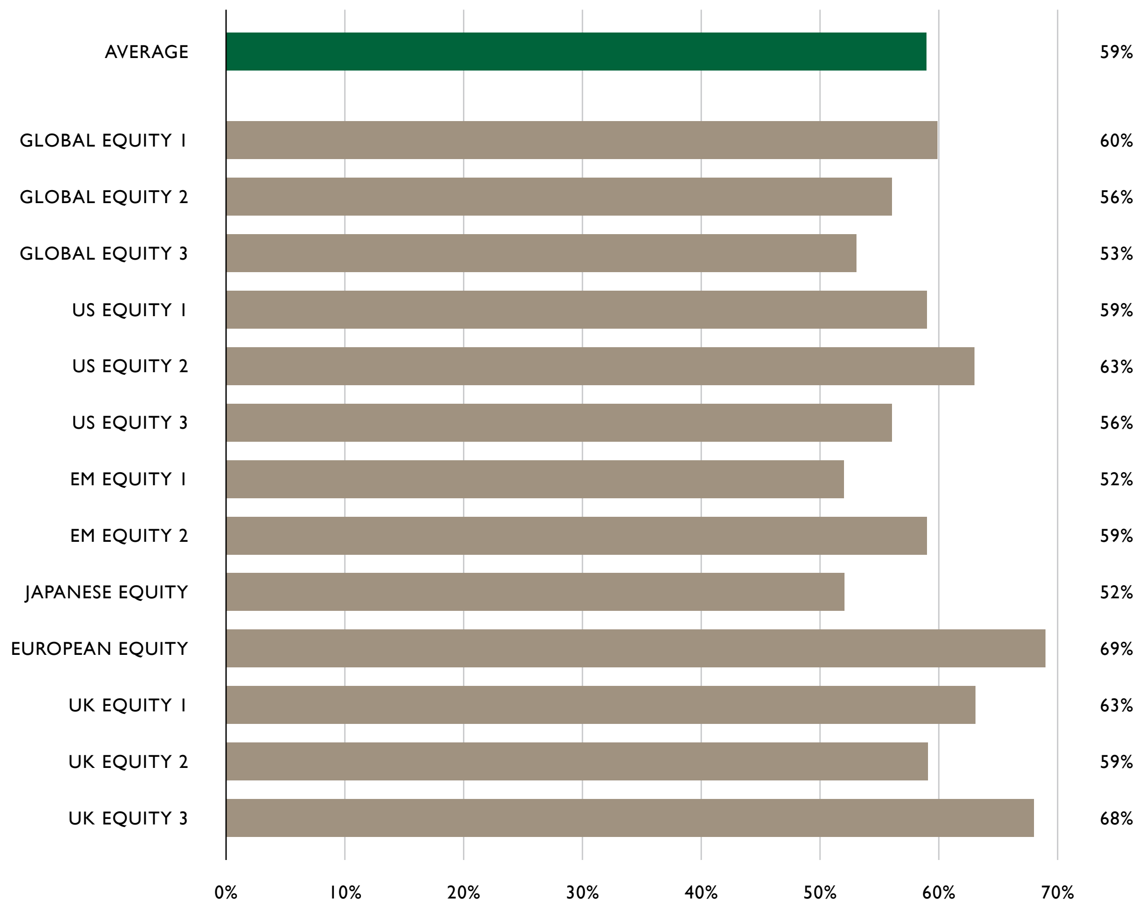
IDENTIFYING THE RIGHT MANAGER

Fortunately for investors and wealth managers, technology improvements have also helped substantially in using active managers more effectively than in the past and in particular the ability to distinguish between those who owe their performance to exceptional skill, rather than exceptional luck.

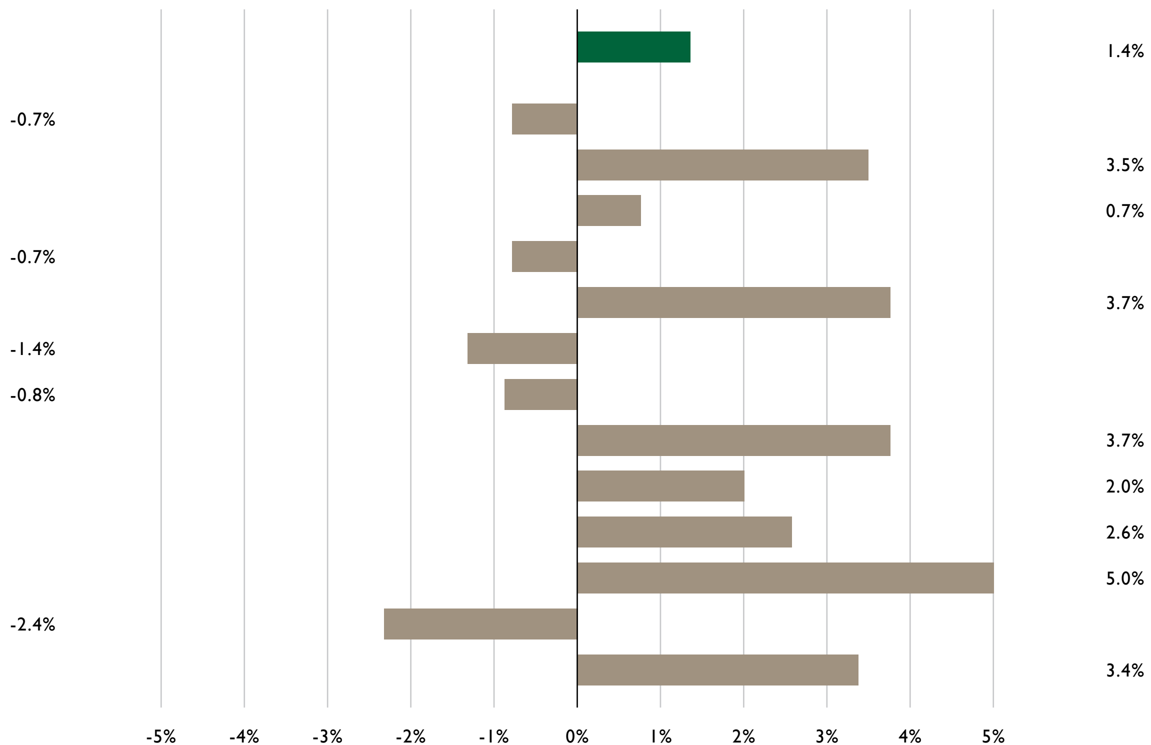
In the past, wealth managers could very closely monitor funds against objectives and strategy, meet regularly with managers ('looking into the whites of their eyes') and watch for any significant changes in behaviour. Technology now enables the monitoring to be vastly more sophisticated, analysing the impact of virtually every decision the manager takes, and helping to establish beyond reasonable doubt whether they have exceptional skills and capabilities in the sectors in which they operate.

By way of example it is now possible to track every buy or sell decision made by an active manager against the eventual outturn. Some investors may be surprised that typically the majority of decisions made by these managers are value destructive rather than accretive. Lee Freeman-Shor in his book "The Art of Execution" found that after analysing 1,866 investments made by the biggest names in the asset management industry, just 49% of these rose in price after the manager invested.

However, applying analytical software alongside other appropriate monitoring to some of the equity funds in clients' portfolios, a selection of thirteen equity managers has achieved an average success rate of 59%. Whilst this might seem a modest differential it can have a substantial impact on the performance of the portfolio, as evidenced by the fact that over the last five years (during this difficult period for active managers) these same thirteen managers have outperformed their respective benchmarks by 1.4% per annum on average, net of their fees.



Past performance is not a guide to future performance.
Source: Stonehage Fleming Investment Management, Inalytics



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CONCLUSIONS

It is estimated that passive funds now account for over 20% of global assets under management, a record high and over four times what they were almost 15 years ago. We believe this trend will reverse to some extent as market conditions change and become more favourable to active managers.

For most investors there is a role for both active and passive investment strategies, with the relative proportions depending on investor preference. Some will be more convinced by the arithmetic arguments as well as simplicity and transparency offered by passive investments; others will be more confident investing in companies they understand and fear that an investment world dominated by a 'follow my leader' approach is bound to end in tears.

At the heart of this debate is benchmarking. An investor who judges his investments purely against the indices will usually do better with passive investments unless he or she has access to exceptional expertise in selecting active managers.

Other investors may prefer to look at their portfolio more in absolute terms for the reasons stated above, but they must be disciplined enough to endure shorter term periods when they may underperform the index. History is littered with the careers of active managers who bet against the market too early, usually because they feared a bubble, only to be proved right after their clients had transferred their business elsewhere!

Our experience is based on a client base with a high percentage of direct business owners, who are naturally more inclined to invest in businesses rather than markets. We look to find the right balance of active and passive investments which takes account of the arguments above, of our own expertise in selecting managers, and of the clients' preferences. All these are legitimate factors to consider, which is why managing a portfolio is such an individual and personalised business, tailored to the needs and preferences of every client.

FOR MORE INFORMATION

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John is Deputy Head of Investments for Stonehage Fleming Investment Management and is responsible for multi-asset investment strategy and research. He joined the Group in 2001 working initially as a Portfolio Manager and Analyst. In 2005 he helped establish Stonehage Investment Partners where he led investment strategy as the CIO.

Prior to that John spent eight years in the engineering industry working on structural modelling and design before entering the investment industry. He practised as a Chartered Engineer and obtained a Master of Science in Engineering for research in numerical modelling and a Bachelor of Science in Engineering (First Class Honours) from the University of Cape Town.

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Prior to joining to Group, Graham was GAM's Group Head of Investments – Multi Asset Class Solutions and Chairman of GAM's Investment Advisory Board where he had overall responsibility for the firm's discretionary mandates and related co-mingled funds. Graham holds Bachelor of Commerce (Hons) and Master of Commerce degrees from the University of Cape Town.

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