A MORE BALANCED NARRATIVE

Broadening the Discussion on Active Management

PART II

CONTENTS

ACTIVE MANAGERS COUNCIL
INVESTMENT ADVISER ASSOCIATION

It's hard to imagine that there's anything more to say about the value of active management, especially in comparison to index investing. The relative merits of the two investment approaches have been extensively studied in the academic literature, hotly debated within the industry, and continuously replayed in the financial media.

But it's time for fresh thinking.

The conventional wisdom on active management was effectively established almost 30 years ago with the publication of Sharpe's "The Arithmetic of Investment Management" in 1991 and Carhart's "On Persistence in Mutual Fund Performance" in 1997. Sharpe argued that active management was, in theory, a negative-sum game in aggregate after costs are considered, while Carhart concluded that, in practice, an analysis of the performance data did "not support the existence of skilled or informed mutual fund portfolio managers."

However, the investment management industry has changed dramatically since these articles were published.

Perhaps most notably, passive investing has gained traction. What was once an underdog strategy is now playing an increasingly important role in the markets. The growth in indexing has been most marked in the United States, where at the end of 2019, over 60% of the assets in domestic equity funds were invested in index funds. But growth in indexing is a global phenomenon; for example, in the euro area, the share of investment fund assets invested in ETFs reached 6.6% at the end of 2019, an all-time high.

Active management has evolved as well. The cost of active management has fallen significantly. For example, fees on equity mutual funds in the United States have dropped from an average of 0.99% bp in 2000 to 0.52% in 2019. At the same time, active managers have honed their product offerings and continued to enhance their investment approaches to increase their value-added for investors.

With all this change, a reconsideration of the conventional wisdom on active management is timely, if not long overdue.

This research brief summarizes themes in the recent thinking on active and passive investing. We look at:

- Reassessments of the conventional wisdom regarding active management
- The role of active management in sustainable investing
- Revisions to approaches to measuring investment success
- A new awareness of the active aspects of all investing
- The centrality of active management in maintaining market efficiency

Overall, the works discussed here present a more balanced narrative about the value of active management. They suggest a new conventional wisdom: that active and passive both add value for investors in different ways and that active investing is essential to the health of the markets.

About the Active Managers Council

The Investment Adviser Association formed the Active Managers Council to foster education and thought leadership regarding active management, curate and sponsor research on active and passive management, and engage on relevant public policy issues. The Council's member firms represent diverse viewpoints, business models and types of investors. More information about active management and the Council is available at www.activemanagers.com.

The material discussed in this research brief was drawn from Council publications.

About the Investment Adviser Association

The IAA is a leading not-for-profit organization that has been dedicated to advancing the interests of investment advisers for more than 80 years. The IAA's member firms manage more than $25 trillion in assets for a wide variety of individual and institutional clients, including pension plans, trusts, mutual funds, private funds, endowments, foundations, and corporations. More information about the IAA is available at www.investmentadviser.org.

Reassessing the Conventional Wisdom

Two recent papers are dedicated to a broad re-assessment of both the empirical and theoretical support for the conventional wisdom on active management.

Cremers, Fulkerson, and Riley (2019) undertook a broad review of the past 20 years' of research on active management. They cite over 300 sources in their article, titled ***"Challenging the Conventional Wisdom on Active Management: A Review of the Past 20 Years of Academic Literature on Actively Managed Mutual Funds."***

The paper argues that, contrary to the current consensus, "active managers have a variety of skills and, in many cases, tend to make value-added decisions. In other words, many funds do appear to create value for investors even after accounting for fees."

The authors take a deep dive into the literature on manager skill in U.S. equity funds. They survey the research that examines the level of active manager skill, whether that skill can be identified in advance, the specific skills that managers bring to bear in managing portfolios, and the market environments that make those skills most useful. They then review the studies of active manager skill in other types of mutual funds.

Among their findings:

- Standard approaches may not accurately measure active managers' skill. Conclusions are highly dependent on benchmark choice, model specification and data quality.
- Investors can identify skilled managers in advance. Active manager characteristics and behavior are solid indicators of future performance, with investment approach being particularly important.
- Active managers add value through stock selection, both on a fund-by-fund basis and at an aggregate industry level.
- Active managers also add value through timing the market, using information effectively, providing corporate oversight, tax management, and use of a disciplined investment approach.
- The value of active managers' skills varies with economic and market conditions. Active managers are more likely to generate positive risk-adjusted returns in recessions and in markets and market sectors that are less popular.

They conclude that, "Our review of the most recent literature suggests that the conventional wisdom is too negative on the value of active management."

In ***A More Balanced Narrative: Setting the Record Straight on Active Management***, Lafferty (2019) addresses common criticisms of active management. He takes a practitioner's viewpoint, focusing on the concerns voiced most often in industry publications and the financial media.

He concludes that many active managers outperform, though relative performance varies across styles and time periods. Lafferty specifically addresses the impact of market direction, mega-cap performance and credit spread trends.

Lafferty notes that Sharpe's theory doesn't mean that individual managers can't outperform or even that groups of managers can't outperform; instead, the data shows that active managers indeed do well in certain categories and time periods.

Lafferty's other conclusions are:

- Investors can identify outperforming managers in advance.
- Active managers are raising their game, by lowering fees, investing in investment processes, increasing portfolio differentiation, and focusing on risk management.

The paper counters the oversimplified conventional wisdom that all passive is good and active is bad. In so doing, it provides a much more nuanced understanding of the pros and cons of both active and passive investing styles, and how each can play an important role in investors' portfolios.

The Intersection of ESG and Active Management

Active management plays a particularly important role in certain market segments and investment approaches. Sustainable investing, which is focused on environmental, social and governance (ESG) factors, is one area where active management is essential.

Sustainable Investing is an Active Process, an Active Manager's Council whitepaper (2020), finds that:

- Sustainable investing inherently involves active decision-making, beginning with an assessment of the materiality of sustainability issues.
- The in-depth nature of the active research process makes it possible for advisers to assess not just short-term risks that are visible in the current data but, even more importantly, the direction of long-term trends and how they will affect companies.
- The active approach is adaptive: able to react to innovation and changes in the environment and to quickly evaluate how they impact the achievement of investor goals.

The paper takes a close look at ESG ratings, which are used in passive approaches to sustainable investing. The paper found that ratings from different providers can seem to have little connection with each other, as Figure 3 illustrates. It plots MSCI ESG ratings of 518 companies against ratings for the same companies from JUST Capital.

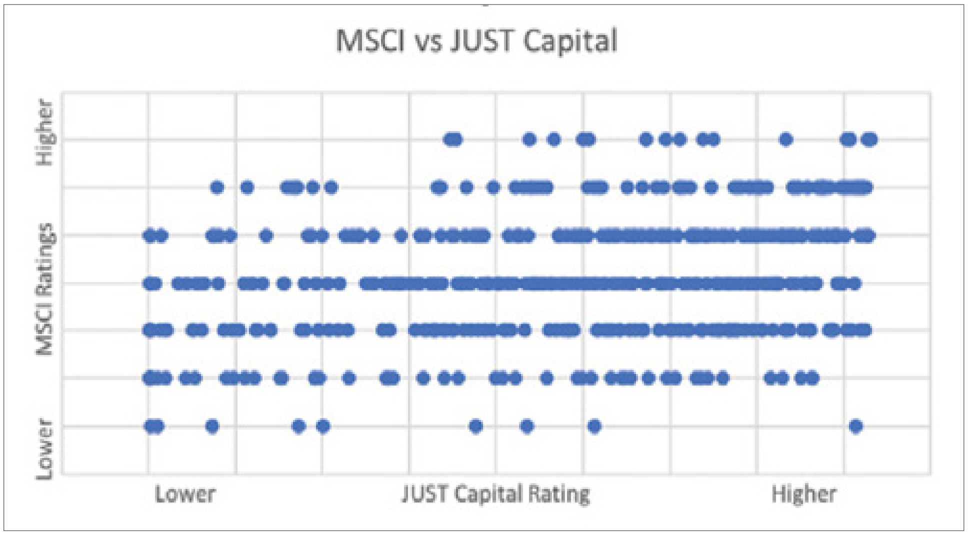

Figure 3. MSCI and JUST Capital ratings available online on May 28-29, 2020.

The dispersion illustrates the subjective nature of the ESG ratings. If the ratings process was 100% objective, all of the ratings systems should generate similar scores for the same companies.

Academic studies have found that divergences in ESG ratings are the norm.

- **"Do Ratings of Firms Converge? Implications for Managers, Investors and Strategy Researchers"** (Chatterji et al. (2015)) finds a "surprising lack of agreement" across social ratings from six raters.

- "**Aggregate Confusion: The Divergence of ESG Ratings"** (Berg, Koelbel, and Rigobon (2019)) calculated that 53% of the discrepancies in 5 sets of ratings "comes from the fact that the rating agencies are measuring the same categories differently," while 47% "stems from aggregating common data using different rules. They argue that their results suggest that "different sustainability ratings cannot be made congruent simply by taking into account scope and weight differences."

- **"ESG Rating Disagreement and Stock Returns"** (Gibson et al. (2020)) found that the average correlations between ratings from six different providers was just 0.46.

- **"Divergent ESG Ratings,"** (Dimson, Marsh, and Staunton (2020)) examines the ESG ratings from three providers for six large companies and finds "minimal correlation" and even disagreement on factual issues.

Dimson, Marsh and Staunton caution, "ESG ratings should not be treated as a black box or used mechanically. . . At best, they are a starting point."

Overall, the studies emphasize that an active approach is essential to helping sustainable investors meet their goals.

[12] Johnson and McCullough, *Barometer, 3.*

Measuring Success

Any assessment of the value of active management starts with a measurement of its success in generating returns for investors. However, recent examinations of the standard measures used to assess active managers' performance demonstrate that they have significant limitations and, therefore, present an inaccurate view of active managers' skill.

Rethinking Survivorship Bias in Active/Passive Comparisons, a research brief from the Active Managers Council (2020), takes a close look at the methodology of Morningstar's Active/Passive Barometer.

Published semiannually, Morningstar's Barometer plays a critical role in determining public perception of active management because of its extensive media coverage. The Barometer has become popular because it provides an easy-to-understand "success rate" for actively managed funds, equal to the percentage of funds that outperform passive competitors over a given period.

However, the Council's research brief argues that the survivorship bias adjustments used in the Barometer are too punitive toward active management. The paper notes that index funds often have similar rates of attrition but are not subject to the same survivorship bias adjustments.

Adjusting active funds' success rate by a factor derived from passive funds' attrition results in a significantly more positive assessment of active managers' performance. In its appendix, the paper also estimates a success rate for passive funds, which when compared to the success rate for active funds, again leads to a more positive evaluation of active management.

The Council's analysis highlights the limitations of active-passive comparisons, especially over long time periods. While focused on Morningstar's Barometer, the research brief's arguments also apply to the SPIVA® scorecard published by S&P Dow Jones Indices, which has a similar purpose and approach. More broadly, it suggests that all studies of actively managed funds that incorporate survivorship bias adjustments may need to reconsider their methodologies if they are to make an accurate assessment of manager skill.

In ***"Measuring Skill in the Mutual Fund Industry,"*** Berk and van Binsbergen (2015) present an alternative to the "success rates" that are commonly used in the mutual fund industry.

For 6,000 actively managed equity funds over a period of over 30 years (from January 1977 through March 2011), they calculate the average value-added for each fund through multiplying "gross abnormal return" by assets under management. The authors believe that this measure is a better assessment of managerial skill than traditional alpha. "A manager who adds a gross alpha of 1% on a $10 billion fund adds more value than a manager who adds a gross alpha of 10% on a $1 million fund," they explain.

Berk and van Binsbergen estimate that the average fund added "an economically significant $270,000 per month, or $3.2 million annually (in Y2000 dollars)." They conclude that they "find it hard to reconcile our findings with anything other than the existence of money management skill."

Even more importantly, the authors suggest that "investors appear to be able to identify talent and compensate it" by allocating capital to funds, thereby increasing fees earned from those assets.

While performance calculation methodologies have come under scrutiny, so has the focus on "performance persistence" – meaning outperformance in consecutive time. While persistence is a measure of success included in many active-passive comparisons, it has been popularized by the S&P Persistence Scorecard, which consistently receives extensive media attention when it is published periodically.

"Persistence Scorecard Doesn't Predict Investor Success," an Active Managers Council blog post (2019), concludes that funds don't need year-after-year outperformance to generate long-term value for investors.

The post examines the performance of large blend funds over a 20-year period and notes that even top-ranked funds underwent shorter periods of underperformance, as illustrated in Figure 1. Specifically, the top 50 funds in the 1999 to 2018 period experienced, on average, 18 quarters of underperformance.

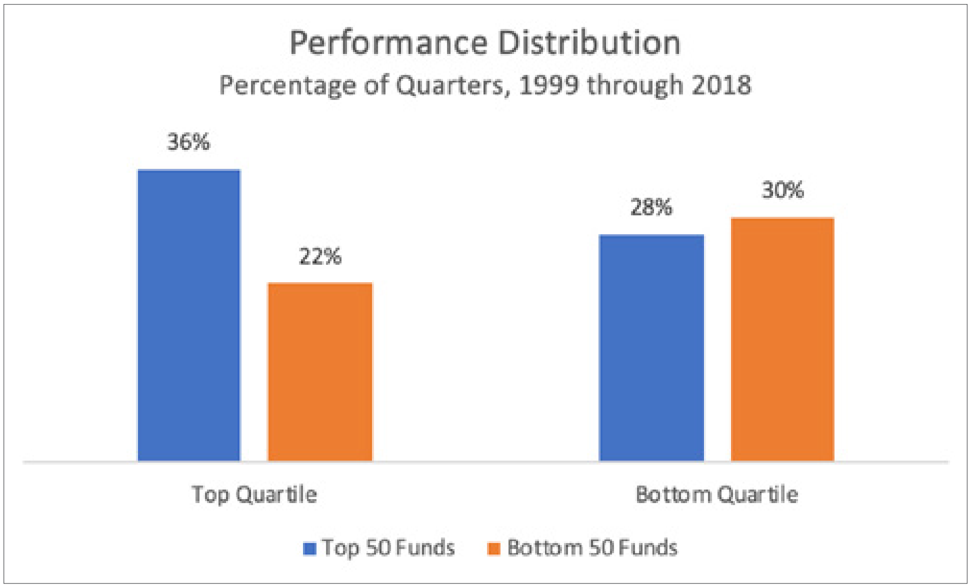

Figure 1. Actively managed Morningstar Large Blend funds with a 20-year performance history as of December 2018 (approximately 220 funds).

The appropriate time period for measuring performance has also received attention. A blog post from the Active Managers Council (2019) highlights the ***"The Long Cycles of Active and Index Performance,"*** as illustrated in Figure 2.

This graph shows the average relative performance of active large blend funds and index funds over a 30+ year period, from 1985 through 2018. When the line is rising, the average active large blend fund is doing better than the index funds; when the line is falling, the average index fund is outperforming active large blend funds.

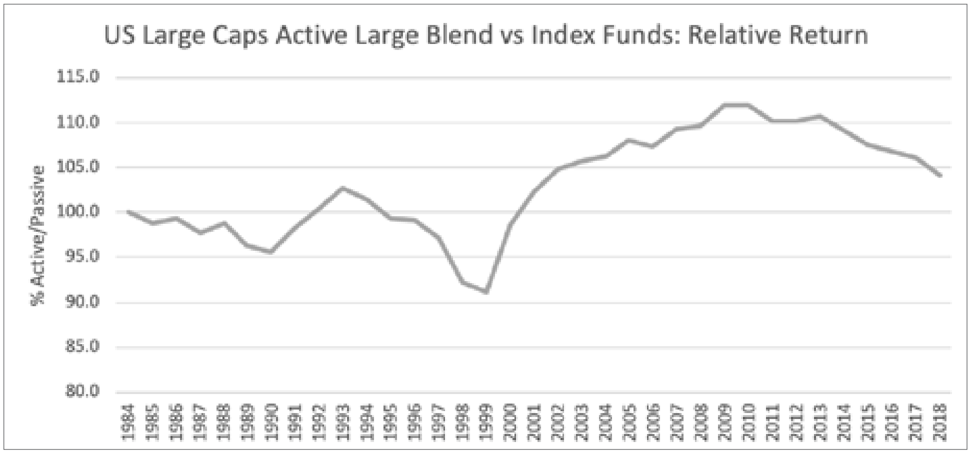

Figure 2. "Active large blend funds" are Morningstar Large Blend funds that are not index or enhanced index funds; "index funds" are funds in the Morningstar S&P 500 Tracking category.

The graph suggests that actively managed funds tend to do better in more turbulent economic environments, while the index funds often outperform when the economy is strong.

Industry executive Carol Geremia comments on the misalignment between investor goals and the time frames used to measure asset manager performance, as summarized in the Active Managers Council blog post (2019), titled ***"Time to Align."***

She notes that active managers typically are hired to produce returns over a full market cycle, meaning from peak to peak of an economic cycle, or from trough to trough. But a survey from MFS Investment Management finds that investors are only willing to tolerate underperformance for 3 to 5 years, which is just half of a full market cycle. This short-term focus is also common among financial advisers, investment consultants, boards of trustees and even asset managers themselves, Geremia adds.

"Identifying skill is a matter of what you measure," she concludes. "We've been avoiding true conversations around time horizons and alignment."

The Active-Passive Continuum

While older research tends to draw a sharp line between active and passive investing, newer thinking emphasizes the active nature of all investing. Index investing and active investing co-exist along a spectrum rather than face off across a divide.

Two papers by Robertson (2018) highlight the active nature of index construction. ***"Passive in Name Only: Delegated Management and 'Index' Investing,"*** analyzed more than 900 indexes, including 603 that are used as benchmarks for 3,208 mutual funds. Robertson finds "substantial heterogeneity across indices," with the overwhelming majority of the indices used a primary benchmark for only a single fund. She concludes that "far from being 'passive' . . . index investing is better understood as a form of delegated management."

In ***"The (Mis)Uses of the S&P 500,"*** Robertson focuses on the construction of the S&P 500. She concludes, that while the S&P is seen as a passive benchmark, its composition changes "substantially over time" as the result of discretionary decision making by the S&P U.S. Index Committee. The S&P 500 is "not 'neutral' or 'universal' in any meaningful sense," she adds.

A blog post from the Active Managers Council (2020), titled ***"Postponed Rebalancings Highlight Active Nature of Passive Investing,"*** comments on the decisions by index providers to postpone index rebalancings because of market volatility caused by the pandemic. For example, S&P Dow Jones Indices announced that it would postpone the first quarter 2020 rebalancing of their equity indexes, deferring membership additions and deletions along with other routine adjustments to index composition. The blog post notes that this decision and similar decision by other index providers put a spotlight on the active decision-making that underlies passive index construction.

In addition, the indexes themselves may provide an active exposure to a specific industry, sector or factor, rather than broad exposure to the overall market. For example, "many ETFs are active investments in both form and substance" even though they are based on an index, conclude researchers Easley et al (2018). In ***"The Active World of Passive Investing,"*** they compare the holdings of 413 U.S. equity ETFs to a passive market portfolio from 2000 to 2017 and find that most ETFs are "highly active" with a median active share of 93.1% and median tracking error of 8.8% per year.

The authors note that the most passive ETFs tend to be the largest in terms of assets under management, while, with some exceptions, the most active ETFs are smaller. However, they find that active ETFs are still a significant portion of the ETF market with "very active" ETFs accounting for 43% of assets.

Hallett (2020) stresses the risks inherent in index investing in his article, ***"Passive Investing's Past Performance Problem."*** "Most indexes are, capitalization-weighted, meaning that the indexes are dominated by securities that have done well in the recent past," he writes. "This focus on yesterday's winners becomes particularly problematic when past performance is concentrated in a small number of constituents or market segments," such as occurred in Japanese stock market indexes in the 1980s and the technology sector today. "Investors may be surprised at just how much price risk is embedded in today's benchmark indices," Hallett cautions.

Nor does investing in index funds ensure that investors will meet their goals. A study of German investors found that individuals investing in ETFs "do not improve their portfolio performance" because of poor market timing combined with poor ETF selection.

Bhattacharya et al. (2017) examined the trading data of a "large number" of individual investors at a "large" German brokerage firm, in ***"Abusing ETFs."*** Contrary to expectations, the researchers found that portfolio performance did not improve as a result of buying ETFs, even though "ETF users appear to be more skilled investors than the non-users."

Active Management and the Markets

Active management plays a critical role in maintaining the efficiency of the securities markets.

"Active Investing and the Efficiency of Security Markets," by Wermers (2021), focuses on the critical contribution of the activities of active investment managers to market efficiency. Wermers concludes that "all investors, both active and passive—as well as the real economy—benefit from the efforts and cost expenditures of active managers."

Wermers describes the mechanisms that translate active managers' activities into market efficiency. Specifically:

- Active managers correct market anomalies.
- Active managers provide liquidity.
- Active managers incorporate information into market prices.
- Active managers monitor corporate management.

In the process, active managers provide "positive externalities for all investors, including investors in passively-managed funds," notes Wermers. This "societal value-added" is in addition to the benefits that active managers provide to their investors, in the form of ability to exploit mispricings and to tailor risk-return profiles to individual preferences.

In sum, concludes Wermers, "the average 'alpha' provided by active managers (meaning the excess return above the relevant benchmark index), even gross of management fees, does not adequately capture the value of the active management industry to capital markets."

"Active Management and Market Efficiency: A Summary of the Academic Literature," an Active Managers Council white paper (2019), provides an in-depth view of the literature on active investing and market efficiency. The paper summarizes the conclusions of over 50 academic studies in six topic areas, specifically:

- How changes in index composition affect the pricing of securities
- The impact on pricing efficiency of the shift to passive investing
- The connection between return comovement (or correlation) and passive index investing
- Whether trading in ETFs and other index products transmits volatility to the underlying securities and the markets in general
- The impact of the introduction of leveraged and inverse ETFs
- The relationship between the level of index investing and the liquidity of the securities in the index

The paper notes that the shift toward passive investing has had a more significant impact in some of these areas than in others. Studies suggest that "pricing efficiency has declined, return comovement has increased, securities prices are more volatile, and liquidity has decreased and exhibits greater comovement."

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