



Does Active Management Add Value?

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The debate between advocates of active and passive investing has been one of the most enduring in the investment literature, frustrating many who try to make sense of the endless studies that purport to prove that one or the other approach is superior. In this note, we seek to clear up some of the confusion and to provide our point of view.

Some Definitions

Passive investing, also known as index investing, is an investment strategy that attempts to replicate the returns of an index by owning the same assets in the same proportions. Investors typically use indexed mutual funds and exchange-traded funds (ETFs) for passive investing.

In contrast, active management is an investment strategy in which managers attempt to exceed the returns of an index by picking stocks based on models and analytical research. Active managers believe that markets can be inefficient, and, therefore, that stocks can be mispriced. Active managers try to identify those stocks and exploit pricing inefficiencies to obtain excess return.

It is important to note that we are not addressing active portfolio management at the asset-class level, but rather whether a manager can add value by actively selecting the individual securities within an asset class.¹

Empirical Results

A recent study by State Street Global Advisors, notable for including the recent financial crisis and recovery, as well as the technology sector bust in 2000, comes to the increasingly-familiar conclusion that active managers can consistently outperform their indexes only in a few specialized asset classes. The study found that during the last 15 years, more than half of active managers beat their indexes in only three asset classes: small-cap blend, small-cap growth and international (Figure 1).

Like many other studies on the subject, this one points to the extreme difficulty of adding alpha (i.e., return in excess of the benchmark index) in fixed-income. More surprisingly, the study finds that emerging-market equity managers also struggle to add value. ***The study concludes that only in the few less-liquid, less-transparent asset classes can a majority of managers hope to outperform.***

Proponents of active management are quick to argue that the whole point is to do thorough due diligence to select only those active managers who are good at their jobs. After all, as shown in Figure 1, the funds that did generate excess returns in any given year outperformed by 1-2% on average, not a small number. Picking a winning manager is not so easy. In 2005, for example, just over half of large-cap blend funds outperformed

¹See Artemis Financial Advisors, *Managing Risk in Volatile Markets*, Brief No. 1, December 2011, for our views on what we call dynamic asset allocation.

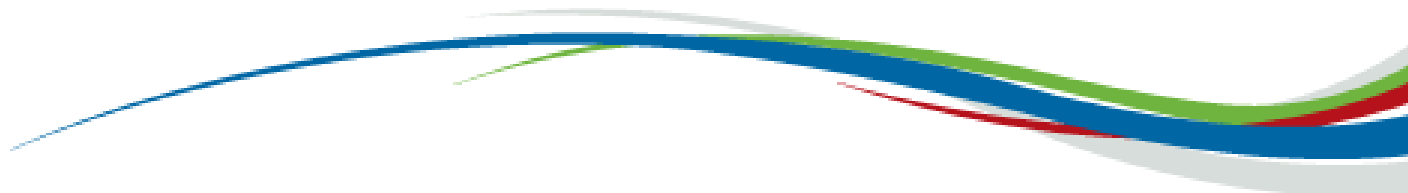
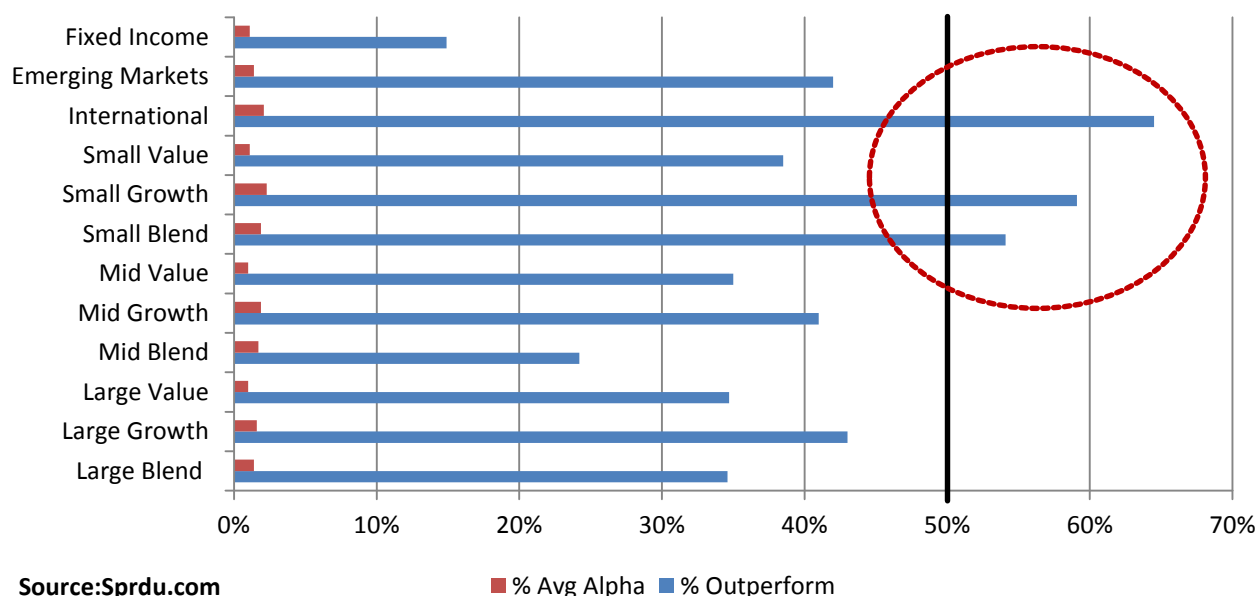


Figure 1: Long Term Performance: % of Active Managers Outperforming with Average Excess Return for Outperforming Funds (15-year annualized period from 1/1/96 through 12/31/10)



the relevant index by 2.9% on average, yet this same group of funds provided very mixed results in the subsequent five years, as shown in Figure 2. Indeed, on average this group underperformed the index by 0.41% over the following five-year period. This speaks to the point that ***while it might be easy to find an outperforming manager by looking at recent results, it is much harder to find those who can consistently beat their benchmarks.***

What is True Active Management?

One study that has generated a lot of excitement was conducted by a group of academics at Yale.² These researchers contend that a basic problem with much of the research on the topic is that many funds labeled as actively managed aren't actually all that actively managed. This is because the manager is often purchasing the same stocks as those in the style index he or she is trying to beat. According to this study, the universe of

truly actively managed funds is only about 20%-30% of all fund holdings. The remainder are either true index funds (about 12%) or so-called closet index funds because they mirror their benchmark so closely.

To identify true active managers, the authors introduce a measure they call Active Share, which describes the share of portfolio holdings that differ from the fund's benchmark. Once they examine funds with high Active Share, they find that active management does predict fund performance: the funds with the highest Active Share significantly outperform their benchmark indexes, both before and after expenses, while the non-index funds with the lowest Active Share underperform.

In summary, the study suggests that there are some really good managers, and that the best way to pick a winning one is to find a true stock picker (easily checked by comparing the fund's holdings to those in the index), who has a small fund and good performance in the prior

²Cremers, Martijn and Antti Petajisto, *How Active is your Fund Manager? A New Measure That Predicts Performance*, Yale School of Management, 2007

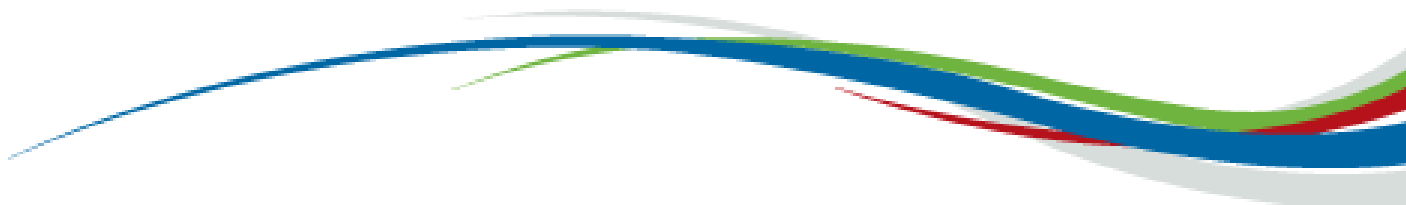
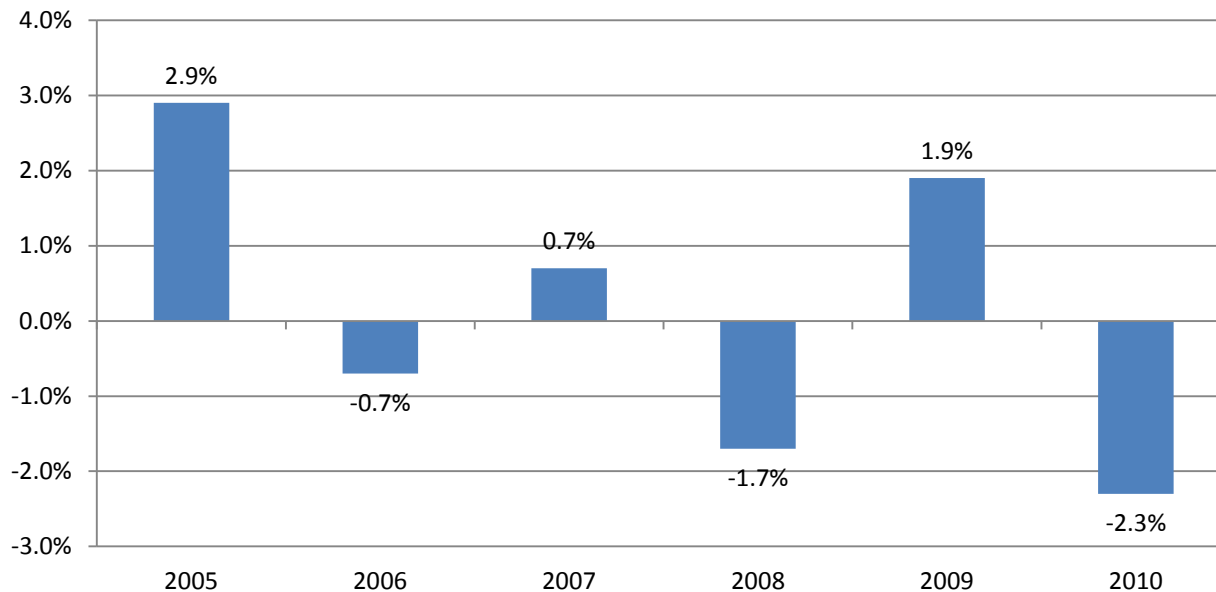


Figure 2: Average Subsequent Excess Returns of those Large Cap Blend Funds that Outperformed in



Source: Sprdu.com

year. Yet the problem with this conclusion is that, on closer examination, only the smaller funds show a statistically significant performance advantage, so it is hard to get overly excited about the study's results.

The Bottom Line

For us, the research all points to the same conclusion: **there are few true active managers and even fewer good ones.** It's even more difficult to pinpoint who will be consistently successful. Indeed, this year we have seen quite a few so-called star managers blow up — e.g., Bill Miller at Legg, Mason and Bruce Berkowitz who runs the Fairholme Fund. At the end of 2010, the

Fairholme Fund was frequently cited a great example of a mutual fund with high Active Share with persistent outperformance. The tide changed in 2011, as the performance of Fairholme in 2011 was a stunning -32.4%, versus a small gain of +2.1% for the S&P 500.

Artemis utilizes index-based funds for the majority of our clients' portfolios and only use active managers either when no good passive alternative exists, or where we believe skill and due diligence might help (e.g., emerging market debt, privately-issued collateralized mortgage obligations). Please contact us to learn more about our investment philosophy.

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