

Most asset classes were positive in May with large-cap U.S. stocks rising 2.3%. In a shift from March and April's trends, growth stocks outperformed value stocks, though smaller-caps continued to lag larger-caps as they have so far in 2014. The large-cap Vanguard 500 Index is up nearly 5% year to date while the small-cap iShares Russell 2000 index is down nearly 2% through the end of May. Economic indicators also remained mixed. In May, GDP data was revised downward to show that growth contracted by 1% in the first quarter. However, there is general optimism that the data will improve as the economy bounces back from temporary factors. The Federal Reserve's mid-month testimony echoed these sentiments, stating its expectation that growth will improve and confirming no change to their current plan for reducing bond purchases while maintaining very low policy rates. At the same time, the Fed observed softening trends in the housing market where, despite some more positive data points in May, overall growth is slower relative to peak levels a year ago. In other news, inflation has shown slight increases in areas such as food, energy, and wages. Overall, though, inflation levels remain mild.

International stocks were positive in May, slightly lagging the United States. Europe continues to contend with slow (or no) growth throughout much of the region and very low inflation overall. As May ended, attention was directed toward the European Central Bank's early-June meeting and the potential for a rate cut or other policy actions intended to stimulate the economy. Emerging markets have bounced back in 2014 following their dismal showing in 2013 (even as concerns about China's growth continue). The emerging-markets benchmark rose 3.1% in May and is up nearly 3% so far in 2014.

Treasury yields continued downward in May, hitting 2.48% by month end. The core bond benchmark was up 1%. Municipal bonds were also positive and have risen 4.8% this year. High-yield bonds continued to gain (up 1% for the month and 4.7% for the year) amidst strong investor demand for higher yielding investments and as default risk appears low. Floating-rate loans were more sluggish as interest rate declines have reduced investor appetite for securities that help protect against higher rates. The benchmark was up 0.7% in May and 2.0% year to date.

Why Are Active Managers Performing So Poorly?

The performance of active managers relative to their benchmarks has been pretty abysmal the past decade. Standard & Poor's conducts an in-depth study of active manager performance twice a year and the results are startling, the table below shows the percentage of managers that have *lagged* their benchmarks.

Report 1: Percentage of U.S. Equity Funds Outperformed by Benchmarks				
Fund Category	Comparison Index	One Year (%)	Three Years (%)	Five Years (%)
All Domestic Equity Funds	S&P Composite 1500	46.05	77.53	60.93
All Large-Cap Funds	S&P 500	55.80	79.95	72.72
All Mid-Cap Funds	S&P MidCap 400	38.97	74.00	77.71
All Small-Cap Funds	S&P SmallCap 600	68.09	87.32	66.77
All Multi-Cap Funds	S&P Composite 1500	52.84	80.38	71.74

In our opinion, there are several reasons why most managers underperform their benchmarks. The first is the *short-term mind-set* that many managers adopt as they chase momentum fads and over-trade in the "hopes" of outperforming. The manager's pursuit of short-term outperformance and the allure of higher bonuses and increased

money flows that come with outperformance, are the main contributor to the poor decision making that leads to their long-term underperformance. The antidote to a short-term mentality and underperformance is what we refer to as “time-arbitrage”. In other words, when other managers pursue short-term strategies they often drive security prices to extreme levels relative to their true intrinsic value. These short-term deviations from fair-value create tremendous opportunities to buy securities at great discounts and/or easily sell at inflated prices. Our willingness to invest with a long-term mind-set allows us to “arbitrage” these great opportunities from the short-term crowd and greatly enhances our ability to outperform the benchmarks. When selecting managers we look for those who invest with a similar long-term approach.

A second factor that causes many managers to underperform is high fees and excessive trading costs. These fees and trading costs can often add up to several percentage points a year, which over the long-term is too much of a hurdle for most managers to overcome. The answer here is simply to pay close attention to the total costs of our investment strategies and avoiding managers with excessive turnover, recognizing that the lower we keep our costs the greater our odds of outperforming our benchmarks. We stay disciplined in our trading strategies to keep costs down and expect the same from the managers we utilize.

Lastly, we see a growing trend of managers becoming “close-indexers”, rather than using their independent judgment to invest. A large percentage of fund managers invest in a very similar fashion to their benchmarks, fearing to deviate too much and risking underperformance. We view this as a recipe for disaster and most managers that invest this way, come up short relative to their benchmarks because of the higher fees they incur that the benchmarks do not. We are firm believers that in order to beat a benchmark, managers need to invest independently and be willing to make significant bets that deviate from their respective benchmarks. Active Share is a concept that we first learned about in 2010 at a Morningstar Ibbotson conference, and we think it can be useful in identifying managers that have the potential to outperform. Below is a review of the Active Share concept and how we incorporate it into our investment process.

Active Share And The Role It plays In Our Investment Process

“Active share” is an academic concept that has received a lot of attention the past few years. It implies a way to identify mutual funds that have a high likelihood of superior long-term performance. In this article, we discuss the origins of active share and our research-to-date on the subject, including its role in effective manager due diligence, implications for portfolio construction, applicability in foreign investing, and potential limitations.

DEFINITION AND ORIGIN

In 2009, researchers Martijn Cremers and Antti Petajisto published the study “How Active is Your Fund Manager? A New Measure That Predicts Performance,” they presented the idea of active share as a way to identify skillful mutual fund managers *in advance*. Active share measures the percentage of a fund’s stock holdings that is different from the fund’s benchmark index. An active share of 0% means there is no difference between a fund and the benchmark, whereas an active share of 100% means the fund shares no holdings with the benchmark. The less overlap there is between stocks owned by a mutual fund and those in the fund’s benchmark index, the higher the fund’s active share. Through their historical research, Cremers and Petajisto showed that of the equity mutual fund managers in the United States, those with the highest levels of active share—presumably the most active stock pickers—added the most value for investors over time. Many subsequent studies have also shown the value of using active share as part of the manager evaluation process.

The active share findings matter because they point to a metric that may be helpful in identifying superior managers. In a 2013 research paper, “Active Share and Mutual Fund Performance,” Petajisto showed that, on average, the best-performing equity fund managers in the United States between 1990 and 2009 were those with the highest levels of active share. These managers, who also tended to run more concentrated portfolios, easily beat the performance of managers with lower levels of active share. In fact, the high-active-share managers that performed the best (labeled “stock pickers” by Petajisto) saw significant net-of-fee outperformance. These managers tended to have low to moderate tracking error (i.e., the managers tended to not take major factor bets but were well-diversified relative to other high-active-share managers).

Another interesting finding of this and other research is that while high-active-share managers have outperformed over time, the most favorable environment for these active managers generally occurs in markets with higher dispersion of stock returns—when there are greater differences among the returns for various stocks. This is intuitive, since skilled managers only have the opportunity to perform well on a relative basis when the stocks they pick can be distinguished from all the rest. In a low-dispersion environment all stocks tend to perform similarly, so a skilled stock picker would face more of a challenge to outperform.

This new research suggests fund analysts should focus manager-selection efforts on a specific part of the active fund universe—where active share is high. However, it is certainly possible to find examples of highly active, concentrated, low-tracking-error managers who have not performed well, as well as highly active managers with significant tracking error that have performed well over the long term. The onus is therefore still on the analyst to more fully research and determine which “stock pickers” are truly skilled and which are not.

ROLE OF ACTIVE SHARE IN EFFECTIVE MANAGER DUE DILIGENCE

Assessment of active share can be an important aspect of an effective manager due diligence process. But this quantitative measure only tells part of the story because, while a portfolio might have high active share, manager skill is still required to pick stocks that are capable of outperforming the market. There are no shortcuts to determining if a manager is truly skilled, and a thorough qualitative understanding of a manager’s investment philosophy and discipline is required to judge the likelihood of long-term outperformance. A high level of active share alone is meaningless if it does not correspond to a manager’s coherent rationale for and conviction in a portfolio’s underlying holdings. To understand what drives the manager’s conviction, the investment process needs to be understood.

At AWM, the purpose of our due diligence approach is to identify disciplined managers with a well-defined investment process that should, over the market cycle, produce higher returns relative to an appropriate benchmark. Intuitively, a manager cannot easily outperform a benchmark if his or her portfolio is similar to the benchmark. One element of being able to beat the benchmark is, therefore, for a portfolio to have a high level of active share. The most important element, however, is the manager’s ability to skillfully select stocks that offer above-benchmark returns. The active share measure can be useful in informing us that our managers are doing what we expect of them, namely picking their highest-conviction stocks without regard to a benchmark. We don’t deem our managers successful or unsuccessful simply by virtue of active share, but rather by virtue of their adherence to a well-understood investment discipline executed successfully over time, of which high active share can be a natural consequence.

CONSIDERATIONS FOR USING ACTIVE SHARE

Active share is a relatively new and often misunderstood concept. A vital aspect of correctly interpreting active share is understanding the benchmark used to calculate the metric for any particular manager. Benchmark selection can significantly affect the level of active share for a manager, as different benchmarks are comprised of different constituents and different constituent weightings, and will therefore compare differently to each manager's portfolio. Care must be taken to select a benchmark that appropriately emulates the manager's investment characteristics and style. Otherwise, a misinformed investor might unwittingly be attracted to a manager who only appears to have high active share relative to other managers in the same asset class. This might occur if the manager is benchmarked to an index that is not the best reflection of the manager's style, leading to a relatively low overlap of securities (and thus higher apparent active share).

Another important point to keep in mind is that the average level of active share can differ by manager category. Small-cap managers, for instance, have a very broad universe of stocks to choose from. These managers therefore have a greater likelihood of taking significant stock bets relative to the stock weightings of their benchmark, and tend to have higher active share on average. Large-cap managers, on the other hand, have a relatively smaller universe of stocks to choose from, which could result in lower active share versus small-cap managers. As a result, when using the active share metric as part of a manager evaluation process, investors should be sure to compare "apples to apples" by comparing managers to their appropriate category and style peers.

CONCLUSION

Active share can be a natural consequence of a superior manager's investment discipline, and is a useful quantitative addition to a mutual fund analyst's toolbox. When applied correctly, it can help identify managers whose portfolios are truly different from their given benchmarks. It can also help investors avoid closet indexers. As mentioned above, active share can be useful as another data point to help inform us that our managers are selecting their highest-conviction stocks. However, this is just one of many elements we consider in conducting our manager due diligence, the most important being a qualitative assessment of the manager's investment discipline, process, and philosophy.

Even though it might be tempting for investors to rely solely on this new measure at the expense of thorough due diligence, investors still need to do the work necessary to determine which active managers possess skill and which do not. To be able to truly discern a manager's skill (as opposed to simply a manager's "activeness"), it is important to understand what drives a manager's conviction and strategy and how effectively they have delivered results. We find the research on active share to be noteworthy, and believe that it provides further evidence that our qualitative due diligence process lays a solid foundation for successful active fund investing.

—AWM Investment Team (6/14)