

# The Benefits of Utilizing Active Management in Portfolios

As a group, mutual fund managers have a difficult time beating their benchmarks. It has been considered common knowledge ever since John Bogle began writing about investing in index funds in the 1970s. The seemingly logical conclusion is that individual investors are better off buying a diversified portfolio of index funds than a portfolio of managers who strive to beat their benchmarks.

It is understandable why, for many, this is gospel. Passively managed mutual funds and exchange traded funds (ETFs) do have lower expense ratios than actively managed funds, and there is much research to support the claim that as a group fund managers do not beat their stated benchmarks over an extended period of time.

But when examining the case for passive investing, a crucial part of the argument is the phrase “as a group.” Research demonstrates that some fund managers do outperform their benchmarks on a consistent basis – and, with due diligence, these managers can be identified.

The first step is identifying the factors that are common among the fund managers who have historically demonstrated the ability to beat benchmarks. According to research by RidgeWorth Investments, fund managers who consistently outperform have several characteristics in common: longer management tenure, a more consistent investment style, and a lower expense ratio than the average mutual fund.

They also tend to have a higher “Active Share” than other funds in their category. Active Share, a concept introduced in 2006 by Dr. K.J. Martijn Cremers and Dr. Antti Petajisto of the Yale School of Management, measures the percentage of stock holdings in a manager’s portfolio that differs from the benchmark index. The

Active Share of a fund varies from 0% (for an index fund) to 100% (for an active manager portfolio with no overlap with the benchmark).

Cremers and Petajisto examined 2,650 funds from 1980 to 2003 and found that those funds with an Active Share of at least 80 percent beat their benchmark by 1.49 to 1.59 percent after fees.

Of course such analyses should be followed by extensive due diligence of each fund manager, however the data confirms that a carefully vetted group of active managers can provide meaningful additional returns versus a passive index.

This does not mean that a portfolio should consist entirely of active fund managers in every asset class. Historical evidence suggests that fund managers in certain asset classes tend to beat their benchmarks more often than managers in other asset classes, possibly because the markets of some asset classes are less efficient than the markets of other asset classes. *(continued on page 2)*



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Market efficiency is the degree to which asset prices reflect all of the information that is publicly available. In a perfectly efficient market, all securities are precisely valued and no active manager has the ability to outperform the market. In a perfectly inefficient market, almost any skilled manager would be able to beat the market.

HBKS believes that a portfolio that combines the careful selection of active managers with passive index funds in certain efficient markets can add value versus a purely passive portfolio.

A study published by the CFA Institute showed that foreign markets, especially emerging markets, are less efficient than markets in the U.S., and so active management can add value. Domestically, fund managers in the Small Cap, Micro Cap, and Large Cap Value styles have also done better than managers in other markets in beating their benchmarks. Where advisors restrict themselves to a passive-only approach in these markets, the case could be made they are missing an opportunity to add value through skillful active managers. In the very efficient Large Cap Core category, active management is unlikely to add value over the long term, although there could be value in benchmark-like returns where tax losses are captured to offset gains elsewhere in the portfolio.

Another factor for consideration is the current market environment. There have been many periods when more active managers outperformed their stated benchmarks. There also have been stretches when a passive index approach was extremely difficult to beat. We believe that today's investment environment dictates using active managers in most asset classes.

Also, index products carry greater market risk exposure; by definition, an index mutual fund or ETF must own all that is in the index. As well, many of the most popular active mutual funds have become "closet indexers" and are now so large they must own these same investments in order to closely track the index. This is an important consideration in the current market environment. Most investments are richly valued after five years of strong returns. If broad markets take a downward turn, these funds will offer little protection. Losses are likely to be magnified by the forced selling of commonly held assets. On the contrary, active funds can avoid assets that could be most at risk thereby providing somewhat of a cushion in down markets.

So while we believe in blending active and passive approaches where appropriate, in the current environment we favor active management relative to most asset classes. □

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