

Excess Returns

Monthly insights for investment marketing and sales professionals



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How do true active investment managers sell themselves in a market that has become deeply skeptical regarding claims of active management? This issue of *Excess Returns* offers advice to active managers seeking differentiation from the crowd of closet indexers.

With best wishes,

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Alpha Partners is an investment marketing firm specializing in research and presentation strategy. Our goal is to create alpha (excess returns) by helping investment firms win, keep and diversify assets under management.

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Benchmark Atheists

I vividly remember the stab of dismay I experienced the first time I heard the term “benchmark agnostic.” I understood that this was a new way to describe active management, but I could not reconcile the concept of agnosticism (lacking in belief, sitting on the fence) to an activity that requires conviction for success. Since that time, “benchmark agnostic” has become a term of art in the investment industry. It is widely used and most people know what it means.

As a human being, I want badly to believe in active management, to believe that the hard work and analytical powers of my fellow humans can generate excess returns. Sustaining this belief these days, however, has become increasingly difficult. The concept of being “agnostic” — the label many active managers now proudly wear — somehow does not convey the requisite conviction. And the rising popularity of [active share](#) as a measure of active management has made it easier to uncover the widespread practice of closet indexing among public equity managers. A study of institutionally focused products by Hewitt Ennis Knupp found that demonstrated skill in active equity has steadily declined since the 1990s to the point where “less than 2% of active equity managers have demonstrated evidence of skill net of fees.”¹

Less than 2%. That is one mighty depressing number. So what if you are an active manager in today’s increasingly skeptical market? How can you convince prospective investors that your strategy is truly active? Here are some suggestions.

Strategies for Selling Active Management

Tell a differentiated story. If your marketing materials and presentations don't say anything different, how can you convince investors that you are doing anything different? A lot of investment firms claim to manage portfolios that are different from the benchmark, but based on review of their marketing and client communications, it is impossible to determine what these differences might be.

If you've got a concentrated portfolio, flaunt it. I have worked with many portfolio managers over the years who initially did not appreciate the marketing power of a concentrated portfolio. Their marketing materials emphasized "in-depth fundamental research" or "excellence in execution" or "a culture of integrity" — all nice to have but difficult to prove and not necessarily differentiating. According to a 2014 Cambridge Associates study, managing concentrated portfolios or a small number of portfolio positions "implies more conviction in each investment ... [helping to] focus a manager's attention and reduce the potential for complacency with smaller positions."² And yet many concentrated portfolio managers don't even mention the number of holdings in their communications — or, if they do mention a concentrated strategy, do not explain and consistently reinforce its merits.

Preempt any misperception that your portfolio may be overly diversified. The market's appetite for concentrated strategies sometimes leads people to forget that portfolio diversification is still often necessary and desirable. In highly volatile, less efficient markets and asset classes, you may need to remind prospective clients that greater diversification does not equate with closet indexing but with more opportunities and less potential risk of capital loss.

Work harder to mitigate human behavior risk. In addition to closet indexing, one of the biggest enemies of active management is human behavior risk, manifested as the stated desire for active management combined with the inability to tolerate the volatility that comes with it. Given human behavior risk, Hewitt Ennis Knupp has recommended that investors treat high-conviction public investment strategies "*as if they were illiquid* like private investments, and pledge to resist making portfolio changes mid-stream."

From a sales, marketing and client service perspective, I see investment firms spending a lot of time communicating about how they measure and manage investment risk. But they should spend more time communicating in ways that mitigate human behavior risk.

There are a lot of white papers, studies and seminars providing education on the merits and challenges of long-term investing — worthy activities and events all at one remove from the process of getting and keeping clients. But rarely do I see marketing materials with education embedded in the story — education about when a strategy is likely to underperform and why and the benefits of being a patient client. Even if a firm does cover this information in its sales materials, only infrequently is it reinforced clearly and consistently in client service meetings. I suspect this is because, in the heat of battle while selling directly, some firms are reluctant to shine any light on past performance shortfalls, which then makes it difficult to provide education about performance in a client service context. Such reluctance may result in signing up the wrong kind of clients (the impatient kind) and an inability to keep even the right clients during performance declines.

A very successful portfolio manager I have stayed in touch with over the years once said, “Benchmark agnostic? Hell, I’m not an agnostic. If anything, I am a benchmark atheist.” Regardless of what label they choose to use, active managers should consider that this is exactly what the most desirable, loyal clients are really looking for: benchmark atheists.

Active Share

Mercer Investments has incorporated active share into the firm’s analysis of individual managers and entire portfolios while many investment firms now monitor active share for all portfolios. What is active share? It is a measure of the level of active management in a portfolio achieved through (1) holding securities not in the index, (2) *not* holding securities that are in the index and (3) holding stocks in different weights than the index. A portfolio with 0% active share essentially is a pure clone of the index while a portfolio with 100% active share has no holdings in common with the index.

The term was coined based on work by Martijn Cremers and Antti Petajisto in their August 2009 research paper, “How Active is Your Fund Manager? A New Measure that Predicts Performance.”³ Cremers and Petajisto concluded that portfolios with higher active share generated better average returns than their lower active share counterparts. Subsequent studies and articles have revealed important nuances around the interpretation of active share:

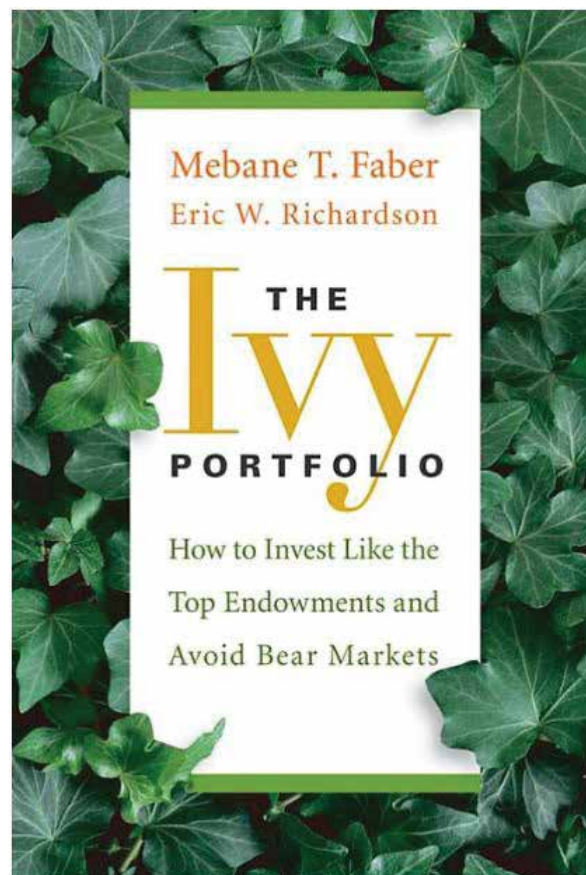
- Small-cap portfolios tend to have significantly higher active share. While 80%+ may indicate true active management among large-cap developed equity managers, Cambridge Associates has observed that “95% may be a better cut-off to determine truly active US small-cap managers.”
- Cambridge also concluded that “combining insight from active share and portfolio concentration with tracking error can help investors identify managers that may be better poised for success, with both a better distribution of outcomes and a better average outcome.”
- Undesirable style and market cap drift can increase active share for the wrong reasons. Fidelity Investments has studied the phenomenon of large-cap managers with high active share derived mainly from investing in out-of-mandate smaller-cap stocks.⁴

In sum, consider the source of active share. Unlike other predictive measures, active share is relatively easy to understand and already has been widely adopted by the consulting community. Even if investment firms choose not to use active share explicitly in their marketing, they can expect to be asked questions about the level and composition of active share in their portfolios.

Ivy Investing

The Ivy Portfolio: How to Invest Like the Top Endowments and Avoid Bear Markets provides inspiration to those of us who still believe in active management. Written by Mebane T. Faber and Eric W. Richardson of [Cambria Investment Management](#), *The Ivy Portfolio* profiles successful university endowments such as Yale, which came under fire in the aftermath of the financial crisis for its emphasis on equity-oriented, illiquid asset classes. Yale, however, lived to fight another day. In the 20 years ending June 30, 2013, the Yale endowment generated returns of 13.5% per annum relative to 8.4% per annum for the median Cambridge Associates manager — a result that Yale attributes to “disciplined and diversified asset allocation policies and superior active management results.”⁵

The Ivy Portfolio documents how large endowments have achieved investment success through size, relationships, allocations to alternative assets and superior active management — with advice on where individual investors should (and should not) consider using the same strategies.



The Ivy Portfolio is an interesting and enjoyable read not only for investors but also for sales and marketing professionals who want to learn more about the university endowment market.

1. “Conviction in Equity Investing,” a 2012 research study by Hewitt Ennis Knupp. All references to the views of Hewitt Ennis Knupp in this issue of *Excess Returns* are based on this study.
2. “Hallmarks of Successful Active Equity Managers,” an April 2014 research study by Kevin Ely of Cambridge Associates. All references to the views of Cambridge Associates in this issue are based on this study.
3. Martijn Cremers and Antti Petajisto, “How Active Is Your Fund Manager? A New Measure That Predicts Performance,” *Review of Financial Studies* 22, no. 9 (August 2009). This article was followed by “Active Share and Mutual Fund Performance,” by Antti Petajisto, *Financial Analysts Journal*, 69, no. 4 (July/August 2013).
4. “Active Share: A Misunderstood Measure in Manager Selection,” Fidelity Investments, February 2014.
5. The Yale Endowment 2013 annual report.