ACTIVE MANAGEMENT

Don’t be too quick to write it off
The recent strong performance of index-based investment funds has led to an outflow from actively managed funds and sparked an intense debate on the relative merits of passive versus active investment strategies. This debate is often framed as an all or nothing proposition, but it need not be. As longtime users of both active and passive management, we believe that there are specific types of active managers who add value, and combining passive strategies with these carefully selected active managers can be the optimal approach to meeting clients’ investment objectives.

In the next few pages we explore qualities of successful active managers and discuss in greater depth our views on employing active management.
THE BULL MARKET IN INDEXING

Over the past decade, investors have withdrawn more than $1 trillion from actively managed mutual funds and placed $1.4 trillion in indexed mutual funds and Exchange Traded Funds (ETFs).

Table 1: Cumulative Net Cash Flow into Index and Active Mutual Funds and ETFs

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<thead>
<tr>
<th>Year</th>
<th>Index Mutual Funds</th>
<th>Index ETF's</th>
<th>Actively Managed Funds</th>
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<tbody>
<tr>
<td>2007</td>
<td>0</td>
<td>0</td>
<td>0</td>
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<tr>
<td>2008</td>
<td>0</td>
<td>0</td>
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<td>2009</td>
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<td>2011</td>
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<tr>
<td>2016</td>
<td>0</td>
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DISAPPOINTING PERFORMANCE OF ACTIVE MANAGEMENT

Disappointment with after-fee, after-tax performance is a major driver of this shift. Over the past 15 years an overwhelming majority of active mutual funds have underperformed across all major asset class categories.

Table 2: Percentage of Active Mutual Funds Underperforming Their Benchmarks, 15 years to 12/31/16

Because active funds tend to trade much more frequently than index funds, after-tax performance is even worse than the chart indicates.

At Tiedemann we take this evidence seriously, which is why indexed investments play a prominent role in our clients’ portfolios.

However, a closer look at the data and our own experience indicate that a certain type of active manager can add value.

We believe that the best way to construct portfolios is to combine indexing and active management, focusing our use of the latter on a small group of strategies in areas where active management is most likely to succeed.

SOURCES

Table 1: John Bogle, Strategic Insight Simfund
Table 2: SPIVA
Quantitative studies of active manager returns focus almost exclusively on mutual funds. Most active mutual funds share a set of characteristics that make them particularly ill-suited to achieving excellent long-term performance. These include high costs, poor alignment of interests, excessive sensitivity to benchmarks and a short-term orientation.

However, studies that dissect active manager return data more carefully suggest that a particular type of manager is capable of outperforming the indices over time, even though the average manager is not. The qualities that are associated with success include:

1. Concentrated, high-conviction portfolios. Most active mutual funds are highly diversified, with about two-thirds holding more than 50 positions. Less than 5 percent have 25 or fewer holdings, as the below chart shows. Overdiversifying allows a mutual fund manager to grow assets under management (and fee income) without running into liquidity constraints and protects against the sort of embarrassing underperformance that could cause investors to pull their money.

Researchers have found that mutual funds with concentrated, high-conviction portfolios outperform. Petajisto and Cremers (2009, 2013) created a metric they call active share to quantify the extent to which a portfolio’s holdings differ from its benchmark index. They found that mutual funds with high active shares beat their benchmarks by significant margins after fees. Cohen, Polk and Silli (2009) found that mutual fund managers’ highest-conviction positions—defined as the largest overweights relative to the underlying index—outperformed the benchmark by a significant margin over a 15-year period. These results indicate that even run-of-the-mill mutual fund managers are skilled stockpickers, within the small portion of their portfolios that they devote to stockpicking rather than indexing.
2. Long-term orientation. Do these benchmark-indifferent managers outperform by capitalizing on fleeting anomalies in stock prices or by owning a small group of businesses for many years? The numbers suggest it is the latter. Cremers & Pareek (2014) found that among retail mutual funds with high active shares, the quintile that exhibited the lowest turnover in holdings outperformed its benchmark after fees by 1.9% per year, while those that traded frequently underperformed, regardless of how much their holdings differed from the index.

Allocating capital successfully to active managers requires a similarly patient, long-term mindset. This point is nicely illustrated in a 2015 study by Vanguard, which analyzed the small group of mutual funds that managed to outperform their benchmarks between 2000 and 2014. The path that most of these funds followed to long-term outperformance was extremely bumpy: more than half experienced seven or more calendar years of underperformance, and two-thirds lagged for three consecutive years or more.

3. Low costs. When it comes to active management, you do not get what you pay for. There is no evidence that mutual funds with high fees are run by more skilled managers. In fact, the best-performing active funds are those with the lowest fees. The chart below, which splits the universe of actively managed mutual funds into the most expensive and least expensive quartile, shows that over every time frame the funds in the cheaper group were more likely to beat their benchmark, while only a miniscule percentage of the expensive funds outperformed.

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4. Independent, focused parent firms. Most active mutual funds are mediocre products because the companies that run them are large, publically-traded “financial supermarkets.” Of the top 50 mutual fund families in the US, only ten are independent, privately held firms. Many of the largest mutual fund companies participate in a variety of non-investment businesses and offer dozens of products across different asset classes, geographies and styles. Investment professionals rarely have significant equity ownership or influence on firm strategy.

The data suggest that investment products offered by large, externally owned investment organizations underperform those of smaller, independent employee-owned firms. A 2015 study by Affiliated Managers Group found that firms classified as boutiques—those with less than $100 billion in assets under management, no non-

Table 4. Percentage of Actively Managed Funds That Have Outperformed Their Benchmark

<table>
<thead>
<tr>
<th>PERCENTAGE OF UNDERPERFORMING FUNDS</th>
<th>0%</th>
<th>20%</th>
<th>40%</th>
<th>60%</th>
<th>80%</th>
<th>100%</th>
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<tbody>
<tr>
<td>10 Years</td>
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<td>25 Years</td>
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Most expensive quartile
Least expensive quartile

SOURCES

Table 4: Vanguard
The data suggest that investment products offered by large, externally-owned investment organizations underperform those of smaller, independent, employee-owned firms.

The average boutique-run product beat its benchmark by 140 basis points per year net of fees. Top-quartile boutiques outperformed by 589 basis points per year, and top-decile boutiques beat their benchmarks by an astounding 1,133 basis points annually. The exceptional performance achieved by the top boutiques suggests that expending time and effort to find the very best managers can bring large rewards.

Table 5. Top-Performing Boutiques vs. Indices: Top-decile boutiques beat indices by average annual 1,133 bps

- BEATING THE MARKET REQUIRES TIGHT FOCUS. The set of active managers who are capable of sustained after-fee outperformance is small. Identifying them and ensuring that they do not stray from their initial discipline is hard work. This argues for maintaining a small roster of active managers focused on areas where inefficiency and potential for outperformance is greatest. Tiedemann employs specialists in regions such as Latin America, Asia, and Africa/Middle East, where we believe managers with strong local knowledge have an advantage. Because we have found few managers who are capable of adding significant value in larger domestic companies, we index this portion of our asset allocation (with a tax-loss harvesting overlay where appropriate) and focus our manager search and monitoring efforts on areas of greater inefficiency.

- AVOID MOST ACTIVELY MANAGED MUTUAL FUNDS. Most mutual funds are mediocre, particularly those run by large, public companies with multiple products. We avoid these types of firms entirely. We use few mutual funds—they represent only 15% of our representative unconstrained portfolio—but recognize that mutual funds can play a role in asset classes such as non-US equities or taxable bonds where registration requirements and execution costs are a burden.

- EMPLOY TRUE BOUTIQUES. The data suggest that top boutiques beat average active managers (and passive indices) by a wide margin. We define boutiques
as employee-owned firms with focused product offerings and significant partner capital invested alongside their clients. One of the managers Tiedemann employs, Southeastern Asset Management, prohibits its employees from investing in equities outside of the firm’s funds. Much of our due diligence on managers focuses on whether they have adopted these and other “best practices.” Does the firm have a culture that rewards excellence and integrity? Does it have a history of turning down additional assets when investor demand outstrips the supply of attractive opportunities? Does it reinvest its cash flow in upgrading its capabilities to improve the likelihood of future success? Is there a stable partnership and a succession plan in place that will ensure the longevity of the firm?

• KEEP FEES LOW AND USE PERFORMANCE-BASED FEE STRUCTURES TO ALIGN INTERESTS. By focusing on a small number of managers for whom we represent a significant pool of assets, we improve our ability to negotiate lower fees and incorporate success-based provisions. Where possible, we structure fees that have a low fixed component and an incentive that rewards the manager for outperformance. This is something that most mutual funds are not able to do. As a result, the average fixed fee on our unconstrained long-only equity portfolios is about 0.80%. This compares to a median fee for comparable global mutual funds of about 1.2-1.3% and a 0.33% fee for a purely passive global equity fund such as the iShares ACWI ETF.

• USE CONCENTRATED, HIGH-CONVINCION ACTIVE MANAGERS WITH COMPLEMENTARY STYLES. We favor managers who own concentrated, benchmark-indifferent portfolios because our experience and the academic research suggest that these types of managers are most likely to outperform. Yet we recognize that any one manager is likely to fall out of favor, sometimes for extended periods. By combining managers with different investment styles, we seek to reduce the likelihood that multiple managers underperform simultaneously. This increases our staying power with managers and allows us to take advantage of rebalancing opportunities, taking capital from managers who have outperformed and adding to those whose style has been out of favor.

• FOCUS ON REPEATABLE PROCESSES DEMONSTRATED OVER AN EXTENDED PERIOD RATHER THAN RECENT RETURNS. Few investor behaviors are as destructive as performance-chasing. One reason why so many mutual funds become “closet indexers” is the tendency of investors to pull money from underperforming strategies. We believe that success in all forms of investing requires a more forward-looking mindset, as well as an ability to recognize a sound process even when results are unfavorable. In evaluating active managers we focus first on how they make decisions. If the philosophy and process articulated by the manager are attractive we will then examine whether the portfolio has reflected them consistently over time. Only then will we delve into a quantitative evaluation of performance, to confirm that it too is consistent with what we understand the manager’s strategy to be.
In conclusion, we believe that both active and passive management are valuable tools when employed properly to meet clients’ objectives. Which tool is most appropriate depends on a set of factors that advisors must evaluate objectively and with a focus on risk-adjusted performance net of all costs. What is often overlooked in the active versus passive debate is that both active management and indexing can be implemented poorly or effectively. Succeeding with active management requires a sharp focus on less efficient segments of the markets and on exceptional money management firms with the right incentives, as well as the patience to ride out extended periods of underperformance. Users of active management who stick to these disciplines have a much better track record than the widely cited statistics on active mutual funds would suggest.