Institutional Perspectives

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Leith Wheeler INVESTMENT COUNSEL LTD. | Quiet Money.®

Probing Passive, Part II: How to Win in Active Management

In Part I of this series, we reviewed the rise of passive investing and flagged some unintended consequences that have resulted. In Part II, we review recent financial literature which queries the robustness of the 20th century research which became 'conventional wisdom' about active vs passive management – and importantly, to what extent it still applies in the 2020s. We then review a checklist that sophisticated investors and consultants follow to help find a skilled active equity manager.

Understanding How We Know What We Know

Much of the fuel for passive demand over the last 25 years has arisen from the prior 30 years of studies interrogating the value of active, culminating in Mark Carhart's 1997 article about the persistence of mutual fund outperformance. A 2019 white paper[i] claims, however, that the authors' forebears were, well, overly bearish on active management. The paper counters four of the key original claims as well as their relevance 20 years on – summarized in Figure 1 in brief:

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> **It is our strong belief that active management adds value – passive investing has its merits, but cannot take advantage of market inefficiencies and therefore doesn't offer additional returns.**
>
> **- Willis Towers Watson[iii]**

Figure 1: Research Challenging Original Conclusions About the Value of Active Investing

Claim	Response (Cremers, Fulkerson and Riley - 2019)
"The average active manager doesn't outperform"	The methodology of the original studies were imperfect as they didn't always compare active funds to investable benchmarks. They were also very end date-sensitive and focused entirely on the (efficient) US market.
"Fees make active management uneconomic"	Active fees in the US have fallen by 20% since 1997, which changes the conclusions materially.
"Persistence of performance is not there"	At least one study points to persistence of performance in 10-20 percent of skilled managers.
"Skilled managers are more expensive"	Two of the 2019 white paper's authors are in fact the originators of the concept of active share[ii] and they suggest that among the funds with high active share (i.e., not benchmark hugging) there is strong evidence they do not underperform and in many cases, outperform. High-cost benchmark huggers thus pull down the overall results.

Assuming then, for the moment, that the theoretical underpinning for passive's superiority needs scrutiny, or at least an updated view, let's look at when passive or active may make the most sense in client portfolios.

The Case for Active

Let's go back to the basic math of net returns. The case for 100% passive makes sense if you consider it versus the *average active manager* – because the average active manager (who neither beats nor lags, wins nor loses more than others) will earn the *market return*. Therefore, clients of that manager will lag the market by the amount of his or her active fees.

Remember, however, that while that is the fate of the *average* active manager, it is also the fate of *every* passive manager – whose goals are all to match that average market performance, before fees. So if the assumption is you will end up hiring the average active manager (or worse), then paying the lower fee for passive is indeed the correct choice.

The world's largest consulting firms believe in active, however, if performed by a skilled manager. **Willis Towers Watson**, which advises on $2.6 trillion worldwide, says in this recent *Financial Times* article, it is urging clients to prioritize active over passive based on concerns about concentration of returns among a few leaders, implications for climate change, and improved opportunities to take advantage of volatility in active. **Mercer** also chimes in, reinforcing the consulting firm's belief in high-conviction active management and pointing to the potential for "quite a high dispersion of returns" going forward.

Figure 2 demonstrates this positive relationship between high conviction, high active share portfolios and outperformance, when executed by a skilled manager.

Figure 2: Skill + Conviction– Portfolio "Filler" = Outperformance

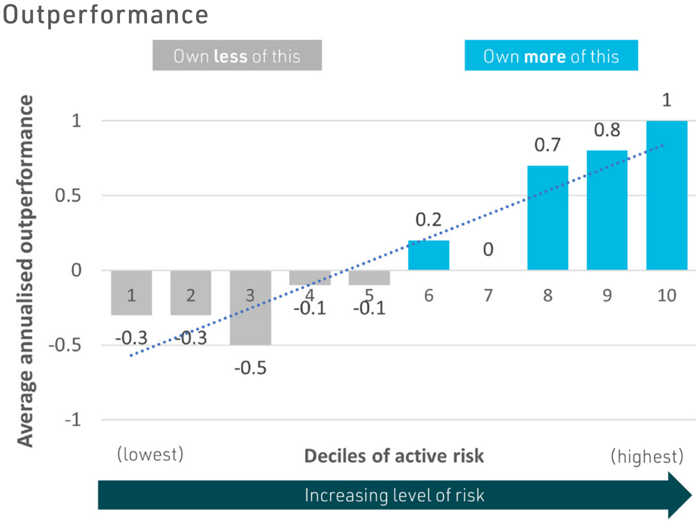


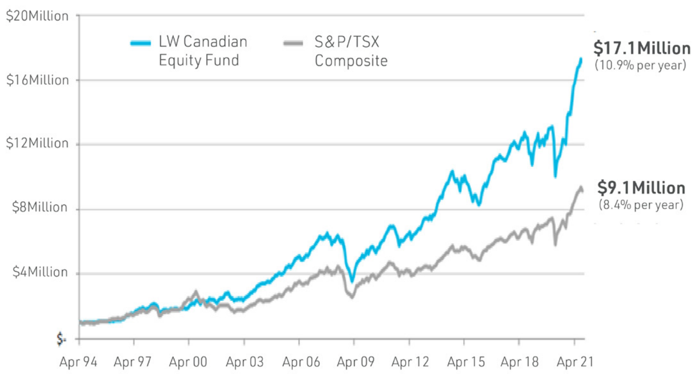
Chart source: Willis Towers Watson.

Data source: Sebastian & Attaluri (2014), Petajisto (2013).

Of course, as managers of equities with a track record through September 2021 of outperforming the S&P/TSX

Composite Index before fees by 2.5% per year since the fund's inception in 1994[iv], we believe in the value of active management. Figure 3 shows how $1 million in the strategy would have translated into a near doubling of the market's gains (again, before fees).

Figure 3: Leith Wheeler Canadian Equity Fund vs S&P/TSX Composite – Growth of $1 million since Inception (April 27, 1994 – September 30, 2021)[v]



Source: Leith Wheeler Investment Counsel Ltd, Bloomberg/S&P Dow Jones Indices.

If a well-chosen active manager can generate significant value for their clients, what criteria should you apply in finding them?

How to Identify an Active Manager with Skill

The world's largest consulting firms are a great place to start, and they suggest looking for the following:

Goals aligned with yours: Fee structures and employee incentives need to align with client experience. Long-term investors should look for managers who charge fees and compensate their professionals based on long-term performance. Look for investment professionals who invest with their clients in the exact same pools as well.

Suitable portfolio concentration: For fundamentally managed active strategies, the preference is for more concentrated portfolios with fewer names, allowing for risk. Managers that do the work and have the conviction to hold larger positions tend to deliver alpha over time. This aligns with the theoretical work discussed above about building non-index-like portfolios.

Employee ownership: Having the person across from you be an owner of the firm managing your money makes a big difference in a variety of ways. One, partners of the firm are able to make long-term decisions not available to a division of a larger organization which faces short-term sales and profit targets. Two, the focus of those decisions tends to be more client-centric as there is an appreciation of the unique client-partner relationship. An example might be the decision to close a strategy to new business in order to protect the performance of existing ones – prioritizing asset management over asset gathering. Three, we have seen consultants express a preference for broadly held ownership, as this allows for critical, independent thinking and also lowers the risk of a sale by large shareholders.

Good teams over stars: Well-constructed teams of skilled and experienced individuals with aligned incentives are preferred over a few talented stars. Teams have the ability to be more resilient over time, are inherently more likely to be diverse, and – with clear accountabilities in place – benefit from contrary points of view.

Healthy corporate culture: Famed strategist Peter Drucker once wrote, "Culture eats strategy for breakfast." A very underappreciated factor that is only recently being explored and framed, culture keeps all of the above going and evolving slowly over time. While simple to intuit, culture is hard to execute. It is an expression of shared values that occurs in each daily interaction and decision, and endures over time. Managers who have it down understand what's at the core of their culture, nurture it internally, and hire for it. Further, to the alignment points above, good culture is more than lip service – it is bolstered by the structure of the firm, with the incentives of the professionals aligned with their clients through broad equity ownership of the firm itself and the strategies being managed.

(Ignore short-term performance - unless there's a risk meltdown): It is not an accident that this element appears down the list. While past performance is an easy filter to create shortlists, as the saying goes, "past performance is not indicative of future performance." Lacking in predictive power, short-term past performance can in fact be a contrarian indicator as managers and styles can go through performance cycles similar to broad market ones. Retail investors (and sometimes institutional ones) can fall for the temptation of the year's top performer, only to see that outperformance evaporate in a few years. Who your manager is and how they manage your portfolio is many times more important than what numbers they put up last year. Long-term, persistent outperformance matters more than short-term trends, especially during periods of high volatility.

Skill, not luck: When assessing a manager's longer-term past performance, it is important to be able to separate skill from luck – or just plain old beta (market exposure). Within specialty mandates, your consultant may compare headline performance to broad or style indices, measure the variability of performance relative to those indices to detect how much the manager deviated from or hugged those benchmarks, or break down in a more detailed way (attributing sector exposures, stock exposures) exactly how the value was created in the portfolio. We touched on persistence of performance above; it's worth looking at rolling 4-year performance records and/or annual performance over an extended period to see if the manager, say, lost money for nine consecutive years and then had a blowout year – because he took on a bunch of extra risk.

Within balanced portfolios, you'll want to see how much value the manager generated by overweighting or underweighting asset classes over time, and to what degree this strategy is employed.

Proactive succession planning: Investment management firms are like any of the businesses they may choose for your portfolio, growing and evolving – and aging. The mark of a good manager is clear and transparent planning for succession of more junior staff into roles of responsibility as the senior professionals approach retirement. You should also look for long lead times to retirement of more than one year, demonstrating the manager will be able to train and transition responsibilities effectively.

For all the criteria we can list, it's important to remember that the best search for a skilled active manager begins with curiosity and an understanding that it's more about Who and How, than What. This mindset will also serve you just as well in assessing an existing manager as it will in selecting a new one. For it's a consistent, transparent, predictable application of these best practices that will generate outperformance over the long-term.

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Endnotes

i Cremers, K. J. Martijn and Fulkerson, Jon A. and Riley, Timothy Brandon, Challenging the Conventional Wisdom on Active Management: A Review of the Past 20 Years of Academic Literature on Actively Managed Mutual Funds. 2019. Financial Analysts Journal. URL: https://ssrn.com/abstract=3247356

ii Cremers, K. J. Martijn and Petajisto, Antti, How Active is Your Fund Manager? A New Measure That Predicts Performance. 2009. URL: https://ssrn.com/abstract=891719 or http://dx.doi.org/10.2139/ssrn.891719

iii Willis Towers Watson. Seeking to improve your active equity portfolio. 9 Novermber 2018. URL: https://www.willistowerswatson.com/en-CA/Insights/2018/11/better-equities-improving-your-active-equity-portfolio.

iv Note Leith Wheeler has managed a Canadian equity strategy since 1982 but the longest-dated, published performance is from March 1994

v Notes: Fund performance is gross of fees. Fund and index performance are annualized for periods greater than one year, returns shorter than one year have not been annualized. Fund and index performance are total return expressed in CAD currency. The inception of the LW Canadian Equity Fund (Series B) was on April 27, 1994. LW Canadian Equity Fund (Series B), pre-fee returns to Sept 2004, then (Series A) pre-fee returns thereafter..