Active Management Unleashed: Addressing Mutual Fund Design Flaws and Reestablishing Value

GDC Research – 2018

Active Managers have continued to lose ground to Passive solutions over the past decade in terms of net flows and perceptions of value. After years of debate and analysis, can Active Managers turn the tide on this trend? The report "**Active Management Unleashed: Addressing Mutual Fund Design Flaws and Reestablishing Value**" provides 1) Advisor perceptions of active vs passive investments, 2) validation of active managers' skill in selecting securities and, 3) identification of mutual fund design flaws that impede active managers' performance.

This White Paper provides valuable insights and cost-effective recommendations that can benefit executives at fund companies, ETF providers, as well as large consumers of active management such as broker-dealers, insurance firms, and institutional investors.

The 40-page whitepaper employs an in-depth and prescriptive analysis that isolates and evaluates high conviction stock selections from top-rated actively managed mutual funds to determine active manager skill, and involved an online survey of over 200 Financial Advisors that explored a variety of attitudes and perspectives regarding Active and Passive Management. But perhaps most importantly, the Paper provides actionable and achievable recommendations for performance improvement.

The White Paper provides buyers with the following insights:

- Advisors' perceived value of Active vs Passive Management
- Advisors' current and future use of investment solutions in client portfolios
- Critical perceptions regarding commoditization of active management and advice
- Evidence that Active Managers have skill in securities selection
- The trade-offs between tracking errors and the diluting effect of **Beta Anchors**
- The tangible benefits of diversification at the process level
- Prescriptive recommendations to employ and improve performance

Table of Contents

TABLE OF CONTENTS **2**

LIST OF EXHIBITS **3**

I. EXECUTIVE SUMMARY **4**

II. INTRODUCTION **6**

III. METHODOLOGY **8**

A. ANALYZING IF ACTIVE MANAGERS HAVE SKILL 8

B. DETERMINING IF THE MUTUAL FUND HAS LEGACY DESIGN FLAWS INHIBITING PERFORMANCE 9

IV. THE ACTIVE VS PASSIVE DEBATE – THE ADVISORS' PERSPECTIVE **12**

A. KEY TAKEAWAYS 12

B. ACTIVE MANAGEMENT VALUE WITH ADVISORS 13

C. ACTIVE MANAGEMENT OUTFLOWS AND UNDERPERFORMANCE 16

V. ASSESSING IF ACTIVE FUND MANAGERS HAVE SKILL. **20**

A. KEY TAKEAWAYS 20

B. SECTION INTRODUCTION 20

C. COMPARING LARGE-CAP BLEND PEER GROUP RETURNS 21

D. CONCENTRATED PORTFOLIOS 23

VI. LEGACY DESIGN FLAWS OF THE MUTUAL FUND **29**

A. KEY TAKEAWAYS 29

B. SECTION INTRODUCTION 30

C. HIGHER EXPENSE RATIOS 30

D. THE IMPACT OF THE BETA ANCHOR 31

E. SINGLE MANAGER DESIGN - LACK OF DIVERSIFICATION AT THE PROCESS LEVEL 35

VII. CONCLUSION **39**

List of Exhibits

Exhibit 1: Hypothetical Portfolio Allocation and Resulting Beta Anchor.....10

Exhibit 2: Comparison of Single Manager vs Multi-Manager Fund Design.....11

Exhibit 3: Value of Active vs Passive Investment Products in Managing Client Portfolios.....13

Exhibit 4: Advisor Ranking of Benefits and Challenges in using Active & Passive Solutions.....14

Exhibit 5: Use of Investment/Product Solutions.....15

Exhibit 6: Expected Use of Investment/Product Solutions.....16

Exhibit 7: Annual New Flows – Active and Passively Managed Funds and ETFs.....17

Exhibit 8: Outperformance of US Domestic Active Equities Funds - % Outperforming Passive.....18

Exhibit 9: Commoditization of Active Management.....19

Exhibit 10: Level of Advisor Agreement on the Commoditization of the Advisor's Role.....19

Exhibit 11: Annual Performance – Average LCB Actively Managed vs S&P 500 Index vs SPY.....21

Exhibit 12: Annual Performance – Top Quintile – LCB Actively Managed vs S&P Index.....22

Exhibit 13: Cumulative Returns – S&P 500 Idx vs. Avg. M-Star Gold-Rated vs. Conc. Portfolios.....25

Exhibit 14: Cumulative Return vs Stand. Deviation– S&P 500 Index vs. Individual Gold-Rated.....26

Exhibit 15: Cumulative Return vs Stand. Deviation – S&P 500 Idx vs. Concentrated Portfolios.....27

Exhibit 16: Relative Performance of LCB Funds vs S&P 500 – By Decile.....30

Exhibit 17: Cumulative Return of LCB Funds vs Tracking Error (2015-2017).....32

Exhibit 18: Cumulative Return of LCB Funds vs Tracking Error (1992-1993).....32

Exhibit 19: Rolling 1-Year Periods – Percent of Periods Each Fund Out Performed the S&P 500.....34

Exhibit 20: Percentage of Periods Concentrated Portfolios Out Performed the S&P 500.....35

Exhibit 21: ACP (net-of-fees) vs S&P 500 - Avg of 16 Underlying Funds & 16 Concentrated Portfolios.....37

Exhibit 22: Rolling One-Year Periods: Percent of Periods Outperforming S&P 500.....38

Exhibit 23: Decile Rankings of ACP by Calendar Year.....39

I. Introduction

One of the most impassioned debates in the investment industry has been the argument over 'active vs passive'. But over the past several years the shouting and trumpeting have seemingly settled down to a quiet buzz. From many quarters, it appears the argument has been won, with passive claiming the prize. Certainly, net flow data would appear to confirm this view: net flows into passively managed US equity funds and ETFs have exceeded the corresponding net flows into actively managed funds for 11 consecutive years.

The advocates on the passive side consistently invoke their fee advantage and add a claim that the markets are too efficient and/or active managers do not have the skill necessary to reliably outperform index products. But is this truly 'settled science'? Does the fee differential between active and passive products adequately explain the habitual underperformance of actively managed funds, and is there proof that active managers are devoid of stock selection skill? Or are their other contributing factors?

Setting aside marketing assertions, this White Paper attempts to determine whether active managers are fated to permanently underperform their low fee, passive counterparts, and if industry fee pricing standards and market efficiencies are too onerous a set of challenges for active fund managers to overcome. Specifically, this White Paper explores the answers to the following questions:

1. Do active investment managers have tangible and repeatable skill in selecting stocks?
2. If active fund managers do have skill, are there obstacles with the legacy design and structure of the mutual fund that are inhibiting fund managers' ability to reliably translate their skill into benchmark outperformance?

In regard to the latter question, a series of interviews with industry thought leaders generated three areas of mutual fund design to focus on, each reflecting potential structural flaws:

- The traditionally higher expense ratios of actively managed funds.
- The diluting effect of an oversized 'Beta Anchor', where a **Beta Anchor** is defined as the portion of a fund's portfolio (stocks and corresponding allocation weights) that are used primarily to maintain a tight tracking error to the fund's benchmark.
- The standard template of using a single manager and investment process per fund – as opposed to a multi-manager, multi-process approach, and the resulting added layer of diversification.

As a final note, it is important to recognize that the purpose of the White Paper is to introduce new insights into the long-standing debate between active versus passive management, question the status quo regarding how the industry creates value, and perhaps trigger discussion and debate that can lead to better outcomes for investors. The data provided is robust, but sample sizes are typically too small to achieve statistical significance. Therefore, while at least some of the conclusions and outcomes presented might be considered disruptive (e.g., re-thinking the design of the mutual fund), they should be considered as directional, rather than conclusive, conclusions.