

The Value of Professional Active Management

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In April 2004, I authored a research paper titled “Total Fund Performance” (Curwood 2004). The genesis of that article was my geeky ability to notice fund performance anomalies, i.e., small, individual numbers on large spreadsheets of data, that look incorrect or unusual.

One of the legendary research pieces in our industry, for which Brinson, Hood, and Beebower (1986) earned phenomenal worldwide acclaim, stated, “That asset mix policy—the percentage allocation to major asset classes—is the principal determinant of a fund’s long term investment performance and explains about 90% of the variation of the fund’s returns.” However, for the 10-year period ending December 31, 2002, the various passive returns of traditional asset mixes (most commonly ranging from 30-percent equity/70-percent fixed income to 70-percent equity/30-percent fixed income) were nearly the same for Canadian investors, about 9.2 percent. This amazed me because it means that performance differentiation or differences in total fund value added in that 10-year period were a function of skill or possibly luck, not favorable differences in traditional asset mix policy. If all relevant traditional asset mixes held constant returned 9.2 percent, then this would be one of the few times when most of the variation in performance could be due to skill or lack thereof rather than mix. A number of interesting conclusions drawn from that analysis have since served me and my clients well.

This article will attempt, through research and factual analysis, to determine future, reasonable, value-added objectives (before fees) for investment sponsors, fiduciaries, and practitioners.

Recently, as I was scanning a Capital Markets Return Report¹ (three sheets of data with 13 columns, 32 lines, and more than 400 numbers per page), I noticed another similar anomaly. You can imagine my glee (only an investment analyst could be so fulfilled by such trivia) at discovering another such rarity.

INTRODUCTION

This article will attempt, through research and factual analysis, to determine future, reasonable, value-added objectives (before fees) for investment sponsors, fiduciaries, and practitioners. It will achieve this through a bottom-up analysis and vet the results by top-down comparison. In other words, it will analyze active manager return performance (bottom-up by asset class for managers) to construct appropriate total fund objectives and then compare those results for reasonability to the actual value added generated by institutional investors (top-down) at the total fund level. If the two approaches arrive at a common answer, as they did in Curwood (2004), it will enable us to state reasonable expectations for total fund value added over the long term

and compare that to the success investment funds have actually achieved. It may also provide context for whether the results attained through active management are worth the considerable effort required by fiduciaries to perform this task well. Finally, it will provide an update on past findings, be they reaffirmed or revised accordingly.

THE RECENT ANOMALY

In the following discussion of the recent anomaly, all returns noted are in Canadian dollars (\$CDN).

- Over the 10 years ending December 31, 2016, the return on domestic Canadian bonds (FTSE TMX) at 4.78 percent was almost identical to that of Canadian equities (S&P/TSX) at 4.72 percent. This is somewhat unusual, because modern portfolio theory (MPT) generally would dictate that equities (the risky asset) should outperform bonds (the more stable return asset) over the long term. That’s why asset mix is usually referred to as the 90-percent solution in MPT. In fact, the last time I saw such returns it was 2002.

Figure 1

CANADIAN BOND MANAGERS VS. FTSE TMX UNIVERSE
FIVE-YEAR, VALUE ADDED DISTRIBUTION, 2Q1989-4Q2016

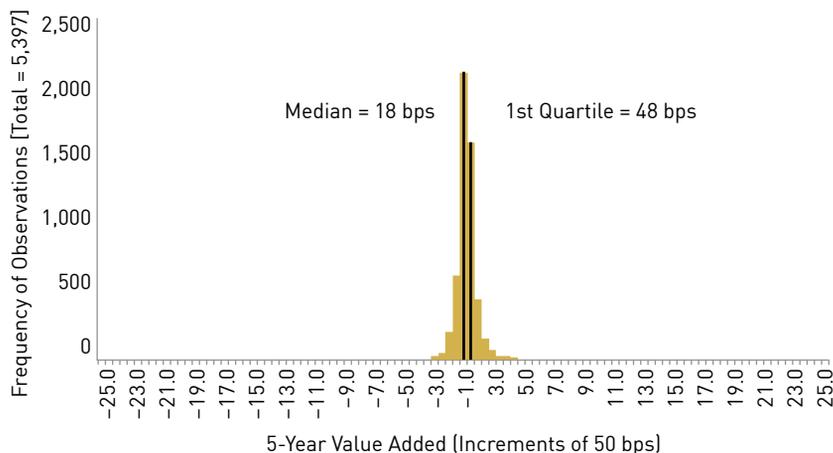


Figure 2

CANADIAN EQUITY MANAGERS VS. S&P/TSX COMPOSITE
FIVE-YEAR, VALUE ADDED DISTRIBUTION, 2Q1989-4Q2016

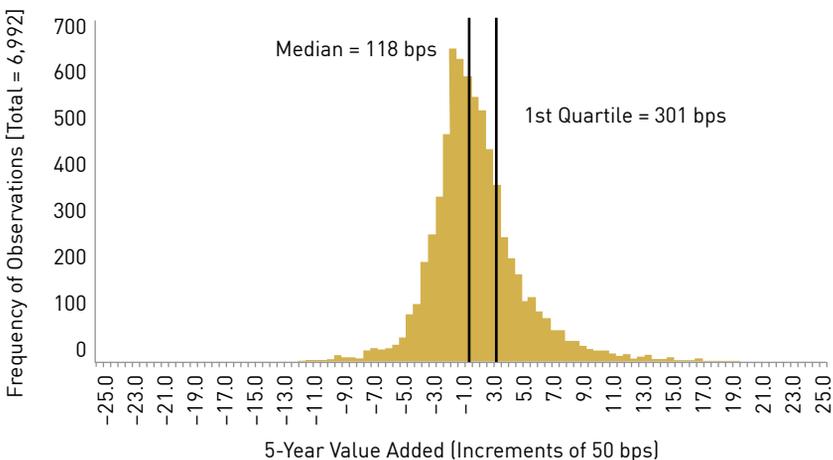
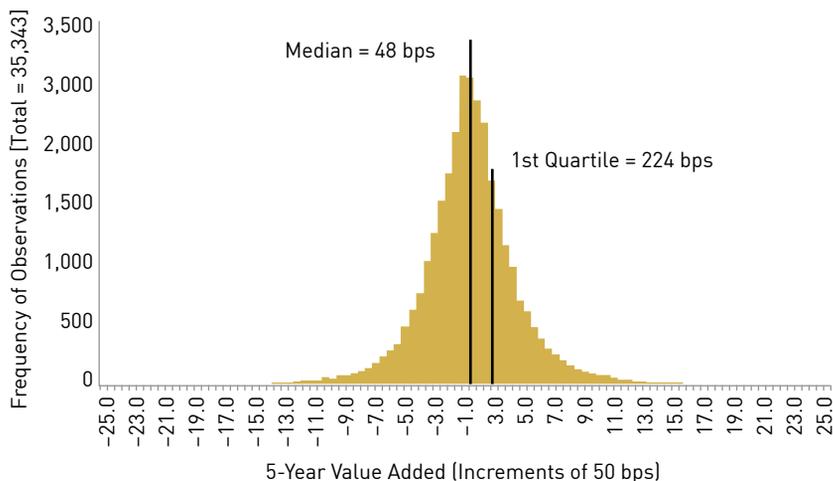


Figure 3

U.S. EQUITY MANAGERS VS. S&P 500
FIVE-YEAR, VALUE ADDED DISTRIBUTION, 2Q1989-4Q2016



- Foreign equities, particularly U.S. equities (8.47 percent), outperformed domestic markets over the 10 years ending December 31, 2016. However, when you consider the underperformance of Europe, Australasia, and Far East (EAFE) stocks (a return of only 2.67 percent) and that many funds had half their currency hedged (which unfortunately reduced return), the difference to domestic returns was slight (MSCI World one-half hedged 10-year return was 5.16 percent).
- Most asset classes provided returns of 4–5 percent (global listed infrastructure 4.27 percent, global real estate investment trusts 4.45 percent, Barclay’s Global Aggregate Bond Index 4.76 percent).
- All this is to show that it was difficult to outperform 5 percent in the Canadian market over the past 10 years because most traditional asset classes returned about 5 percent or less. As a result, we will use this aggressive 5-percent past-return market target as our total fund hurdle rate for the past decade.
- This will also help us put Canadian total fund 10-year returns into perspective and enable us to evaluate the value added through active management, be it luck or skill.

DETERMINING REASONABLE VALUE-ADDED EXPECTATIONS AT THE TOTAL FUND LEVEL
BOTTOM-UP ANALYSIS OF MANAGER PERFORMANCE

The Russell Investment Group (Russell) has maintained actual active manager return performance by asset class for more than 30 years in Canada (longer in the United States).² By comparing these manager returns by asset class relative to the common benchmarks that each manager is attempting to outperform, we have been able to construct the rolling five-year value-added frequency distributions (histograms) shown in figures 1–4. Russell has therefore been able to calculate the average median and first-quartile manager value added by

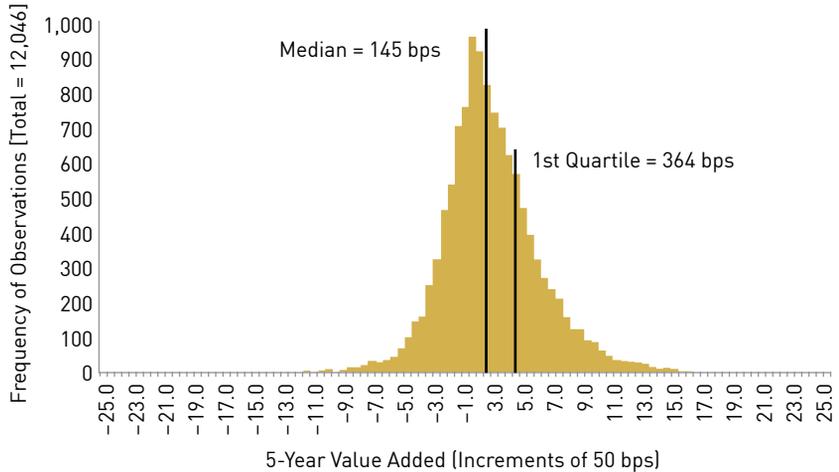
traditional asset classes used commonly by most Canadian institutional investors.

Note that the value added (VA) varies by asset class. The Canadian bond and U.S. equity markets still seem to be the most efficient because the median manager performance differs only marginally from the respective benchmark (18 and 48 basis points, respectively). On one hand, the median Canadian equity manager and median non-North American (NNA) equity manager (i.e., international or EAFE manager) have been able to add considerable value to their respective benchmarks (118 and 145 basis points VA, respectively) over the 30+ years shown. These results show that for equities even the median institutional manager has been able to add value to the benchmark on average, especially Canadian and NNA equities, over rolling five-year periods for the past 30+ years. So professional, active management undoubtedly has added value historically.

In addition, these observations, although not statistically significant, seem consistent with industry anecdotal evidence and past experience. The U.S. marketplace and, in particular, the large-cap S&P 500 Index have long been known as difficult to outperform. In fact, it was reported recently that “only 17% of the mutual funds included in the Morningstar US Large Blend Category outperformed the Russell 1000 index for the five years ending 2016.”³ Similarly, since the dawn of personal computers and given the high composition of government debt within the Canadian bond index, it has been difficult for the average bond manager to add value without taking undue duration risk (which has been difficult to succeed at consistently) or going outside the index (e.g., core plus mandates, with additional exchange risks). The depth and breadth of the S&P 500 and the government bond market is well-evidenced, but that is less so in the case of Canadian equities (the S&P/TSX Composite) and NNA equities (MCSI

Figure 4

NON-U.S. EQUITY MANAGERS VS. MSCI EAFE
FIVE-YEAR, VALUE ADDED DISTRIBUTION, 2Q1989-4Q2016



EAFE). Both Canadian equities and NNA equities have had periods of high concentration. The over-representation of Japan (which made up about two-thirds of the EAFE market’s capitalization in the mid-1980s), and the concentration of Canadian equities in 2000 (during which Nortel composed more than one-third of the S&P/TSX) are both excellent examples where portfolio managers could have outperformed by simply over and underweighting single elements of these less-efficient indexes and markets. Additionally, in most years, three sectors—energy, materials, and financials—in Canada dominate more than 67 percent of the S&P/TSX index.

But there may be reason to believe the past will not hold into the future. After all, most market inefficiencies usually are corrected over time through arbitrage or regulatory intervention. In 1991, Bill Sharpe made a simple yet powerful observation: A market is composed of all the participants in the market. Therefore, it has to be true that the average return of all participants in the market, as a whole, is zero before fees and costs (i.e., a zero-sum game). Consequently, the only way to beat the market aside from luck is to have special skill. A market participant must be substantially better than all other market participants in order to win, especially when fees and costs are considered.⁴

Based on the aforementioned, let’s define good active management as the difference between median and first quartile and assume fund sponsors have the capability to select such top-performing managers. Therefore, returning to figures 1–4, let’s subtract the median from the first-quartile performance in these histograms, to reflect what 30+ years of history has demonstrated is a reasonable, value-added return by asset class. We’ll then temper those results with some perceived differences in today’s markets to arrive at a sensible value added total fund objective for the future. In particular, we’ll add a little value added for Canadian bonds to take into account the larger corporate bond component (more than 26 percent since 2002, but only 10 percent some 10 years earlier) and modern domestic fixed income investing, where managers invest beyond the Canadian debt market (in global bonds or core-plus mandates) and the opportunity exists for greater value added. We’ll subtract a little value added for NNA and Canadian equities, where the decision to add value through the Japan effect or Nortel weighting will be limited in the future and where international investing is far more commonplace today, increasing market efficiency. We’ll also do some rounding down for conservatism, especially in U.S. equities, which is an extremely efficient market. That leaves us with the

Table 1

REASONABLE VALUE-ADDED ASSET CLASS TARGETS

Asset Class (1st quartile – median = difference)	Reasonable Value-Added Target
Bonds (1st quartile 48 bps – median 18 bps = 30 bps)	40 bps
Canadian Equities (1st quartile 301 bps – median 118 bps = 183 bps)	150 bps
U.S. Equities (1st quartile 224 bps – median 48 bps = 176 bps)	150 bps
NNA Equities (1st quartile 364 bps – median 145 bps = 219 bps)	150 bps

Table 2

TOTAL FUND VALUE ADDED EXPECTATIONS

Asset Mix Equity/Debt	70/30	60/40	50/50	40/60
Total Weighted Value Add	117 bps	106 bps	95 bps	84 bps
78% Active Value Add	91 bps	83 bps	74 bps	66 bps

following reasonable value-added targets by asset class for skilled active management (see table 1).

In fact, these reasonable value-added targets at the asset class level are exactly equal to those estimated in Curwood (2004), with the exception of NNA equities, where we reduced the value-added target by 50 basis points (bps) to 150 bps, taking into account increased market efficiency. After all, among equities, who can discern in which region funds will outperform in the future? Certainly not me. So, why not let all equity, value-added regional targets be equal?

Most Canadian institutional fund sponsors, who are not liability matching and invest in traditional assets, have policy mixes between a low of 40-percent equities/60-percent bonds (conservative mix) and a high of 70-percent equities/30-percent bonds (aggressive mix). Let's also assume funds have increased their foreign content to two-thirds of their equity component over time but still maintain some home-country bias, which is likely today given that Canadian equities are less than 3 percent of the total world equity market. Applying our active management value-added targets by asset class outlined in table 1 to these relevant policy ranges (in 10-percent increments) leads us to table 2.

These total fund expectations, assuming 100-percent active management, range from 84 bps to 117 bps VA at the total fund level, depending on the equity risk assumed. That stated, many funds have less than 100-percent active management for various reasons. Therefore, we arbitrarily discounted our total fund value added expectations accordingly, for a 22-percent passive component, reducing the new total fund value added range from 66 bps to 91 bps.

Based on the aforementioned, and given that most funds will not have the capability to select first-quartile managers in all four major asset classes over a 10-year period, a reasonable range for active management value added at the total fund level would be about 50-100 bps, based on these bottom-up projections. Now let's compare these results to actual total fund performance for the past 10 years.

TOP-DOWN ANALYSIS OF ACTUAL INSTITUTIONAL TOTAL FUND HISTORICAL PERFORMANCE

I am not a proponent of universe data and relative fund comparisons (Curwood 1994). There are many reasons for my skepticism. Comparing one fund's return to another when they have various asset mixes, diverse liabilities, different risks, dissimilar costs, and numerous other factors that are not

equal is like comparing apples to oranges. Apart from that, the biases (survivorship, end date sensitivity, etc.) in the data are usually too numerous to mention and explain.

Nevertheless, as outlined in the introduction to this article, for the 10-year period ending December 31, 2016, most traditional asset class mixes in Canada returned about 5 percent or less, somewhat leveling the playing field for comparative evaluation. This rarity meant that performance differentiation in this 10-year period was more a function of skill or possibly luck, but not favorable differences in traditional asset mix policy. With those earlier caveats in mind, it was determined that perusing several of the largest comparative measurement universes might be useful for our top-down analysis and also in determining total fund value-added skills. Imagine my nerdy elation at uncovering this unusual coincidence and finally being able to review comparative performance in a more meaningful way.

Skill in active management is generally a function of three factors:

- good manager or stock selection and retention;
- timely changes to strategic asset mix allocation; and
- improved implementation (i.e., good execution, cash equitization, and favorable rebalancing).

So, let's review the performance of three of the largest comparative universes in Canada on that basis and determine how skilled their members were over the decade ending December 31, 2016. On average, were they able to actually add value through active management?

- In a large money manager survey (MMS), we perused the performance of numerous institutional manager pooled funds segregated by asset class and at the total fund level (i.e., aggressive, moderate, and conservative balanced funds based on

equity allocation). The 10-year median for balanced funds ranged from 5.4 percent (conservative) to 5.9 percent (moderate), and the first-quartile balanced managers provided average returns between 5.7 percent (conservative) and 6.1 percent (aggressive).

- In a major pension plan survey (PPS), we reviewed the performance of sponsor defined benefit pension plans in Canada. The total fund median return for the 10-year period ending December 31, 2016, was 6 percent for the 88 funds that provided data; the first-quartile return was 6.4 percent.
- A major Canadian endowment survey (CES) contained the performance of university endowment funds in Canada. The total fund median return for the 10-year period ending December 31, 2016, was 5.6 percent for all the return data; the first-quartile return was 6.1 percent.⁵

With returns of 5.4–6 percent, it appears that even the median total fund outperformed our 5-percent hurdle rate by adding considerable value (0.4–1.0 percent) for the 10-year period ending December 31, 2016. This differs from our 2004 observations where the median returns for the 10-year period ending 2002 were equal to market expectations for the PPS and just 0.3 percent below market indexes for the CES. Let's chalk this up to improved professionalism by larger institutional fund sponsors over the past decade (but for statistical purposes the jury is still out). Evidence of this expertise is demonstrated by the CES and PPS sponsors, who have successfully allocated considerably more assets into alternatives (i.e., nontraditional investments) over the past decade. For example, the top 18 university endowment funds, which comprise more than 80 percent of endowment assets in the CES, had 14 percent of their assets in nontraditional investments as of 2016. These top 18 university endowment funds in the CES also outperformed the others in the survey, with a median of

6.2 percent (versus 5.6 percent for the entire CES endowment survey, which includes the top 18). We did however note that making timely changes to strategic asset allocation is one of three ways to outperform and add value through skilled active management. The use of alternatives has been less-evident in the MMS, where managers have not been as willing to adopt these nontraditional strategies in such quantity, often due to shorter investment time horizons or liquidity needs.

Even the median fund outperformed, net of fees over the past decade. But as we noted earlier, first-quartile performance generally is considered a better standard of success.

First-quartile total funds provided additional value added, with average returns ranging from 5.7–6.4 percent (or 0.7–1.4 percent above our indicative 5-percent hurdle) in the three comparative surveys. Again, the first-quartile returns for the CES (6.1 percent) and PPS (6.4 percent) are higher than the MMS (a range of 5.7–6.1 percent), probably due to greater diversification into alternatives. Nevertheless, given that first-quartile performance is considered an indicator of value-added success, these top-down results also back up our bottom-up value-added expectations that 50–100 bps in value added is still a reasonable total fund objective. Our conclusions are therefore similar and consistent; whether they are derived from the bottom-up or top-down approach, in this paper and Curwood (2004). The Ontario Teachers' Pension Plan (OTPP) is often considered the gold standard in Canadian performance. Over the past 10 years OTPP's actual 10-year performance, as of December 31 2016, provided 1 percent value added over

policy.⁶ In short, good active management should be able to add 50–100 bps in value at the total fund level, before fees, and it has done just that, and more for some, over the past decade.

VALUE OF GOOD ACTIVE MANAGEMENT IN PRACTICE

Institutional returns, such as those noted above, are always quoted as gross returns (i.e., before fees), because most fund fee structures are based on assets under management, which vary by fund. Fees, however, must be considered to answer these questions: "Does the manager have skill?" or "Does the fund add value through active management?" Each of these is a totally different question for each fund, where the response varies by assets under management (the more assets under management given to the manager, generally the lower the fee). But given that average institutional fees would be about 0.40 percent (40 bps) or less, for most larger total funds, these results demonstrate that the net value added was positive in all three comparative surveys. Even the median fund outperformed, net of fees over the past decade. But as we noted earlier, first-quartile performance generally is considered a better standard of success. First-quartile performers have, however, added considerable net value added in both 10-year periods studied (ending 2002 and 2016). In short, professional active management can definitely add value, net of fees, for institutional investors.

A logical question at this juncture would be, "Do all the author's clients add value, net of fees, at the total fund level?" From the experience of my specific institutional client base, the short answer is, "Unfortunately, not all do." Of the Canadian institutional retainer clients, for which Russell has performance returns over the 10-year period ending December 31, 2016, all (100 percent) have exceeded the 5-percent hurdle with on average 82 bps in gross total fund value added,

but only two-thirds have outperformed net of fees, which average about 40 bps. When I look for the reason those clients underperformed net of fees, it's generally attributable to less than optimal governance (e.g., slow to respond to manager downgrades, not taking consulting advice, etc.) and/or reducing risk in their portfolios. However, even including those lower-performing clients, the average net value added of all the above consulting clients over the past 10 years, net of average fees, has been 42 bps per annum.

So, what do these basis points in value added mean in dollar terms over the long term? Again, that depends on the assets under management. But the following should illustrate that point nicely. Over the past 10 years, the average total assets under advisement was about \$6.5 billion and, as noted above, the average net value added through active management was 42 bps per annum. So the annual net savings for those clients was approximately \$27.5 million per annum or conservatively (without compounding) \$275 million over the past decade. Therefore, active management has been a worthwhile endeavor for most of Russell's Canadian consulting clients.

SUMMARY AND CONCLUSIONS

A number of interesting conclusions can be drawn from this article and Curwood (2004):

1. Adding value to the passive benchmark, net of fees, through active management is usually no mean feat for the average fund.
2. Nevertheless, for the 10-year period ending December 31, 2016, even the median manager in three different comparative surveys was able to equal or exceed the 5-percent passive common index target, net of fees, at the total fund level (which was not the case for the decade ending 2002).
3. As little as 40 bps for the decade ending in 2016 (or 60 bps for the

decade ending 2002) in gross value added at the total fund level may lead to first-quartile performance.

4. 50-100 bps in gross value added is still a reasonable expectation at the total fund level for funds that can engage good active managers, based on either a bottom-up or top-down analysis.

If performing well is so difficult and the rewards of active management are only 50-100 bps before fees, many fund fiduciaries may ask why bother to employ active managers at all? Why not just invest passively? The reason is simple. Those basis points are not trivial. This was very evident from the practical example given, where the Russell Canadian consulting clients in total were able to save about \$27.5 million per annum (or conservatively \$275 million in the recent decade). This is not uncommon because most large institutional funds that are professionally managed have been able to garner very good value added at the total fund level over the past decade.

The prize for successful active management is therefore significant in terms of reducing costs, increasing benefits, or sometimes even just reducing volatility (risk).

This is particularly true in today's low-return environment. Note that 50 bps net value added via active management was a far greater component of total fund performance for the 10 years ending December 31, 2016, when market returns were only 5 percent (50 bps VA / 5% total fund return = 10.0%), than for the 10 years ending December 31, 2002, when market returns were 9.2 percent (50 bps VA / 9.2% total fund return = 5.4%). With interest rates near their nadir and U.S. equities more than eight years into a bull market cycle, few prognosticators are calling for a return to double-digit total fund returns and most expect absolute total fund returns to be low.

In conclusion, I leave fund fiduciaries with one final question: Given that the research shows that successful active management is a worthwhile endeavor, what is your fund's special skill set to provide you with a competitive advantage over the average institutional investor? Remember, Bill Sharpe has warned us about the need for a sustainable competitive advantage to derive added value from investment management. In short, being average is usually not good enough with active management. ●

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ENDNOTES

1. *Russell Analytics*, "Capital Market Return: Canadian Investor Perspective" periods ending December 31, 2016.
2. *Russell Research*, "Value Added from Active Management by Asset Class, Quarterly Rolling 5 Years, Inception Q3 1984 to Q4 2016 inclusive."
3. Morningstar, "U.S. Large Blend Category, Russell 1000 Index, Rolling 5 Year Returns January 1, 1998 to December 31, 2016."
4. Bill Sharpe is one of the recognized founders of modern portfolio theory and recipient of the 1990 Nobel Memorial Prize in Economic Sciences.
5. Canadian Association of University Business Officers, "University Investment Survey 2016, Investment Pool data."
6. See <https://www.otpp.com/investments/performance>.

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