Benefits of Active Management

by InterSec Research

Quarterly snapshots of annualized performance often mislead investors on the long-term performance benefits of active management. In this memo, InterSec Research examines the performance of active managers in non-U.S. equities and demonstrates that, "going active" in international portfolios has delivered superior long-term investment returns relative to passive alternatives.

Stock market rallies over the last two months have brought a welcome relief from the indiscriminate sell off investors faced last year. While most of 2008 proved to be a difficult stretch for the median EAFE manager to add value, the past six months (ending March 31, 2009) have been more favorable, and the median manager in InterSec's EAFE Plus Universe has added 2.0% over the MSCI EAFE Index. Simultaneously, managers in the top quartile of this Universe added 3.3% over the benchmark largely as a result of astute stock selection.

While the market rally has offered investors an opportunity to benefit from the stock picking ability of active managers, clients of InterSec Research have expressed concerns as plan sponsors increasingly have raised questions as to the effectiveness of active management compared to passive alternatives. Relative under-performance for a number of EAFE managers in 2008 prompted some U.S. plans to terminate active managers in cross border investments all together, while institutional investors still weighing the pros and cons have begun to reevaluate the merits of active management across their plan structure. In this memo, we examine the performance of active managers in non-U.S. equities using data from InterSec's EAFE Plus Universe and illustrate that through careful manager selection, "going active" in international equity portfolios has been a beneficial pursuit for U.S. tax-exempt investors over the long term.

Absolute Returns Drive a Closer Look at Passive

Last year was not an outlier in terms of relative performance. While the median EAFE Plus manager out-performed the MSCI EAFE Index by only 0.02% for the calendar year 2008, five other calendar year returns over the past 15 years have been far worse in terms of the median manager's under-performance relative to the benchmark (illustrated in Exhibit 1). Interestingly, the worst years of relative under-performance took place during advancing markets. With the exception of 2008 and 1994, each of these periods of relative under-performance occurred in calendar years where the MSCI EAFE Index yielded double-digit returns, minimizing the perception of the under-performance, as absolute numbers exceeded investor expectations. In 2008 however, the severity of absolute performance was foremost on investors' minds and was likely a driving force behind questions surrounding the benefits of active management.

Year	Median EAFE Plus Manager Relative Performance	MSCI EAFE Index 1-Yr. Return
1994	-4.2%	7.8%
1998	-4.0%	20.0%
2003	-2.9%	38.6%
2004	-1.3%	20.3%
2006	-0.5%	26.3%
2008	0.0%	-43.4%

Exhibit 1.

Active vs. Passive Investments in Non-U.S. Equities

In a 1991 Financial Analysts' Journal article, William Sharpe made a compelling case for a passive approach to investing by asserting that based on his simple arithmetic, "The average actively managed dollar must under-perform the average passively managed dollar, net of costs."[1] As a consequence of the losses taking place across actively managed portfolios in 2008, a number of plans seemingly revisited Sharpe's assertion and began increasing allocations to passive non-U.S. equities mandates, totaling $7.6 billion in net inflows as of year-end. Exhibit 2 demonstrates the shift in active vs. passive fundings between the first half and second half of 2008, while Exhibit 3 plots the historic net flows to active, passive, and enhanced mandates in non-U.S. equities since 1992.

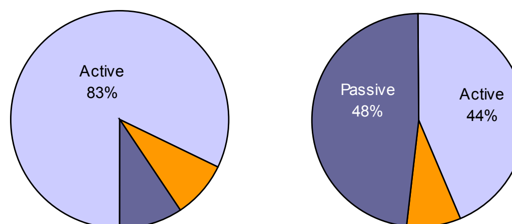


Exhibit 2.

1 William Sharpe, "The Arithmetic of Active Management" The Financial Analysts' Journal Vol. 47, No. 1, January/February 1991. pp. 7-9.

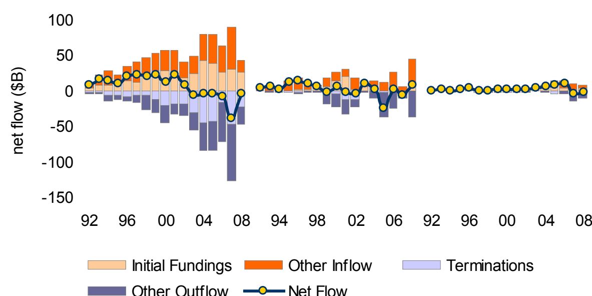


Exhibit 3.

While Sharpe's remarks coupled with the recent rise in initial fundings to passive mandates has caused a number of active managers to take pause, Sharpe was not remiss later acknowledging (within the same FAJ article) that, "It is perfectly possible for some active managers to beat their passive brethren, even after costs."[2] Furthermore, Sharpe conceded, "It is also possible for an investor (such as a pension fund) to choose a set of active managers that, collectively, provides a total return better than that of a passive alternative, even after costs."[3] (We highlight fees in the Appendix of this memo on page 8.) In the next section of this memo, we'll expand upon Sharpe's latter points through a review of performance data from InterSec's EAFE Plus Universe and demonstrate that active managers have added value in non-U.S. equity markets over longer time frames.

Non-U.S. Equity Active Managers Demonstrate Value Added

At year-end 2008, the median manager in InterSec's EAFE Plus Universe shed 43.2% while the MSCI EAFE Index fell 43.4%. Sharpe's theory on the average passively managed dollar out-performing the average actively managed dollar after fees was proven in the recent environment where the average active manager struggled to add value. But how does his theory play out over longer periods? The table below highlights InterSec Research data showing the annualized excess performance trends of the median EAFE Plus manager as well as the quartile break points within the Universe over 1- , 3-, 5-, and 10-year periods.

Exhibit 4 certainly challenges Sharpe's claim of the advantages of passive management when looking over longer periods of time. The median active manager in the EAFE Plus Universe out-performed the MSCI EAFE Index by 140 basis points on a 5-year basis and 270 basis points on a 10-year basis. While shorter time periods of performance measurement (especially during the heightened volatility of 2008) highlight the potential for dramatic fluctuations in quarter by quarter returns, the likelihood of active management's under-performance relative to a passive index tends to diminish considerably over longer time frames. While annualized periods do contain an imbedded survivorship bias, we compensate for this shortcoming in Exhibits 5, 6, and 7 by examining the consistency of manager performance in our EAFE Plus Universe on a rolling basis. These charts highlight the quarterly rolling 1-, 5-, and 10-year returns of our Universe along with the quartile break points.

Over rolling 1-year periods, Exhibit 5 confirms Sharpe's claim that on a median level, the average actively managed dollar has struggled to out-perform the average passively invested dollar (represented by the performance of the MSCI EAFE Index). From the first quarter of 1999 through the first quarter of 2009, the median manager

Time Period	# of Funds	High	First Quartile	Median	Third Quartile	Low
1 Year	130	7.5%	4.1%	0.8%	-2.0%	-4.9%
3 Year	125	6.3%	3.1%	1.4%	-0.8%	-2.7%
5 Year	121	5.6%	2.8%	1.4%	0.2%	-1.8%
10 Year	87	7.0%	4.4%	2.7%	1.4%	0.2%

Exhibit 4.

2 Ibid.
3 Ibid.

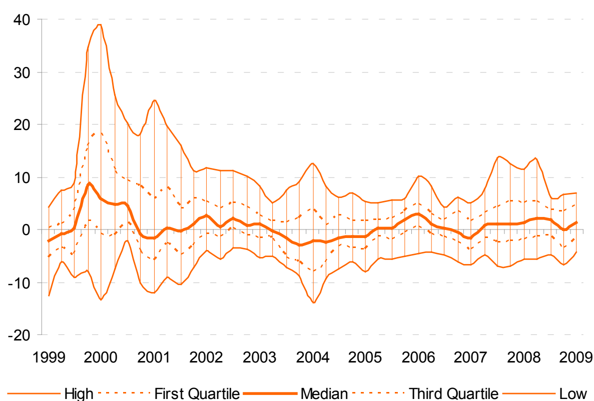


Exhibit 5.

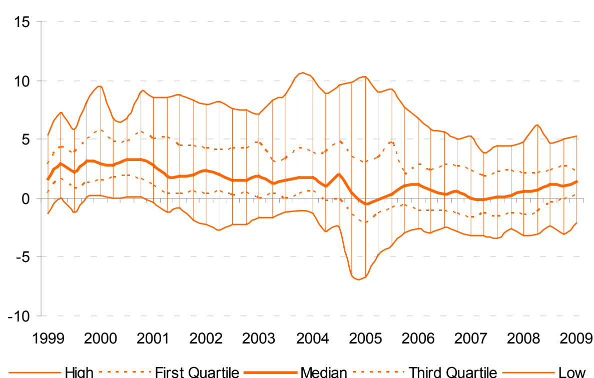


Exhibit 6.

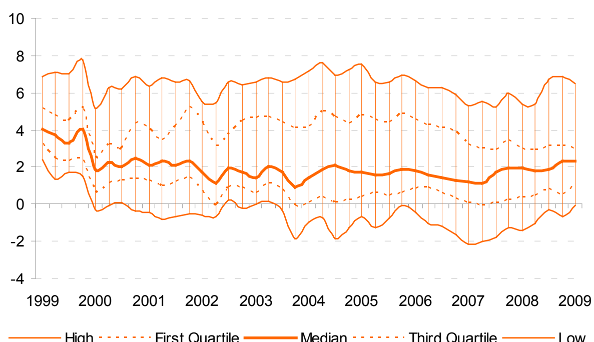


Exhibit 7.

in the EAFE Plus Universe averaged 68 basis points of relative out-performance based on rolling 1-year returns over the 10-year period. The median manager essentially delivered an excess return nearly equivalent to the median management fee for our EAFE Plus Universe constituents (see Appendix on page 8 for published fee tables). However, performance has been anything but uniform quarter to quarter. The median manager's relative performance has varied from as much as -2.9% to 8.6% during any rolling 1-year period. Furthermore, EAFE Plus managers occupying the first quartile and fifth percentile (indicated as "high" in Exhibit 5) delivered an average excess return of 4.5% and 11.5% respectively over this same 10-year period based on rolling 1-year returns. Consultants capable of discerning these top-quartile managers can clearly provide clients with a significant increase in value added, and are equipped to direct clients toward managers that can out-perform, even in periods when the median manager does not.

By lengthening the period of performance evaluation from rolling 1-year to rolling 5- and 10-year periods (in Exhibits 6 and 7) it becomes evident that the median active EAFE Plus manager has consistently added value over the benchmark. In comparison to the results shown in Exhibit 5 where the median manager out-performed the benchmark only 66% of the rolling 1-year periods, over 3-year time frames the median manager out-performed in 83% of the rolling periods.

Expanding this out over rolling 5-year periods, the median manager out-performed the MSCI EAFE Index 98% of the time and 100% of the time over rolling 10-year periods. In addition, the median manager was able to compensate for the higher management fees associated with active portfolios by generating average excess returns of 1.4% over 5-year periods and 2.0% over 10-year periods. Managers occupying the first quartile more than doubled the median manager's excess return, averaging 3.6% of out-performance on a 5-year basis and 4.0% on a 10-year basis.

After deducting the median management fee of 75 bps, a U.S. tax-exempt investor with a $20 million portfolio invested with the median active EAFE Plus manager

would have received a 0.65% bump in year-over-year performance in the average rolling 5-year period by opting for the median active manager over a passive alternative. Similarly, this same hypothetical investor investing passively in the MSCI EAFE Index would have left $658,505 on the table over an average 5-year period and $2,645,416 on the table over an average 10-year period (net of fees) by pursuing a passive approach over the median manager in non-U.S. equities. Please note that these figures do not account for the fees charged by passive investment firms, which on average range from 10 to 20 basis points for an equivalent size portfolio.

A Historical Perspective on Top Winners

While reviewing the median manager's performance sheds light on the broader universe, it was also revealing to take a closer look at some of the top-performing managers' performance over the most recent 5-year period. Specifically, we were interested in reviewing the peer rankings of those managers that recently won the greatest assets, as well as those managers that had the best long-term track records. For EAFE Plus managers to remain in the top quartile during the 10-year period from March 31, 1999 to March 31, 2009, they would have needed to achieve an average out-performance of 347 basis points above the MSCI EAFE Index return on a rolling 3-year basis. In Exhibit 8, we illustrate the difficulty of achieving this feat by ranking the top 10 managers (based on initial fundings from 2006 to 2008) in our EAFE Plus Universe and plot their rolling 3-year performance relative to their peers. Initial fundings to each mandate are indicated by dots and range in size corresponding to the respective funding size.

As Exhibit 8 illustrates, seven out of the top 10 EAFE managers had at least one period where they fell below median on a rolling 3-year basis. Additionally, three of these top managers fell into the bottom decile during at least one 3-year performance period. The volatility in peer rank for the top 10 managers demonstrates that even those investment managers most sought after by clients and consultants encountered periods of short-term under-performance relative to their peers and the broader benchmark.

Not only were periods of short-term under-performance apparent among top asset gatherers, but it was also an apparent trend among top performers. A review of the top 10 asset managers in InterSec's EAFE Plus Universe (based on 10-year annualized return as of March 31, 2009) illustrated that even the best performing managers experienced at least one quarter where they were ranked below median in their peer universe based on rolling 3-year return. Some of these top-performing managers endured prolonged periods of under-performance relative to their peer group, and four out of the top 10 fell into the

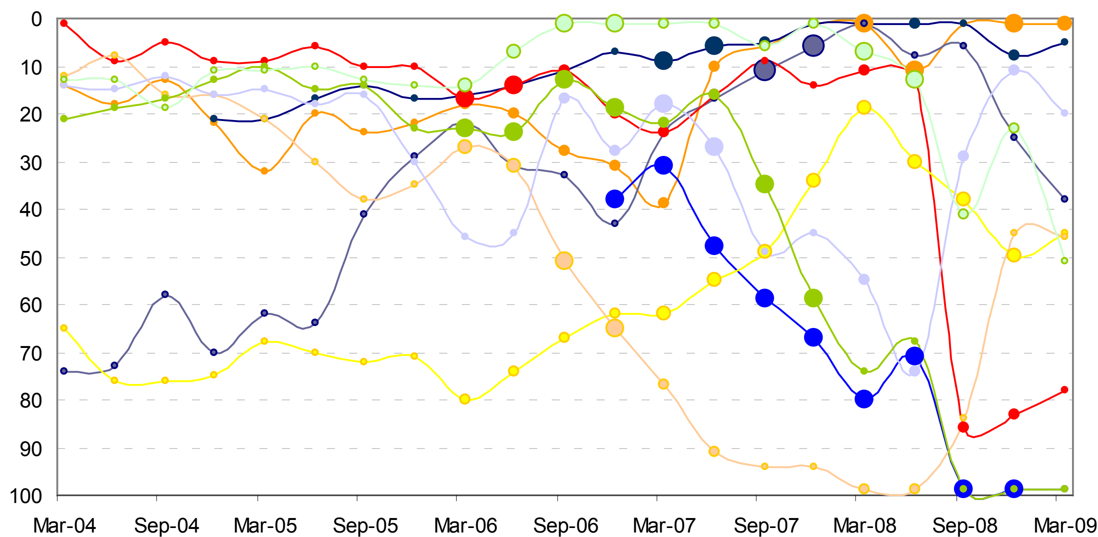


Exhibit 7.

lowest decile in at least one time frame during the 10-year stretch based on their rolling 3-year return. (See Appendix page 7 for a detailed chart.)

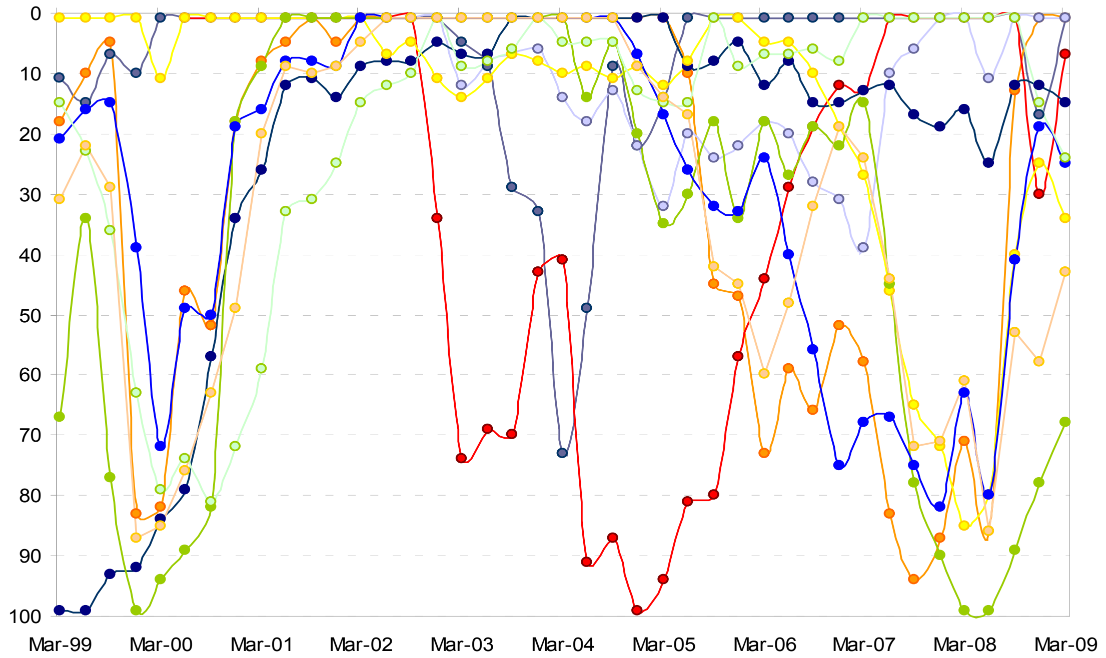
Conclusion

Ultimately, investors must learn that periods of short-term under-performance are part of engaging in active management – even among the best managers. A manager can not achieve long-term out-performance without a willingness to look quite different from their peers or the benchmark over the short term. While the majority of EAFE managers experienced negative absolute returns during 2008 and struggled on a relative basis over the trailing 12-month period as of year-end 2008, evaluating manager performance over longer time horizons has demonstrated that volatility is part and parcel of active management, and over the long term, active managers have delivered compelling returns relative to passive alternatives. Out of 41 rolling 5-year periods, the median EAFE Plus manager out-performed the passive MSCI EAFE Index in all but four instances. Simultaneously, managers occupying the first quartile and fifth percentile delivered considerable value added (averaging 3.6% of relative out-performance based on rolling 5-year returns over the period reviewed) and experienced no periods of under-performance relative to passive alternatives.

Quarterly snapshots of annualized performance can often mislead investors on the long-term performance benefits of active management. Investors should anticipate that even the best managers in the EAFE space will encounter periods of short-term under-performance relative to both their peers and a broader index. Identifying top-performing managers in non-U.S. equities is achievable, however rarely accomplished without the proper assistance of a skilled consultant, unbiased third party research, and the appropriate universe to conduct peer analysis.

Appendix

Top 10 EAFE Managers (based on 10-Year Annualized Performance as of 03/31/2009) Quarterly Peer Ranking based on Rolling 3-Year Performance



MSCI EAFE Index Ranking within EAFE Plus Universe over Annualized Periods ending 03/31/2009

EAFE Plus

1
2
3
4
5
6
7
8
9
10

	1 Yr	3 Yr	5 Yr	7 Yr	10 Yr	15 Yr
Index Rank	62	69	78	79	99	99

Appendix

Publically Published Annual Separate Accounts Fees as of March 31, 2009

Fees are represented in basis points and based on notional account values Universes are InterSec Research Universes, though not all managers' fees were attainable for this study.

	ACWI ex-U.S.		
	$20M	$50M	$100M
5th Percentile	85.5	80	75
25th Percentile	80	75	67.5
Median	75	70	62.5
75th Percentile	73	66	57.5
95th Percentile	64	60	52
High	95	87	83.5
Low	55	47.5	41.2
# Observations	*37*	*37*	*37*

	EAFE		
	$20M	$50M	$100M
5th Percentile	90	81.9	76.9
25th Percentile	80	75	70
Median	75	70	62.8
75th Percentile	70	66.4	57.5
95th Percentile	60	55	48.3
High	100	100	96.2
Low	30	30	27.5
# Observations	*124*	*124*	*124*

	EAFE Pure		
	$20M	$50M	$100M
5th Percentile	80	77	75
25th Percentile	75	72	66
Median	75	70	62.5
75th Percentile	65	65	55
95th Percentile	56	49	42
High	81.2	80	80
Low	30	30	27.5
# Observations	*25*	*25*	*25*

Publically Published Annual Commingled Fund Fees as of March 31, 2009

Fees are represented in basis points and based on notional account values. Many commingled funds include custody and transaction costs in their annual fees. Universes are based on InterSec Research Universes, though not all managers' fees were attainable for this study.

	ACWI ex-U.S.		
	$20M	$50M	$100M
5th Percentile	95	93.8	93.8
25th Percentile	87.5	85	77.5
Median	85	75	71.4
75th Percentile	75	70.3	62.9
95th Percentile	57.3	55.3	50.1
High	138.4	118.1	108.1
Low	55	47.5	41.2
# Observations	*26*	*26*	*26*

	EAFE		
	$20M	$50M	$100M
5th Percentile	98.8	95	92.5
25th Percentile	86.3	82.3	75
Median	75	75	68.8
75th Percentile	70	67.8	60.8
95th Percentile	55	52.5	45
High	138.4	118.1	108.1
Low	27	27	26
# Observations	*91*	*91*	*91*

	EAFE Pure		
	$20M	$50M	$100M
5th Percentile	92.1	84.8	84.8
25th Percentile	79.8	75	69.4
Median	75	70	62.5
75th Percentile	70	63.1	53.6
95th Percentile	55	47.8	41.4
High	100	90	85
Low	27	27	26
# Observations	*22*	*22*	*22*

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