The Reports of the Death of Active Investing have been Greatly Exaggerated

RWC Equity Income
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Does active management still work?

The answer is yes – when funds are managed within a truly active construct.

In this edition of our Investor Letter Ian Lance scrutinises the relative merits and pitfalls of active, passive and “smart beta” investing.

Portfolio Managers

Ian Lance, Nick Purves and John Teahan have managed funds together for over 10 years. Their loyalty and experience is leading within the industry and has awarded them a number of accolades. Ian, Nick and John joined RWC Partners in 2010 to establish the Equity Income team and now manage over £3.5 billion for their clients.

The team’s approach fully integrates conviction led, value-based stock selection with a distinctive and technical approach to stabilising assets, with the aim of delivering investment solutions that both grow investors’ assets and protect the purchasing power of capital and income.
Active versus Passive versus Smart Beta

The difficulties facing active fund managers have been widely reported\(^1\). Looking at the charts below, the flows out of active and into passively managed funds have been very significant over the last decade and the fact that this transition has occurred in a virtually straight line suggests that much of it has been driven by fees demanded for passive exposure falling continuously over this time period. The conclusion seems to be that active fund managers have over charged and under delivered for too long, enriching themselves at their clients’ expense and are now getting their comeuppance\(^2\).

\(^1\) For instance 'Large investors pull $350bn from active equity funds' FTFM December 11, 2016
\(^2\) This view has been endorsed by the FCA in their recent report in to active management
The strange thing is, despite being an active fund manager for all of my career, I can completely sympathise with those who have made this transition, as in aggregate I do not think the fund management industry has done a great job over the last few years. Passive investing has been a force for good in that it has brought down active fees which, although justified in the 1960s to 1980s, became unsustainable given the increased scale of the industry and advances in technology that occurred in the following decades. In addition, as expected returns fell, so fees ate a greater proportion of them and also implied a need for costs to fall. What worries me about the stampede towards passive investing is that the financial services industry has an unfortunate habit of over selling products by over-playing their positive aspects whilst under-playing the pitfalls and I believe we have reached this stage in the active/passive debate. In this note I will attempt to even up the debate by highlighting some of these pitfalls but first let us start by looking at some of the arguments used by the passive industry against active investing.

**Argument 1: Investing is a zero sum game therefore the median fund manager cannot outperform**

Across the entire equity market, this is true but that does not mean it also holds across actively managed equity funds since they are NOT the entire market. If we take the example of the US, the equity market is $38 trillion but when one considers the amount of this owned by large pensions and endowments, private investors, and corporates themselves, the segment owned by active mutual funds is only $3.6 trillion (about 9%)³. Mathematically speaking anyway, there is no reason why the average active mutual fund manager cannot outperform.

**Argument 2: 86% of active funds fail to beat their benchmarks after fees**

When accompanied by a chart such as the one below, the high percentage of active funds that fail to beat their benchmark is a very powerful narrative in favour of passive investing⁴.

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³ *Is active management dead? Not even close* by Jason Voss 26 July 2016

⁴ *Active managers defend their performance record* by Madison Marriage FTFM 24 March 2016
Here of course, I am not disputing the result but it is a clever use of a limited amount of statistics. For instance, a chart of the percentage of passive funds that underperform their benchmarks after fees would show 100% in each country. They are designed to give the market return less fees so mathematically they will all underperform (some more than others).

In addition, the data used does not tell us about the distribution or range of returns hence it could be that the average active manager is only underperforming by 5bp whilst all passive managers are underperforming by 10bps. We also don’t know how much those who succeeded actually outperformed by. If the answer is 4% p.a. then it would suggest the additional return is worth looking for. We don’t know anything about the size of the funds (is the 90% figure made up of ninety small funds which underperformed whilst ten large ones outperformed?). Moreover were the ninety funds low tracking error, low active share funds and the ten winners all focused funds? More data is needed to be able to make a reasonable judgement here and yet the narrative is clearly ‘there is no sense in investing in active funds’.

**Argument 3: Outperformance does not persist, therefore there is no reason to own active funds**

One study I have seen looks at fund managers consistently in the top quintile for five years and then asks how many of them are in the top quintile in the following five years. Since the answer is not many, the conclusion is that active management is not worth paying for. Yet again, this is highly misleading since the question to ask is who was in the top quintile for the ten years – whether they got there by being first quintile followed by third or vice versa is almost entirely irrelevant.

**What you need to know about passive investing**

The articles trashing active management rarely seem to balance their criticism by highlighting the pitfalls of passive investing which we now consider.

**Passive investing automatically overweights expensive shares and underweights cheap ones**

The vast majority of passive investing is done via mainstream cap weighted index-based instruments. For anyone who believes in the long term merits of value investing, passive investing should make little sense since it is the antithesis: passive investing structurally overweights expensive stocks whilst underweighting cheap stocks. Passive investors in 2000 were allocating large chunks of their money to bubble stocks like Cisco, Sun and Yahoo, and also to accounting frauds like Enron and Worldcom which were on their way to zero. This negative aspect of passive investing is demonstrated by the fact that index returns can be improved just by equal weighting, or weighting by a variable such as sales. In fact, a piece of research by Rob Arnott showed that you can use virtually any methodology to weight a portfolio and it will outperform a cap weighted one because it introduces value and small cap tilts in to the portfolio.

**Do not confuse tracking error risk with risk of losing money**

In yet another recent article entitled ‘The end of active investing’ Charles D Ellis stated:

‘As indexing earns higher returns at lower cost and with less risk and less uncertainty, the world of active management will be taken down, firm by firm, from its once dominant position.’

Mr Ellis does not explain what he means by ‘risk’ but since he states that passive investing is less risky, then I can only assume he is talking about tracking error here. For Mr Ellis, buying the market at today’s elevated levels thus represents ‘low risk’ whereas to me it looks very risky.

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5 The case for low-cost index-fund investing’ by Harbrton, Roberts and Rowley, Vanguard Research August 2016
6 The actual figure is 16.2% which does actually indicate that about 1 in 6 managers were able to outperform on a sustainable basis.
7 The Surprising “Alpha” from Malkiel’s Monkey and Upside-Down Strategies
8 The end of active investing by Charles D Ellis Financial Times 20 Jan 2017
Passive investing will blindly follow bubbles up and then back down again. For instance, Japan was 17% of MSCI World in 1982, going on to peak at 41% in 1989 before falling back to 12% in 1997. Despite performing in line with the index, those investors who suffered a 78% loss from the peak may question whether this was a good outcome.

There are times when the market return is good enough, but now is not one of them

Many people investing in the stock market are doing so on the basis that they want to be able to fund some future liability and hence will often have a required return on their investment which will enable them to meet that liability. A good example here would be pension funds and by looking at the return assumptions of the pension funds of the biggest US and UK companies, we can get a feel for those required returns.
So US pension funds require a c. 6-7% p.a. return whilst a variety of indicators suggest US equities are priced for -3% real returns which is considerably less than that required. Locking in these returns with a passive strategy doesn’t strike me as a particularly fruitful way to meet future liabilities.

In conclusion, active investors may not have not covered themselves with glory but some of the criticism of them seems dubious. Conversely, passive investing undoubtedly has its uses but people also need to be aware of the pitfalls.
A third way – smart beta

The debate between active and passive has now moved on to a third option which is frequently referred to as ‘smart beta’. This is a systematic rules-based form of investing in which asset classes are broken down into factors that explain their risk return and correlation, which allows investors to remodel their portfolios by allocating assets to risk factors such as value, size, market, low volatility, term and credit. The move away from active equity mutual funds and into index funds, ETFs and hedge funds is being driven largely by investors’ desire to move away from funds that provide a total market exposure, and into funds that provide exposure to beta, macro factors, sector, style and idiosyncratic risks separately, or packaged together as required, and importantly, at a conservative price.

Once more, I have no problem with smart beta other than, yet again, I think it has been oversold. Thus the three good things you can say about smart beta are: 1) it’s low cost, 2) it’s consistent i.e. the computer doesn’t get depressed and finally give up when its strategy is out of favour, and 3) it has allowed investors to specifically select the exposures they are comfortable with at the right price. I do believe, however, that smart beta may have over promised and be set to under deliver for the following reasons.

Back tested results frequently perform better than the real strategy

I am sceptical of some of the back tested results from smart beta which frequently don’t make sufficient adjustment for transaction costs (t-costs) or the negative impact of an increase in AUM. The chart below shows how the returns from a large fund including t-costs can end up looking radically worse than those from small fund with no t-costs.

**FIGURE 8: CUMULATIVE DAILY RETURN**

Cumulative daily return to t-cost optimised value portfolios, February 1987 – December 2008

<table>
<thead>
<tr>
<th>Year</th>
<th>High AUM, gross of t-costs</th>
<th>Low AUM, gross of t-costs</th>
<th>High AUM, net of t-costs</th>
<th>Low AUM, net of t-costs</th>
</tr>
</thead>
<tbody>
<tr>
<td>1987</td>
<td>0.27</td>
<td>0.70</td>
<td>0.08</td>
<td>0.51</td>
</tr>
<tr>
<td>1990</td>
<td>0.70</td>
<td>0.70</td>
<td>0.51</td>
<td>0.51</td>
</tr>
<tr>
<td>1993</td>
<td>0.27</td>
<td>0.70</td>
<td>0.08</td>
<td>0.51</td>
</tr>
<tr>
<td>1996</td>
<td>0.70</td>
<td>0.70</td>
<td>0.51</td>
<td>0.51</td>
</tr>
<tr>
<td>1999</td>
<td>0.27</td>
<td>0.70</td>
<td>0.08</td>
<td>0.51</td>
</tr>
<tr>
<td>2002</td>
<td>0.70</td>
<td>0.70</td>
<td>0.51</td>
<td>0.51</td>
</tr>
<tr>
<td>2005</td>
<td>0.27</td>
<td>0.70</td>
<td>0.08</td>
<td>0.51</td>
</tr>
<tr>
<td>2008</td>
<td>0.70</td>
<td>0.70</td>
<td>0.51</td>
<td>0.51</td>
</tr>
</tbody>
</table>

Information Ratios

Source: Goldman Sachs Asset Management, 16 June 2009
Secondly, the factor portfolios used to measure returns are long stocks with the desired characteristic, e.g. cheap stocks, and short stocks with undesired characteristics, e.g. expensive stocks. In reality, an investor cannot practically invest in factor portfolios because of the restrictions on shorting and leverage.

Thirdly, there is a whiff of data mining about many of the factors that have been ‘discovered’. Harvey, Liu and Zhu (2015) document over 300 distinct factors but note that because the number of factors is practically unlimited and stock price changes are largely random, hundreds of false positives are inevitable.

Finally, evidence has accrued over the years that it becomes harder to profit from market anomalies once they’re harvested en masse. According to research from David McLean, a finance professor at DePaul University, the returns from investment ideas outlined in academic papers fall by more than half three years after publication9.

Most of the excess return from smart beta comes from exposure to value and size

In a paper called ‘The Surprising Alpha from Malkiel’s Monkey and Upside-Down Strategies’ the authors showed that various smart beta strategies outperform a cap weighted benchmark but went on to show that so did an equal weighted index. The reason for this is that an equal weighted benchmark loads on factors which are known to perform such as value and small cap. They then extended this analysis to the major smart beta strategies and showed (in the table below) that when these strategies are corrected for their exposure to value and size, they exhibit no statistically significant outperformance compared to a cap-weighted benchmark.

| FIGURE 9:                             |
| US STRATEGIES 1963-2012               |

<table>
<thead>
<tr>
<th></th>
<th>Return</th>
<th>Standard Deviation</th>
<th>Sharpe Ratio</th>
<th>Value</th>
<th>Small</th>
<th>Alpha t stat after Value and Size</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cap Weighted</td>
<td>9.66</td>
<td>15.29</td>
<td>0.29</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Equal Weighted</td>
<td>11.46</td>
<td>17.37</td>
<td>0.36</td>
<td>X</td>
<td>XX</td>
<td>0.38</td>
</tr>
<tr>
<td>Minimum Variance</td>
<td>11.75</td>
<td>11.69</td>
<td>0.56</td>
<td>XX</td>
<td>X</td>
<td>1.39</td>
</tr>
<tr>
<td>Maximum Diversification</td>
<td>11.99</td>
<td>13.96</td>
<td>0.48</td>
<td>XX</td>
<td>XX</td>
<td>0.54</td>
</tr>
<tr>
<td>Risk Efficient</td>
<td>12.50</td>
<td>16.81</td>
<td>0.43</td>
<td>XX</td>
<td>X</td>
<td>1.32</td>
</tr>
<tr>
<td>Risk Cluster Equal Weight</td>
<td>11.18</td>
<td>14.61</td>
<td>0.41</td>
<td>XX</td>
<td></td>
<td>0.49</td>
</tr>
<tr>
<td>Fundamental Weight</td>
<td>11.60</td>
<td>15.45</td>
<td>0.41</td>
<td>XX</td>
<td></td>
<td>1.83</td>
</tr>
<tr>
<td>Simulated Simians</td>
<td>11.26</td>
<td>18.34</td>
<td>0.33</td>
<td>X</td>
<td>XX</td>
<td>-0.31</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Inverse Strategies</th>
</tr>
</thead>
<tbody>
<tr>
<td>Minimum Variance</td>
</tr>
<tr>
<td>Maximum Diversification</td>
</tr>
<tr>
<td>Risk Efficient</td>
</tr>
<tr>
<td>Risk Cluster Equal Weight</td>
</tr>
<tr>
<td>Fundamental Weight</td>
</tr>
</tbody>
</table>

Source: Arnott, Hsu, Kalesnik, Tindall (2013)

9 Wall Street’s Hottest Investment Idea May Be Getting Too Hot by Dani Burger 06 February 2017
Returns from smart beta, like all investment strategies, are reliant on starting valuation

This is something we discussed in our recent white paper on the subject of ‘quality investing’. In summary, we concluded that there is no evidence of a quality premium in the long run and that even returns from quality are dependent on starting valuation (see Figure 10).

The second observation is that recent strong returns from quality strategies have been driven by expansion of valuation and future returns should therefore be lower as this valuation mean reverts. Generally speaking, if a factor does not include a rotation or update feature (so stocks with the desired characteristics are constantly recycled) then the factor may get more and more expensive as its popularity grows which ultimately reduces its future expected returns. The notable exceptions are value and momentum where the nature of these factors means that the composition of funds and indices will be constantly updated with new stocks which exhibit the required factor.

Some factors are difficult to identify on a quantitative basis

When a smart beta product seeks to produce exposure to a particular, factor e.g. quality, they will choose a measure such as return on assets and then look at historic figures, which can sometimes be overly simplistic and a poor guide to the future. In the case of ROA, returns could be at a cyclical high and about to collapse. The same applies to value smart beta where the use of measures such as price-to-book or price-to-earnings can lead to the selection of stocks which are anything but good value. Prior to the financial crisis, many low volatility ETFs had high exposure to financials because they had exhibited very low volatility. Unfortunately for investors in these funds this changed dramatically in 2008.

Too much money has gone into certain smart beta strategies thus sowing the seeds of its own destruction and actually leading to a potential gap risk

In 2007 many active quant strategies performed badly during the financial crisis. Leading up to 2007, quantitative investing had become an increasing percentage of the overall market. When quantitative investors were forced to unwind their positions simultaneously in August 2007, it created the dramatic moves that were synchronised across factors and markets shown in Figure 11.

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FIGURE 10: QUALITY PERFORMANCE BY STARTING VALUATION QUINTILE (%)

Source: SG Cross Asset Research/Equity Quant, FactSet, FTSE, I/B/E/S
As certain smart beta products such as low volatility and minimum variance have attracted lots of money, there must be a risk that in the event of sudden drawdown and redemptions, many funds will be forced to sell similar positions into an illiquid market, causing significant share price reactions.

‘If anything, we think it’s reasonably likely a smart beta crash will be a consequence of the soaring popularity of factor-tilt strategies.’

Some believe that the ‘side crashes’ of 2014 and 2016 (where many smart beta and active managers experienced significant underperformance in what appeared to be uneventful, non-directional markets) were early indications of the potential vulnerability of these strategies. An example of this was given in an article entitled Wall Street’s Hottest Investment Idea May Be Getting Too Hot by Dani Burger:

“For example, total assets in the iShares Edge MSCI Minimum Volatility fund reached $15 billion by late July, more than twice what they were at the start of 2016. Soon, the BlackRock Inc. product began to see historically large price swings. It fell 2.8 percent in October, its worst month in over a year, as investors pulled $2.1 billion in the last three months of 2016.”

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12 How can Smart Beta go Horribly Wrong by Arnott, Beck, Kalesnik and West Feb 2016
In conclusion, smart beta serves a function and has played a big part in bringing down fees but is maybe not the investing nirvana that it is being sold as.

**Why don’t active managers do better?**

In the same way that all the academic evidence shows fund managers can’t outperform, lots of evidence shows that certain factors do generate excess returns: value, size and momentum. Figure 13, from one of the most famous studies ‘What works on Wall Street’ by James P O’Shaughnessy, shows the excess return from value strategies. This then raises another interesting question, if it is theoretically possible for active investors to earn excess returns, why do so few achieve this in practice?

**FIGURE 13:**
VALUE OF $10,000 INVESTED IN VARIOUS STRATEGIES FOR THE 52 YEARS ENDING IN DECEMBER 2003

<table>
<thead>
<tr>
<th>Strategy</th>
<th>Value USD</th>
</tr>
</thead>
<tbody>
<tr>
<td>High PSR</td>
<td>$19,118</td>
</tr>
<tr>
<td>Low PSR</td>
<td>$22,012,919</td>
</tr>
<tr>
<td>High P/Cashflow</td>
<td>$136,834</td>
</tr>
<tr>
<td>Low P/Cashflow</td>
<td>$17,724,382</td>
</tr>
<tr>
<td>High P/Book</td>
<td>$267,147</td>
</tr>
<tr>
<td>Low P/Book</td>
<td>$22,004,691</td>
</tr>
<tr>
<td>High PE</td>
<td>$793,558</td>
</tr>
<tr>
<td>Low PE</td>
<td>$8,189,182</td>
</tr>
</tbody>
</table>

Various attempts have been made to explain why active managers don’t perform better, with some of the most common factors being as follows.

- Career risk and psychological pressure leading to closet tracking
- Funds becoming excessively large
- Investors don’t stay with funds across a market cycle

The common theme running through all of these issues is the agent principal conflict. In essence, this refers to the fact that the interests of the underlying investor or principal are different from the fund manager or agent. The latter wants to grow his AUM as large as possible since he is paid an ad valorem fee, whilst the former wants the best risk-adjusted returns. Most managers know which investment factors work (value, size, momentum) but they also know that these styles will often be out of favour for periods of time. They also know that they are likely to get fired after three years of poor performance and hence their best chance of minimising this is to blend factors across the portfolio, keep tracking error low and thus hopefully reducing the chance of a sustained period of poor performance but also sacrificing potential return. Welcome to the world of the closet tracker.

Finally it is also worth noting that active and passive scale differently – passive needs to be very large in order to drive efficiencies of scale and keep fees low whilst active returns deteriorate beyond a certain fund size.\textsuperscript{13}

So returns can either be destroyed by fund managers straying from the optimum investment strategy in order to safeguard their job, or investors in funds can diminish their own returns by chasing performance between funds as shown in the chart below. This suggests that on average investors have given up about 2% p.a. by not sticking with funds.\textsuperscript{14}

In order to maximise returns investors need to be willing to stick with a strategy even during periods when it is not ‘working’.

\textbf{FIGURE 14:}
\textbf{U.S. EQUITY MUTUAL FUNDS: RETURNS REALISED BY TYPE OF FUND (NET OF FEES)}
Monthly Data Compounded to Annual Periods (1991 to 2013)

\begin{figure}
\centering
\includegraphics[width=\textwidth]{chart.png}
\caption{Monthly Data Compounded to Annual Periods (1991 to 2013) for U.S. Equity Mutual Funds}
\end{figure}


\textsuperscript{13}The active management dead? By Jason Voss discusses the issue of ‘fund bloat’ or how returns deteriorate as funds grow larger

\textsuperscript{14}Taken from ‘Timing Poorly: A guide to generating poor returns whilst investing in successful strategies’ by Hsu et al
What can active managers do better than passive or smart beta?

One of the main claims active managers will make is that by taking an absolute approach to valuation, they can protect on the downside by going to cash at times when valuations are high. I would also contend that this is better done on a bottom up basis than a top down one as the top down investor struggles to see the valuation dispersion within a market that may offer opportunities even when the cap weighted index valuation looks full.

I do, at this juncture, struggle to defend the industry as a whole. As the chart below shows, across the industry, fund managers tend to raise cash after the market has fallen (as in 2008) and invest it after the market has gone up (now) thus almost guaranteeing a return that is worse than a passive fund that had been fully invested throughout. It is important to note, however, that this is an industry average and that within this there would be funds like us, who have been increasing cash levels over the last few years.

**FIGURE 15:**

![Graph showing liquidity ratio and S&P 500 Index](source)

Source: Bloomberg, StockCharts.com, ICI, 28 September 2006 to 30 November 2016

The liquidity ratio of equity funds (the percentage of liquid assets over total net assets) was 3.2% in August, compared with 3.3% in July

Is now a good time to make the switch from active to passive?

In a recent note from Nomura Quant Strategy\(^\text{15}\), the authors pointed out that active performance tends to go in cycles and this is the fourth trough reached in the last fifty years. Each one has been followed by a mean reverting recovery as active managers have bounced back (see Figure 16).

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\(^{15}\) Peak passive: The coming active renaissance by Nomura Quant Strategy 5 January 2017

There is a logic to the patterns of active performance; active managers tend to outperform when cross sectional volatility (return dispersion) is high, and pairwise correlation (the extent to which all stocks are being driven by common factors) is low, hence allowing for unique insights to be used into the investment process. This concept is demonstrated in the chart below which shows the correlation of equity hedge fund excess return with 3 month return dispersion.

**FIGURE 17:**
**STOCK-PICKERS STRUGGLE WHEN DISPERSION IS LOW**
3-month return dispersion and equity hedge fund excess return vs. S&P 500

Source: Goldman Sachs, 1992-2017
Unfortunately for active managers, since 2007 macro factor risk has driven correlation to historically high levels and return dispersion to low levels. A recent article in the Wall Street Journal explained, in plain English, why fundamental based stock pickers have struggled in this environment.

“Last year’s markets were difficult for Tiger Cubs and other bottom-up investors because companies often didn’t rise or fall on their individual fundamentals. Instead, entire sectors of the market traded in lockstep, such as when energy companies rallied during the first half and when financial stocks surged after the presidential election of Donald Trump on expectations of economic growth. Stocks that traditionally were more expensive and had strong growth prospects also sold off, another development that surprised some of these managers.”

There are now signs that this is changing and dispersion could be set to increase. If history is any guide, now could be the worse time to consider a switch from active to passive.

So if you are going to hunt for an active manager, what should you look for?

- One that follows an approach with empirical backing. Value, momentum, and size have been shown to work whereas ‘quality at any price’ or ‘we do lots of company meetings’ have not.
- They have followed that approach which has been proven to work over a long period of time and they have applied it in a disciplined fashion. They have the patience and discipline to stick to this approach throughout periods when it is not working.
- Someone who thinks in absolute terms rather than joining the relative performance derby. This will necessitate going to cash when there are no opportunities around, sometimes for long periods of time.
- The strategy is implemented in a concentrated fashion. Numerous studies show managers with high active share strategies are more likely to generate long-term alpha. Martijn Cremers and Antti Petajisto wrote the seminal study defining active share: ‘How Active Is Your Fund Manager? A New Measure That Predicts Performance’ in 2007. They concluded:

> “Funds with the highest Active Share significantly outperform their benchmarks, both before and after expenses, and they exhibit strong performance persistence. Non-index funds with the lowest Active Share underperform their benchmarks.”

FIGURE 18:
DIFFERENT TYPES OF ACTIVE MANAGEMENT

Source: Cremers and Petajisto (2009)

17 Juliet Chung The Wall Street Journal 07 February 2017
This evidence was supported by recent research from Sanford Bernstein who not only showed that funds with higher active share generate higher returns, but that they also had a higher information ratio (see Figure 19).

**FIGURE 19:**
RISK-ADJUSTED PERFORMANCE OF FUNDAMENTAL FUNDS BY ACTIVE SHARE BUCKET

<table>
<thead>
<tr>
<th>Active Share</th>
<th>Annualised return (Gross performance)</th>
<th>Annualised TE</th>
<th>Return/Risk</th>
</tr>
</thead>
<tbody>
<tr>
<td>&lt;50</td>
<td>1.1%</td>
<td>2.9%</td>
<td>0.39</td>
</tr>
<tr>
<td>50-70</td>
<td>1.8%</td>
<td>1.3%</td>
<td>1.38</td>
</tr>
<tr>
<td>70-90</td>
<td>2.5%</td>
<td>1.8%</td>
<td>1.37</td>
</tr>
<tr>
<td>&gt;90</td>
<td>4.2%</td>
<td>2.9%</td>
<td>1.45</td>
</tr>
</tbody>
</table>

Source: eVestment and Bernstein analysis

- Costs such as turnover are kept to a minimum. Research by Roger Edelen “Shedding Light on ‘Invisible’ Costs: Trading Costs and Mutual Fund Performance” found a strong negative relationship between aggregate trading costs and fund returns. Mutual funds in the lowest quintile of aggregate trading costs in Edelen’s study had average annual returns 1.78 percentage points higher than the highest quintile, highlighting the detrimental effect trading costs can have on performance.

- In terms of the asset management firm that your active manager works for, I would tend to focus on two things. Firstly, is the firm independent and owner managed or is it a large quoted firm? David Swensen, the former CIO of Yale Endowment has said he prefers smaller, private partnership over the larger, listed full service operator. Secondly, as Tim Price suggests in his book ‘Investing through the Looking Glass,’ fund management firms can be broadly separated into asset managers and asset gatherers:

  “The investment world is polarised between asset managers, who focus their energies on delivering the best possible returns for their clients, and asset gatherers, who just want to maximise fee income. Most fund management firms fall into the latter category. Favour the former.”

**Conclusion**

- Passive funds have been a force for good as they have put pressure on industry fees and allowed investors to buy market return cheaply. Some of their criticism of active funds, however, is disingenuous at best. Investors also need to be aware of the pitfalls of going passive, namely that the strategy over-weights expensive stocks and under-weights cheap ones and that even an equal weighted strategy can improve returns by tilting towards value and size. Whilst they may have no tracking error risk, going passive at a time of very high valuations almost guarantees low future returns which may be insufficient to meet future liabilities.

- Smart beta has clouded the differentiation between active and passive and is a systematic strategy that allows exposure to certain factors. Fees for the strategy are very competitive and it has attracted a significant amount of money. Investors need to be aware that most of the excess return comes from exposure to value and size, and that many of these factors are trading at historically high valuations which should lower future returns, and that the crowding of money into the strategies could cause turbulence in the event of a drawdown which leads to redemptions.

- The returns from active funds can be disappointing, either because managers do not expose the fund to factors which should produce an excess return, or because investors are unwilling to stick with strategies through a full market cycle.

- Active fund managers should be able to reduce drawdown risk by increasing cash at times of high valuations, although the evidence suggests many actually do the opposite.

- The most successful active managers tend to follow a strategy tilted towards factors which have been shown to work, such as value, momentum or size, but have the patience and discipline to stick with them through a market cycle. They will often have high tracking error, high active share and concentrated portfolios, but have low turnover and keep costs to a minimum.

- Finally, the manager is likely to be working in a stable business environment that allows them to effectively implement their investment strategy and one which encourages longevity.

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