Succeeding with Active Portfolios in a Passive World

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Late in 2018, the move from active management to passive management continues unabated. While investors have repeatedly called for a period of outperformance by active managers, the flow data continues to show investors fleeing active management products and moving into passive products, mostly into exchange traded funds.

Through the end of June 2018, US equity investors have favored passive investing by withdrawing almost $200 billion from active funds while investing $165 billion into passive ETFs and mutual funds. In 2017, there were over $200 billion in withdrawals from active US equity funds and inflows of $220 billion into passive products. Exhibit A details flows for various products between passive and active. Passive is winning across the equity spectrum.

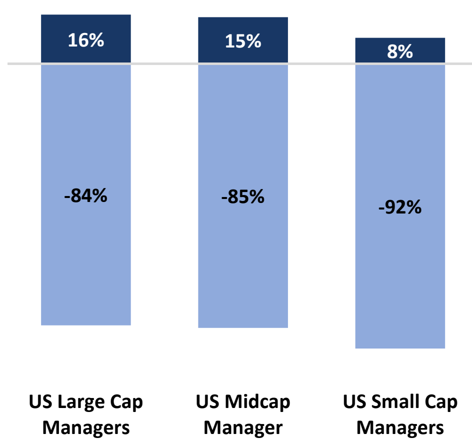
Exhibit A: Estimated Net Flows to Mutual Funds and ETFs ($Millions)
(12-Month flows through June 30, 2018)

Category	Active	Passive
U.S. Equity	(199,095)	165,088
Sector Equity	(21,167)	36,175
International	50,826	144,150
Equity Allocation	(31,191)	2,193
Taxable Bond	141,372	171,489
Municipal Bond	21,999	5,750
Alternative	3,435	2,050
Commodities	5,902	(462)
All Long Term	(27,919)	526,433

Source: Morningstar Direct Asset Flows. Includes liquidated and merged funds

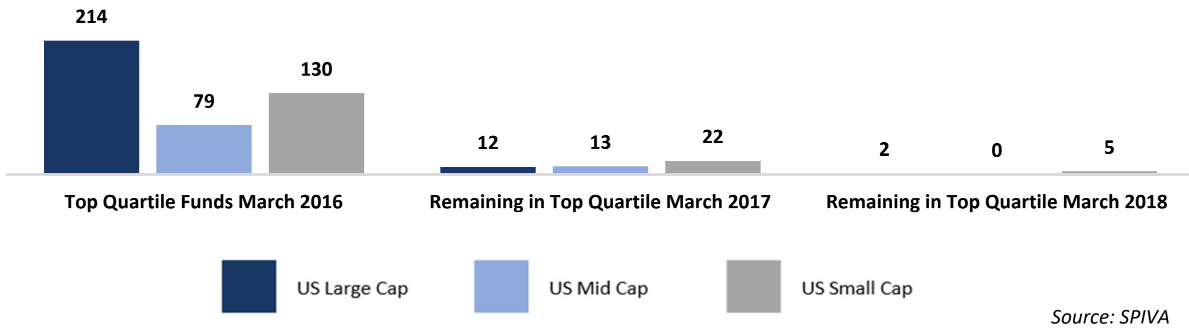
The moves make sense, given the recent performance of active funds relative to indexes (Exhibit B). S&P Dow Jones publishes a report on index versus active performance for US domiciled mutual funds and the evidence is compelling on the side of indexing. For the five years ended 12/31/2017, only 16%, 15% and 8% of US large cap, mid cap and small cap managers, respectively, outperformed their policy benchmarks.

Percent of Managers Outperforming/Underperforming Benchmarks
5 years ending 12/31/2017



Source: SPIVA

Exhibit C: Performance Persistence Relative to Peers



Source: SPIVA

In addition, as shown in Exhibit C, there is not much persistence in funds outperforming at any point in time. While there were 214, 79 and 130 US large cap, mid cap and small cap funds, respectively, in the top quartile of their peer groups for the five year period ending March 2016, only 12, 13 and 22 funds remained in the top quartile by the end of March 2017 and only 2 large cap and 5 small cap funds remained in the top quartile by the end of March 2018.

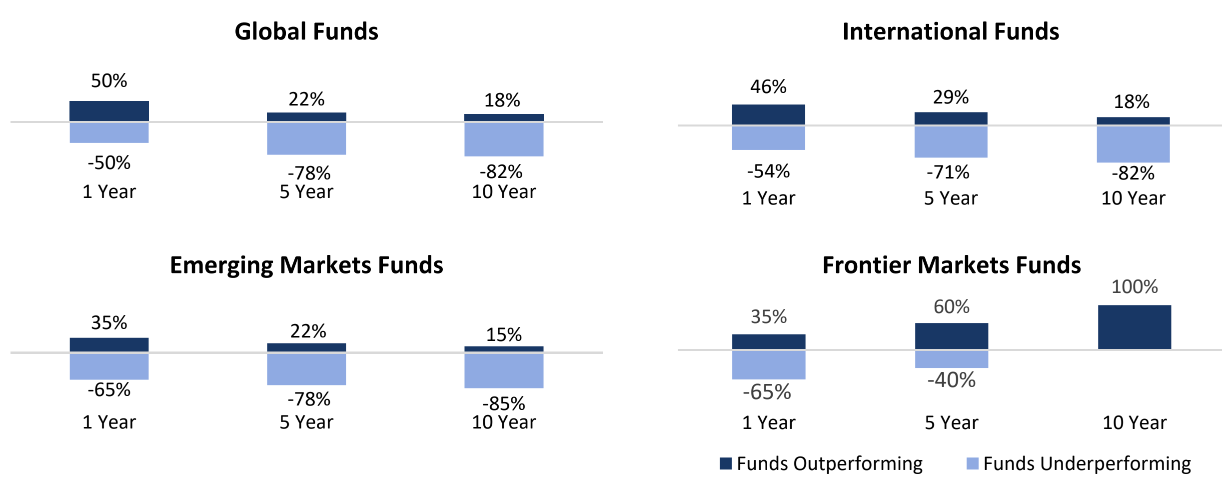
The underperformance carries over to global, international and emerging market funds as well, as shown in Exhibit D.

About the only place where active outperformance has been found is in the frontier markets, where 35% of managers have outperformed on a one-year basis, 60% have outperformed on a five-year basis and all six managers that were in existence in 2008 have outperformed on a 10 year basis. In an earlier paper, we discussed the inefficiencies that have supported active management in the frontier[i].

All the charts show performance net of fees.

There have been a number of reasons offered to explain the underperformance of active managers outside of frontier markets. These include efficient markets, a narrowing of the opportunity set, low volatility, skewness and kurtosis, factor underperformance since the financial crisis, closet indexing or overdiversification, portfolio construction mistakes, fees and trading costs.

Exhibit D: Outperformance/Underperformance of Funds by Asset Class



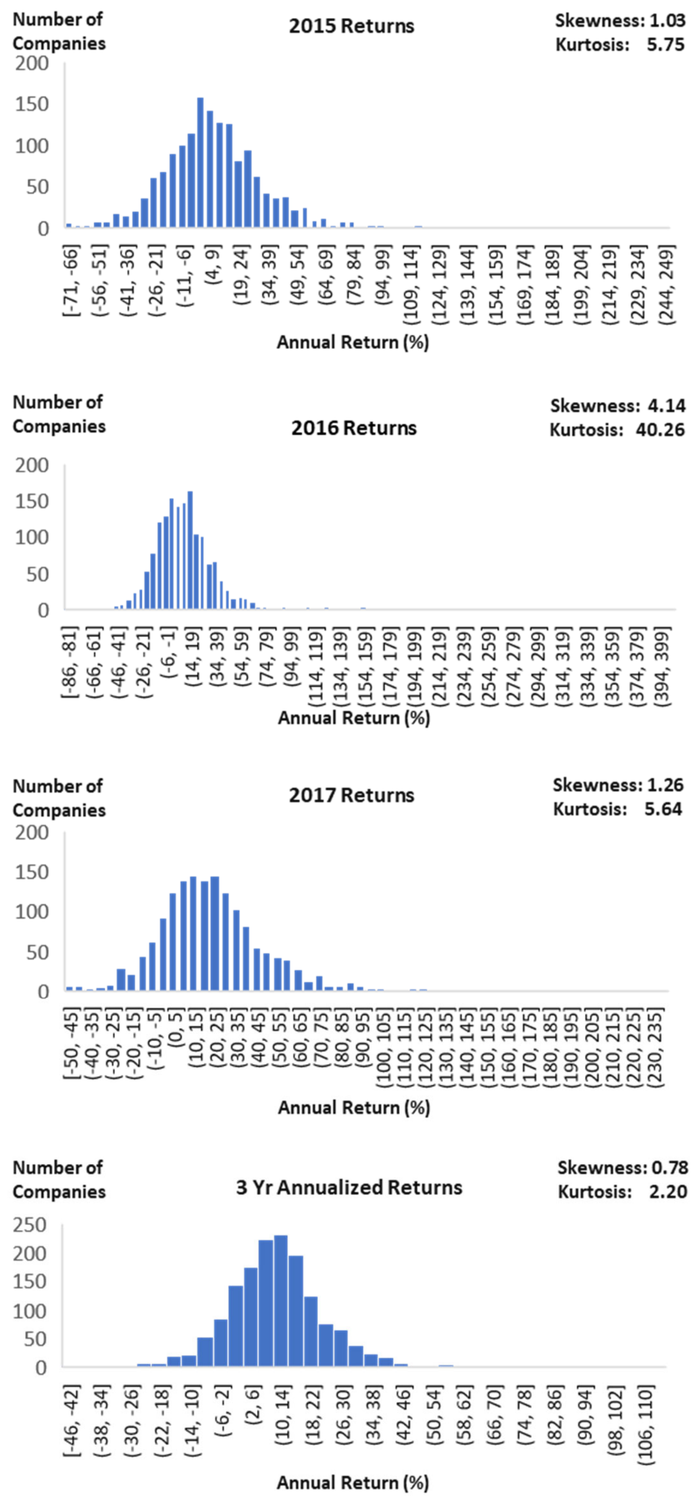
The first three reasons can be dismissed fairly easily. As most of you know, we don't subscribe to market efficiency in the manner of modern portfolio theory and random walks in stock price behavior. We believe investor emotion plays an important role in driving under/over valuation and inefficiency in the markets. We utilize behavioral finance tools to identify mispriced securities. Academic research has shown that the strong form of efficiency does not hold, and a number of factors have been identified that can be exploited to generate alpha. While the number of US securities has been declining, there are now over 3000 stocks in the US and 12,000 plus stocks outside the US, therefore we believe the opportunity set is large enough to build a portfolio of a reasonable number of securities without becoming a closet index. The key is to construct the portfolio in a manner that gives the investor a chance to outperform, as discussed below.

Skewness refers to the level of asymmetry in a distribution. If a distribution is perfectly bell shaped, it exhibits no skewness. If it leans to one side, it shows a skewness toward negative or positive results. Kurtosis refers to the size of the tails of a distribution. If a distribution presents infrequent but extreme outlier results it is said to be leptokurtic or exhibiting greater than normal outlier results.

Skewness and kurtosis are an issue. Academic research has determined that stock returns are not normally distributed and that there is a "skew" in returns to the upside in a few stocks. The mean stock therefore tends to underperform. However, we believe that skewness and kurtosis can be minimized by taking a longer-term view of investments.

As shown Exhibit E, for 2015, skewness of individual stock returns for the MSCI World Index is 1.03 while kurtosis was almost 6. Both of these numbers are well outside what would be observed with normally distributed returns, which would have a skewness of 0 and kurtosis of 3. The same can be found for security returns in 2016 and 2017. Markets with high skewness to the right and high kurtosis (a fat tail on the right) have narrow leadership in a few high performing stocks. This is challenging for active managers who may be skeptical of those stocks.

Exhibit E:
Impact of Skewness and Kurtosis on Ability to Outperform



Source: FGP, FactSet

However, when we analyze compound annual returns for the entire period, we observe some reversion to the mean and the skewness and kurtosis come down to 0.8 and 2.2, respectively. This tells us that taking a longer-term view and holding stocks for a longer period of time does not eliminate but helps mitigate the skewness and kurtosis effect on portfolio performance.

FGP believes that the main reasons for underperformance are the last few reasons listed above; mainly closet indexing or overdiversification, portfolio construction mistakes, fees and trading costs.

In the landmark paper "How Active is Your Fund Manager? A New Measure That Predicts Performance"[ii] authors Martijn Cremers and Antti Petajisto (2009) identified Active Share as the correct measure of structural active bets in a portfolio and showed that alpha was correlated with active share rather than the tracking error of a portfolio. They found that only 20% of US funds have active share of over 80% in the mid-2000's compared to 60% in the mid-1980s, clearly demonstrating the push towards tracking error control and closet indexing. This move has been led by a fear of underperformance from managers and a desire to control risks from clients and has created the exact opposite effect to that desired. Most managers are running closet index funds but charging active management fees, thereby almost guaranteeing underperformance after fees. Cremers and Petajisto also found that the highest quintile of active share products delivered almost 1.5% of benchmark adjusted alpha.

We believe in building portfolios with high active share. As shown in the table below, our global equity portfolio has an active share of 91.5%.

Conclusions

At Frontier Global Partners, we strive to build all of our portfolios with active shares greater than 80%, and we believe we can deliver value with this method. We also believe the way to manage active portfolios is to concentrate your active management in inefficient asset classes and make sure your managers are:

- Building portfolios with high active share
- Pursuing a low turnover, long-term approach
- Minimizing other costs

Facts About Active Share

Only 20% of US funds have active share over 80%, down from 60% in mid 1980's.

The highest quintile of active share delivered almost 1.5% in benchmark-adjusted alpha.

Tracking error was not a good predictor of outperformance.

Cremers and Petajisto (2009)

Sample Global Portfolio

Holdings July 31, 2018	Weight	Country	Sector
Amgen Inc.	4.3%	US	Health Care
Apple Inc.	9.0%	US	Technology
Astellas Pharma Inc.	3.0%	Japan	Health Care
Bandai Namco Holdings Inc.	5.9%	Japan	Cons. Discretionary
Bank of New York Mellon Corp.	3.2%	US	Financials
Cisco Systems, Inc.	5.9%	US	Technology
Coca-Cola Company	4.2%	US	Consumer Staples
Federated Investors, Inc.	2.6%	US	Financials
Foot Locker, Inc.	2.5%	US	Cons. Discretionary
Haier Electronics Group Co.	2.4%	China	Cons. Discretionary
Lear Corporation	5.6%	US	Industrials
Magna International Inc.	3.0%	Canada	Industrials
Microsoft Corporation	6.9%	US	Technology
NetApp, Inc.	6.9%	US	Technology
Okuma	2.9%	Japan	Industrials
Persimmon Plc	2.4%	UK	Cons. Discretionary
Porsche	3.5%	Germany	Cons. Discretionary
Qualcomm Incorporated	4.4%	US	Technology
Samsung Electronics	3.5%	Korea	Technology
Taisei Corp	2.8%	Japan	Industrials
Taiwan Semiconductor	7.2%	Taiwan	Technology
Teleperformance SE	7.3%	France	Industrials

About Frontier Global Partners

Frontier Global Partners manages a focused set of investment solutions covering international, global and frontier market equities, asset allocation and alternative investments. Under the direction of managing partners Lawrence Speidell, CIO, and Horacio Valeiras, CEO, the organization sustains a dynamic investment culture rooted in behavioral finance. The firm's investment strategies reflect a shared commitment to investing in high-quality securities at prices that represent good value and to managing portfolios that exhibit low turnover. Born of twin organizations that covered separate and distinct global market segments with common approaches, the firm manages concentrated equity portfolios drawn from the breadth of the world's markets. Frontier Global Partners is an independent, employee-owned organization with offices in La Jolla, California and Boston. A majority of the firm's equity is held by women and minority partners.

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[i] *Speidell, Larry, Frontier Market Investing: Active versus Passive, Winter 2016, The Journal of Investing.*

[ii] *Cremers, K. J. Martijn and Petajisto, Antti, How Active is Your Fund Manager? A New Measure That Predicts Performance (March 31, 2009). AFA 2007 Chicago Meetings Paper; EFA 2007 Ljubljana Meetings Paper; Yale ICF Working Paper No. 06-14.*