Manole
Capital Management

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Active versus Passive Management

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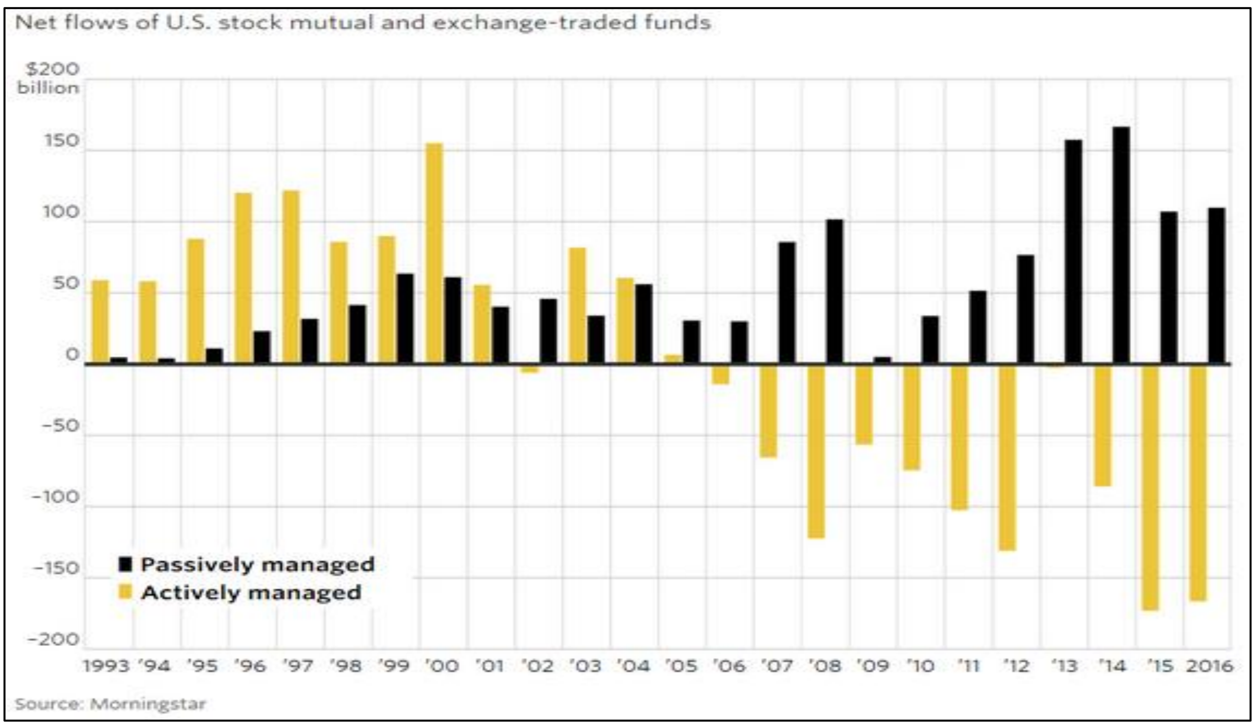
Not to state the obvious but…beating the market is hard. Really hard! It seems that every financial publication has already emphasized how passive investing has won the race for assets and returns. The idea that investment managers cannot beat the index has become an investing truism; that the single best choice for most individual investors, wishing to gain market exposure, is simple low-cost indexing. In fact, legendary investor Warren Buffett advocated this very idea in his most recent annual newsletter (seen here).

Quite simply, over the last few decades, investors have benefitted from a rising market. Mutual funds have been the typical avenue for investors and this provides daily liquidity and modest transparency. Name brands have been built and established and retail investors gain comfort with adding additional resources to their IRAs and company-sponsored 401(k)'s. We wholeheartedly agree that more and more Americans need to save more for their retirement. However, getting invested and staying invested is only half the battle.

The Market Index

What could be wrong with getting market returns at unbelievably low prices? Not much! It is our opinion that passive investing plays a key role in any investor's diversified portfolio. We believe that passive investments are best used when one is looking to replicate or mimic a certain sector or exposure. In addition, passive investments can be wonderful vehicles where the underlying manager has no inherent knowledge advantage. This can be especially helpful in cyclical sectors with unpredictable data points. For example, rather than forecast the price of WTI crude per barrel, one can simply choose to hug the benchmark weight in the energy sector and purchase the XLE. If you do not have a fully comprehensive view of what will happen to ObamaCare, one could purchase the XLV and avoid the entire, controversial healthcare debate.



According to Morningstar, over the last two years, investors have pulled nearly $600 billion from actively-managed US funds and put almost $1 trillion into passive vehicles. In a low-growth and low-interest-rate environment, smart investors flocked to low-cost passive funds. There are essentially 3 players in the highly competitive passive index business. The "Big 3" are Blackrock's iShares, Vanguard and State Street's Spiders, which garner over 80% of the market. This is a scalable business model, but this race towards 1 basis point management fees will likely hurt all participants (but ultimately help investors). Index investors benefit from

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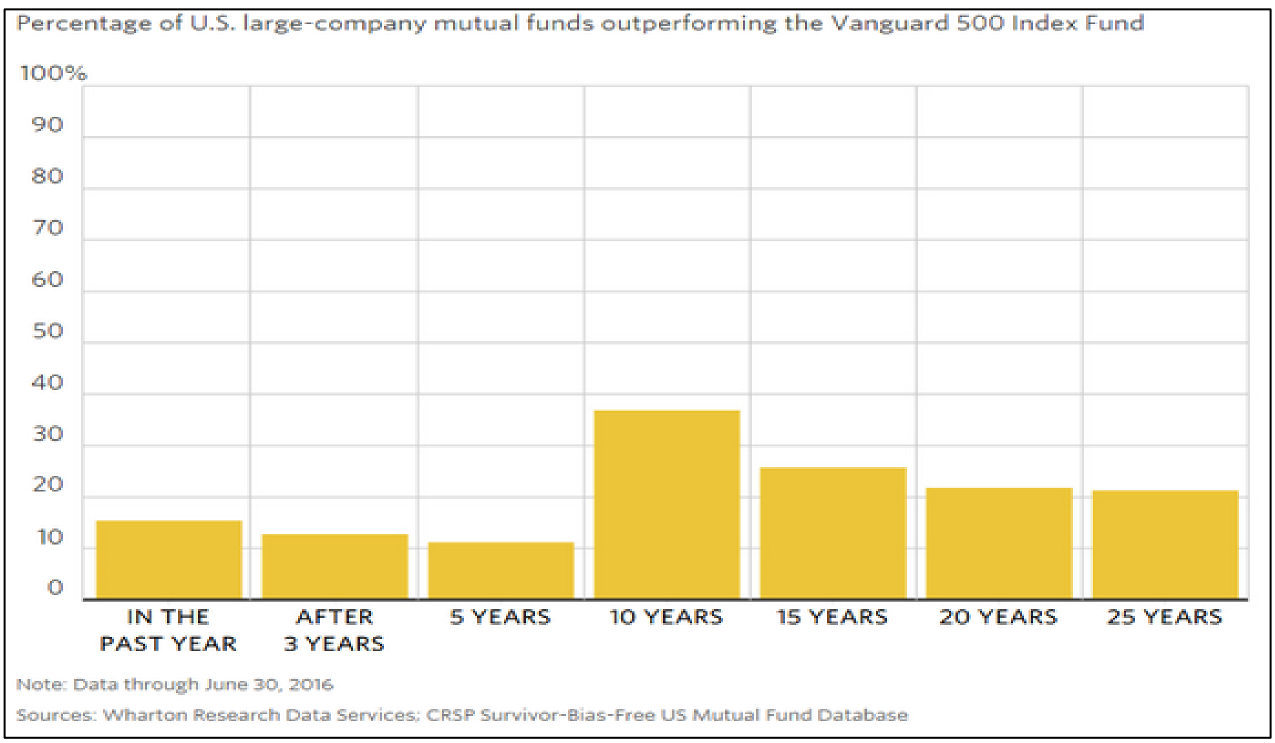
lower and lower fees and can easily mimic a certain benchmark. Vanguard is a perfect example of the explosion of passive investing. Over the last seven years, its assets under management have grown from $1 trillion to $4.2 trillion today. Over the last three years, Vanguard has brought in over $800 billion. If one looks at the other 4,000 investment managers, Vanguard has attracted more than 8 times all its peer group combined (less than $100 billion). Is this growth about to stop? Absolutely not! In fact, one should anticipate more and more assets to continue to flock towards passive investments. Active US managers oversee nearly $10 trillion in assets compared to passive funds with $5.4 trillion. Despite the passive sector doubling since 2012 and up a whopping 158x since 1993, we do not envision any change to this market trend. Considering passive investment vehicles represent roughly 30% of total US funds, it should continue to steal market share from the active segment.

Peek Behind the Curtain

Active managers prefer you know less about their philosophy and strategy. Why? Since clients pay higher fees for active management versus passive, there needs to be something inherently special in the process. To quote the wizard in The Wizard of Oz, "Pay no attention to the man behind the curtain." S&P Dow Jones recently published its 15th annual index versus active scorecard. Over 15 years of analysis, which easily covers a full market cycle, active managers were handily beaten. 92% of large-cap, 95% of mid-cap and 93% of small-cap managers underperformed their benchmark. While value managers did better than their growth peers, 79% of large-cap value managers trailing their bogey is far from ideal. This widespread underperformance applies to both long-only and long/short managers (i.e. hedge funds), which would prefer to keep their "original formula" management process under "lock and key". Investors should always ask for transparency and clarity into positions and holdings. Unfortunately, this cannot be accomplished in traditional co-mingled products. For example, 1940 Act mutual funds are able to shield their positions and weights for 60 days following quarter-end. Why all the deception? Are managers really concerned that investors are looking to mimic their returns? This assumes investors would even want to follow this level of underperformance.

This is one reason why Manole only offers separately managed accounts or SMA's. This allows our clients to have 100% transparency into positions and holdings for *their* account. As the industry shifts more towards customization, truly active managers providing proprietary products should be able to succeed.



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Performance, Performance, Performance

Unfortunately, an opaque process does little to fuel investor confidence or improve retention. The ultimate arbiter of excellence comes down to one thing – performance. Are you able to beat the market or applicable index? In asset management, outperformance remains the ultimate benchmark bogey. How can one gauge if their portfolio manager possesses this expertise or knowledge? One could look at long-term performance returns, but this only tells part of the story. During 2016, only 31% of actively-managed funds beat their benchmark. In fact, active managers have a lengthy stretch of underperformance that will take years to unwind. The last year when even half of active managers beat their index was 2009. A recent study by Prudential's asset management business (PGIM) found that active manager performance runs countercyclical to the overall market. Additional research has proven that active managers have the best chance of outperforming in two distinct environments – high volatility and down markets. During the downturns of 2000 (dot-com era) and 2007 (financial crisis), 66% and 53% of actively-managed funds outperformed. Simply stated, large-cap managers tend to deliver stronger relative returns when the market heads down.

Opportunity

In our opinion, it comes down to limited choices. Investors in an index fund will generate the market return, less a very modest management fee. Passive investors benefit when the market is headed higher, but some fail to appreciate the downside. In the event the market heads lower, the same passive investor locks in all the market losses. A recent American Funds analysis stated that only half of all investors were aware that index funds expose them to 100% of the volatility and losses during a market downturn. According to the National Bureau of Economic Research, our current expansion is in its 94th month. We are in the midst of the 2nd longest bull market on record, as we enter its eighth-year anniversary. One could easily argue that this is a widely-accepted view. If that is the case, and experienced investors realize that markets are a series of "ups and downs", we should anticipate a market correction sometime in our future. While the upside and downside (relative to the overall market) is essentially known with passive investments, the investor has limited their opportunity. While it might not sound like much, we appreciate the value of being able to "lose less" than an index during market declines. If an investor chooses an active manager, he or she at least has the opportunity to outpace the index. Obviously, one always wishes to maximize returns when they are trending higher, but isn't it also valuable to control the damage on the way down?

A New Trend

While there is no arguing with the facts and numbers, we have a somewhat non-consensus belief. We run contrary to the widespread belief is that it is more advantageous to outsource all investment decision-making to an index committee rather than an industry sector expert doing bottoms-up research. We believe some of this underperformance stems from too many portfolio managers seeking to become generalists, as opposed to sticking to a sector specialty - a "jack of all trades, but master of none". We are not claiming that outperformance cannot be attained from a diversified portfolio, but we believe in the market trend of becoming more and more specialized. Why not selectively pick an industry specific expert to manage a smaller slice of your assets, as opposed to hiring a somewhat knowledgeable manager of every global industry? We have a tremendous amount of respect for Jim Cramer of CNBC. He knows a few key bullets about a remarkable number of companies. This knowledge is on display each night during his "Lightning Round". But we intentionally choose to be a sector specialist and not a broad, market generalist. Instead of being a mile wide and an inch deep, we prefer to focus our attention on one specific area – Fin Tech. This is not a new-found interest, but one we have specialized in for over 20 years. Long before this emerging category got popularized, we were investing in payment companies classified as either "non-traditional" financials or "chicken tech" companies.

Understanding the benchmark

The S&P 500 is the most widely used benchmark for gauging US large capitalization equities. If one looks at the S&P 500 composition today, they would see a diversified mix of various sectors. For example, the three largest segments of the benchmark are Technology at 20.4%, Financials at 16.0% and Healthcare at 14.7%. In addition, a passive investor gets exposure to Consumer Discretionary (12.9%), Industrials (10.1%),

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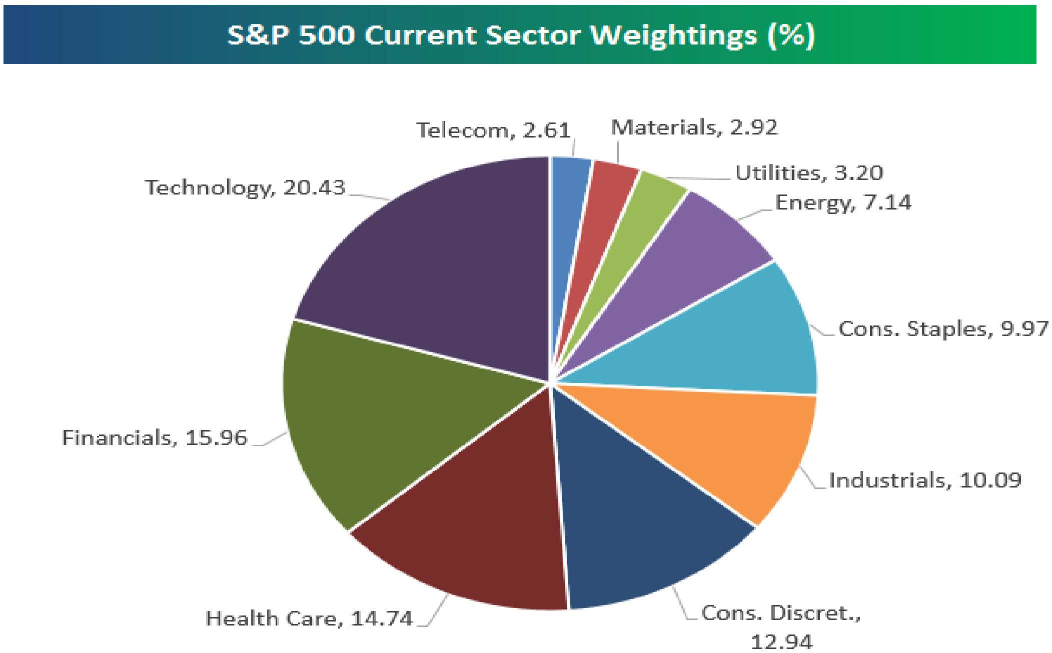
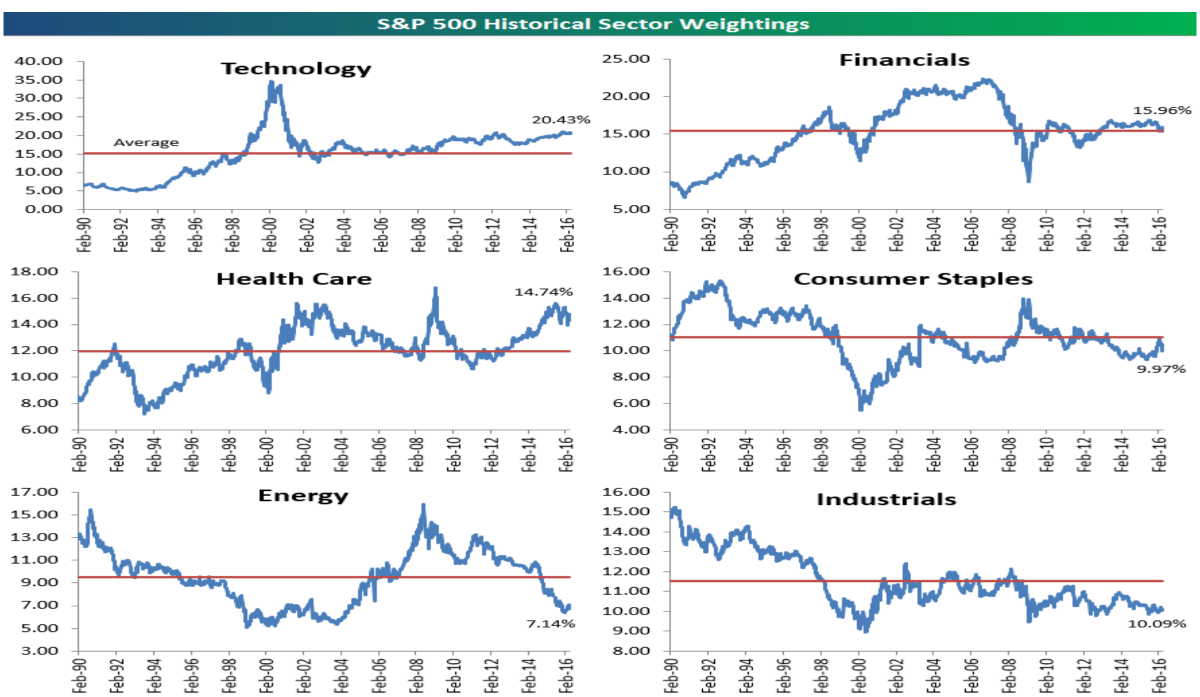
Consumer Staples (10.0%), Energy (7.1%), Utilities (3.2%), Materials (2.9%), and Telecom (2.6%). S&P Group (ticker: SPGI) sets the weights and regularly re-balances this index. Our issue is not with the market benchmark, nor its composition. When compared to the share price-determined Dow Jones Industrial Average (DJIA), the S&P 500 is a remarkable improvement (see our note here on the flaws of the DJIA). However, the S&P 500 has a market capitalization size bias too. For example, the single largest weight in the SPX is Apple (ticker AAPL) at 3.7%. The smallest weight in the benchmark is News Corp (ticker NEWS) at 0.008%. Once again, we view the S&P 500 as the single best index or benchmark reflecting the overall US equity market. We simply have some concerns with it upon closer scrutiny.





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Flaws

What is our problem with benchmark weightings? The biggest issue we have with sector bets can be explained by the need of passive asset managers or investors to follow applicable benchmark weights, whether or not they agree with current valuations or sentiments. One good example can be found by analyzing sector weights back in the late 1990's. During the dotcom era, technology was rapidly changing our world and valuations for certain companies moved dramatically higher. By 1999, technology was the largest segment of the S&P 500 with a weighting well in excess of 35% (see the chart above). When a sector or company is in favor, the index fund must buy even more of it, which may or may not be the wisest decision—passive portfolios were thus forced to take their technology weight and assets to 35%. Unfortunately, within three months of 2000, the technology sector plunged and so too did those passive portfolios. And similarly, the financial sector weightings peaked in 2007 at nearly 25%, right before the financial crisis occurred.

Last year

Using 2016 as another example, passive investors were unknowingly whipsawed. When oil bottomed out in February of 2016, it triggered several more market moves. As mentioned above, the S&P 500 has roughly 7.1% in energy companies. Over the course of a few years, oil prices moved from a peak of $155 in June 2008 to the low $20's in February 2016. With this massive energy move, a sector specialist might have determined that some stocks were oversold and attractively valued. The move lower in energy also had secondary ramifications. Emerging markets began to fall, bonds declined and the dollar surged. Any active portfolio manager closely monitoring the market is able to notice these seismic shifts and react. As the fundamentals change, he or she can and should understand the ramifications of these changes to their portfolio. A great manager does not react to the markets, but attempts to anticipate. Now, while this is much harder to do (than simply say), at least the active manager has a choice.

Another shock impacted the market in June, with the UK decision to exit the European Union. Some viewed this market decline as an opportunity to pick up companies impacted from uncertainties and the unknown. Then, in November, another shock to the system occurred with the surprising US election of Donald Trump. The market quickly assessed the winners and losers of the election and reacted. Financials, infrastructure and technology stocks rallied strongly while telecoms and utilities fell. These events, whether known or unpredictable, can alter the investing landscape. Having the opportunity to react and capitalize on these events, is the advantage active management has over passive.

Active management

We believe that active management has an important part to play in the markets. In an efficient market, investors should be looking for expertise and niche managers. Using a medical analogy— if you needed knee surgery, would you go to a psychologist? But beware of closet indexing. If an active manager charges higher fees, he/she needs to make choices that attempt to outperform the market. To quote Kopin Tan in Barron's recent article *Dawn of the Active Managers*, "at least with passive funds, you get sheep in sheep's clothing. With active managers who run closet index funds, you pay a higher fee – for a toothless wolf in a sheepish herd."

To weed this out, one can analyze a portfolio's **active share** or the percentage of how much a portfolio differs from its benchmark. This study, from Yale's Marijn Cremers and Antti Petajisto, is considered the best measure of identifying managers that stay too focused on benchmark weights. For example, a perfectly executed index fund has an active share of 0%. Cremers and Petajisto, studying returns from 1980 through 2003, found that those portfolios with an active share of 80% or higher outperformed their benchmark by 2.0% to 2.7% before fees. If one wishes to analyze any mutual fund they own, simply visit https://activeshare.info for a calculation of active share. Importantly, just being different from the benchmark is not the only key to outperformance. A portfolio manager also needs to be correct. And this conviction level can at least be displayed with a high active share percentage. By focusing on high-quality, financially sound companies, managers with low-turnover, high active share concentrated portfolios have the opportunity to outperform. For example, our active share in the Fin Tech portfolio is just under 97%. Again,

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while nothing guarantees success, this at least provides the framework for potential outperformance. Further, a portfolio manager displaying such a high level of conviction by deviating from the benchmark is likely a manager with industry expertise, not a broad market generalist.

Valuation

At Manole, instead of focusing on the sector classification, we identify and invest in companies that possess certain characteristics we believe lead to future outperformance. When the overall market is priced at 18x forward estimates, we continue to see article after article claiming the markets are overvalued. As an index investor, one is bound by arbitrary rules set by a benchmark committee. If the index owns 2% of XYZ Company, you continue to own 2% of this company, regardless of whether its valuation is highly attractive or grossly overvalued. While there are some stocks that are overvalued on traditional metrics, we prefer to analyze companies on various valuation metrics. We do deep fundamental analysis and look at underlying intrinsic value to properly frame valuations. We continue to find attractive companies that sell at a discount to our calculation of intrinsic value, all while maintaining our rigorous criteria of desirable company characteristics. With many companies failing to generate organic growth, we have built a concentrated portfolio of Fin Tech holdings that continues to grow sustainably and predictably. It is this dedication to identifying wonderful secular growth companies, with targeted characteristics, that we spend our days researching.

Further evidence

Blackrock (ticker BLK) is the world's largest asset manager with over $5 trillion in assets under management. As mentioned above, they are one of a select few that dominates the passive investment industry. However, BLK also has a sizeable active manager with over $275 billion of client assets. Despite growth in total assets at BLK, the active equity franchise has seen assets fall in each of the last three years. To counter this trend, on March 28th, BLK decided to undergo a radical and fundamental change to its profitable active equity business. To drive sustainable alpha and improve investment performance, BLK has decided to focus its attention on country and sector-focused stock products. In addition, it is steering more attention away from fundamental analysis and attempting to leverage quantitative techniques. BLK believes it can outperform if it focuses its energies on specific markets with educated, concentrated bets. We believe BLK is perfectly positioned to understand this market dynamic shift towards passive investing, and is sizeable enough to absorb the active market share losses. By pivoting towards specialty products and altering a stable and profitable franchise, BLK is taking a risk, but also being a leader. The active asset management industry has been slow to react to changing dynamics and we believe successful managers sometimes need to be willing to be unpopular or not follow consensus to rise above the tide. We give BLK credit for at least attempting to change the active management discussion and only time will tell if their decision to specialize was wise.

Conclusion

There is nothing remarkable about stating that the biggest trend in the asset management business is index investing. The drumbeat for passive has gotten quite loud and we have simply attempted to provide some counter for this argument. These products provide a key component for both retail and institutional investors to get low-cost exposure. The asset management industry, specifically active managers, will continue to lose market share if they are unwilling to adapt. We believe the market is shifting towards customization and getting more specific. It is our opinion that those managers that provide a proprietary product, that cannot be replicated with a 5 basis-point index fund, will succeed. Special opportunities, especially separately managed accounts that provide full transparency, should ultimately carve out a profitable niche. For asset managers, shifting towards higher value products also can benefit their bottom lines, in the form of higher fees. Being able to justify those higher fees will be measured appropriately with outperformance versus the appropriate benchmark.

Research has proven that active management does better in volatile and downward trending markets. If you believe we are headed in that direction, isn't it better to have an opportunity to at least adapt and change? Are you better off having an engaged and skilled active manager running your portfolio or blindly flying on

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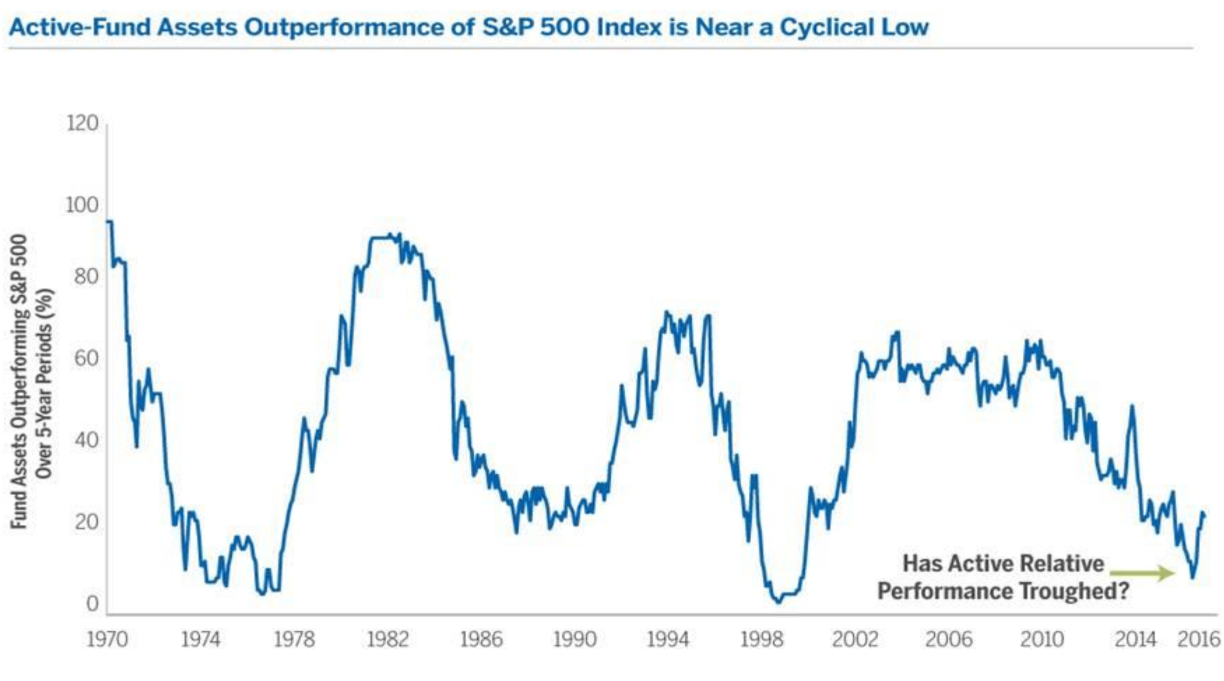
autopilot? There will continue to be a place for passive management allowing for specific market exposures at low fees. Unfortunately, many investors have failed to ask the ultimate question of any asset manager. Are you adding value? Today, only index managers can easily answer that question.



Source: Nomura and FactSet.