HQAM

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CORPORATE EXCELLENCE INSIGHTS

We are a specialized provider of systematic Quality Investment Solutions and one of the few providers of Quality equity investment strategies worldwide. Corporate Excellence Insight is our monthly publication that includes a brief update on markets and our thoughts about major trends that are impacting the investment management industry.

MARKET UPDATE: STRONG ECONOMIC AND EARNINGS FUNDAMENTALS

Economic readings, both in the U.S. and globally, have improved steadily, with incoming data (on everything from employment conditions to manufacturing activity to consumer sentiment to global trade) signaling that the global economy is on fairly firm footing.

$26.5bn

SWEDEN'S SPOTIFY BEGINS TRADING PUBLICLY ON NYSE

Spotify Technology SA went public on April 3rd at a valuation of $26.5bn, making it the 8th largest tech listing in history and the largest since Snap Inc went public last year.

18%

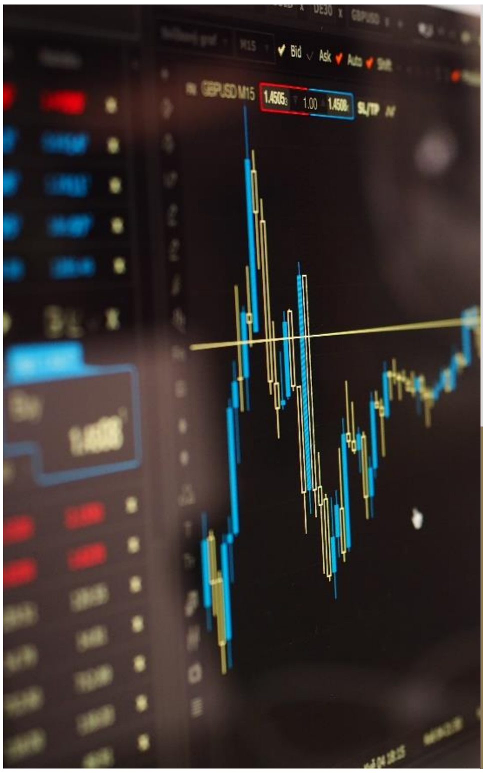
RISE IN GLOBAL INVESTMENT IN SOLAR POWER IN 2017

Investments in solar power in 2017 rose 18% to $160.8bn, driven by the Chinese market. This total is more than the amount invested in coal, gas and nuclear power combined over last year.

1.75%

U.S FEDERAL RESERVE LIFTS INTEREST RATES TO 1.75%

The Fed raised interest rates from 1.50% to 1.75% and forecasts at least two more hikes in 2018, showing growing confidence in the economy and anticipation of inflation growth.



MONTHLY TOPIC ACTIVE OR PASSIVE

If the market turns south, the passive investor is guaranteed to lock in all market losses. There is evidence that really active managers have the best chance to outperform in two distinct environments – high volatility and down markets. Reasonably skilled managers are able to capture alpha in an uncertain environment.

We all know it is very unlikely for an active manager to beat the market all the time as there are always times when a strategy is lagging, but over a business cycle an active manager should be able to beat the market. The time horizon is crucial because, given a full cycle, a disciplined and carefully implemented strategy will deliver the outperformance.

A significant number of the largest US equity funds have relatively low active and tracking error. This raises the question whether all funds claiming they are active managers can be considered as active. It points to the flaws in the argumentation that, in the long term, active managers underperform.

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ACTIVE OR PASSIVE INVESTMENT IN AN UNCERTAIN ENVIRONMENT

2017 proved to be an excellent year for the quality factor, as Hérens Quality Asset Management products delivered considerable outperformance against their respective benchmarks, even as equity assets delivering strong double-digit growth across the board globally (Fig.1).

Fig 1. Herens Quality Asset Management products performance in 2017

	USA	Europe	Switzerland	Emerging markets	Global	Global TOP 8
Quality Portfolio	28.2%	14.6%	23.5%	34.2%	25.4%	25.3%
Benchmark	21.8%	10.6%	19.9%	37.3%	17.4%	17.3%
Out/Underperformance	**6.3%**	**4.0%**	**3.6%**	**-3.1%**	**8.0%**	**8.0%**
Alpha (since Inception)	2.0%	2.2%	1.6%	0.3%	2.9%	10.1%

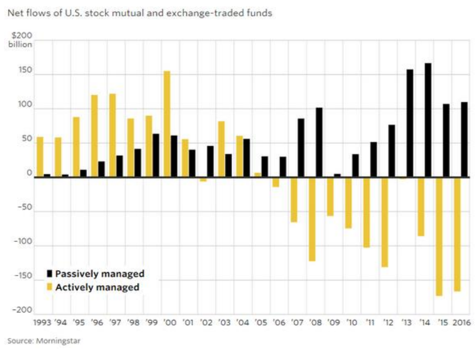
Source: Hérens Quality Asset Management

In addition, 2017 was characterized by the lowest levels of volatility since 2007. However, the start of the new year has seen the calm of the markets interrupted by a spike in volatility caused by uncertainty of inflation expectations and increasing bond rates. Despite the challenges these conditions bring, this is also an opportunity for active managers to prove their competence and defend their position in the passive vs active debate. But what are the arguments behind this debate?

While discussing the topic of passive vs active, Howard Marks[1], the co-founder of Oaktree Capital, commented that, "the foundation for passive investing is the belief that passive investors can free ride on the efforts of the active investors." It is the active manager who establishes fair marketprices by analyzing companies and detecting under- or overvalued stocks. With more investors selecting the passive route, the likelihood increases for an active manager to outperform its passive competitors. Increasing flows into passive indices and ETFs inflate the value of stocks held within these investment vehicles, while stocks that are not included or disproportionately underweighted present an opportunity for active managers to find quality undervalued investment opportunities.

The debate itself is not new, as in the 1970's some economist already argued that, as a group, active money managers would not outperform the market – their competition is a zero sum game. However, pure passive investment was not as dominant as it is today. Since then, the share of passively-managed assets in the US has grown to a third of the total, according to Bloomberg. Only the creation of cost efficient instruments made the world of passive index investments easily accessible for retail and institutional investors. This aftermath of the 2008 financial crisis were the main reasons for the sizeable growth of passive investments globally. This recent growth has again brought the active vs. passive discussion to the forefront.

Fig 2. Flows into passive products accelerated in recent years



Source: Morningstar

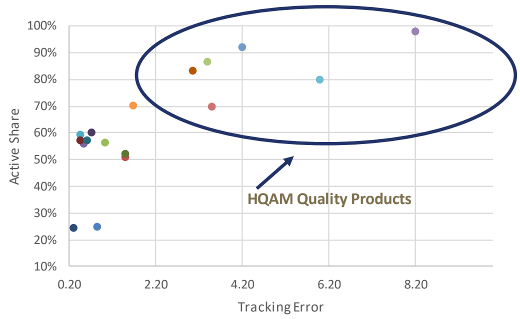
We do not believe the question can be answered in a binary manner, arguing for or against all active or all passive. There are valid arguments in favor of both. Let's discuss the factors that should be considered.

What defines a successful active manager?

We all know it is very unlikely for an active manager to beat the market all the time, of course there are times when a strategy is lagging, but over a business cycle an active manager should be able to beat the market. The time horizon is crucial because given the whole business cycle, a disciplined and carefully implemented strategy will deliver the outperformance. But what exactly is needed to be ahead in the rankings?

In a paper published by Vanguard[2], there are four elements which are considered important in choosing a successful active manager: Alpha expectation, Cost, Active risk, Active risk tolerance. While the expected outperformance of a specific manager is not easy to determine, the active share, or the percentage of how much a portfolio differs from its benchmark, is a good starting point.

Fig 3. Active share and tracking error of Hérens Quality Asset Management products vs. ten largest US active equity funds



Source: Hérens Quality Asset Management, Reuters

The chart shows that the majority of the largest US equity funds do not attempt to stray far from the benchmark as active share does not exceed 60% and the tracking error is rather low (Fig.3). So, the question is whether all managers claiming they are active can truly be considered as such. This also demonstrates flaws in the argumentation that, in the long term, active managers underperform. Only a few active managers are truly active and therefore may skew the results of studies surrounding this topic. Support for active investing is also found in the results of a study on active share and mutual fund performance, where it is demonstrated that the most active managers outperformed the respective benchmarks even adjusting for transaction costs and fees (Petajisto, 2013).

The identification of talented managers is a very crucial task. We would argue that such an assessment should focus on the consistency of style, patience and prudent management. Of course, cost cannot be neglected, and only by delivering consistent returns over time will bring a manager in a position to justify reasonable active fees. Investors must also consider the active risk, which measures the risk taken by a manager in deviating from the benchmark, and over time provides a reliable indicator to assess a manager's skill. Finally, the investor must evaluate their own risk tolerance or tolerance for downside risk. At the outset, positive return expectations prevail, but they have to be compared against the risk of underperforming the index. An investor must have the risk capacity to tolerate performance deviations from any given index over time.

As mentioned, there is an increasing number of investors, both individual and institutional, that are abandoning active management. Given the recent period of positive performance of almost all major indices it is understandable that investors believe it to be easier and more cost efficient to go passive. But there is a hidden danger that must be highlighted. If the market turns south, the passive investor is sure to lock in all market losses. On the other hand, there is evidence that truly active managers have the best chance to outperform in two distinct environments – high volatility and down markets. Reasonably skilled managers are also able to capture alpha after markets start to recover.

Conclusion

There is nothing remarkable about stating that the biggest trend in the asset management business is index investing. 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 easily can succeed.

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 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?

Sources:
1. *The paradox of passive investing , https://news.cgtn.com/news/.../share.html*
2. *Vanguard Research Daniel W. Wallick; Brian R. Wimmer, CFA; Christos Tasopoulos; James Balsamo, CFA; Joshua M. Hirt (2017), Making the implicit explicit: A framework for the active-passive decision .*
3. *Petajisto, A. (2013). Active share and mutual fund performance. Financial Analysts Journal, 69(4), 73-93.*