Dodge & Cox®

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Understanding the Case for Active Management

Robert Turley: Can active investment managers outperform passive indices over the long term? We believe that they can. Our research and those of others have identified key characteristics of investment managers who can preserve and enhance client capital over the long term.

They have active portfolios, they charge low fees, and low expenses. These managers have low portfolio turnover. They're conscious in valuations and portfolio risk. They show a focus in their investment philosophy. And they've aligned their interest with those of their clients. These are traits of quality investment managers. Academic research has shown each of these is correlated with performance that on average outperforms passive benchmarks. Even active managers with excellent long-term strategies will have periods of short-term underperformance, and short term doesn't just mean a few weeks or months. It can mean years. When we looked at the 107 large cap U.S. mutual funds who outperformed the S&P 500 over the past 20 years, it typically had about six calendar years during which period their trailing 5-year return underperformed. Clearly, seeing a fund underperform for five years is usually not enough evidence by itself to judge long-term prospects. In fact, the six characteristics of quality active managers we are highlighting are each far stronger predictors of a manager's long-term performance than the prior five-year return. Let's now look at these characteristics.

First, high active share. It should be clear that active investment managers cannot hope to outperform their benchmark if they hold the same stocks at roughly the same weights. This type of closet indexer is essentially providing a passive portfolio for an active management fee and cannot hope to offer a better return or lower risk. When two young Yale professors, Martijn Cremers and Antti Petajisto, introduced the portfolio statistic known as "active share" about a decade ago, they were trying to identify the active managers who truly offered portfolios that were differentiated from their benchmarks. In their papers, they attempted to label investment management strategies as closet indexing, factor bets, diversified stock picks, and concentrated stock picks. Petajisto reports that the stock pickers with high active share outperformed their benchmark by more than a percent per year after fees. In contrast, closet indexers underperformed their benchmark by about a percent per year, which, not surprisingly, is very close to their average expense ratio.

While future returns may be uncertain, we know the manager's expenses with certainty. These have a direct negative impact on performance. Mark Carhart's PhD dissertation has become the classic paper on persistence in mutual fund performance. He concludes that while the best investment managers are able to generate returns that exceed their expenses, most funds show a pattern of underperformance that is partly driven by the size of their expense ratio. It is easy for investors to see investment management fees and expenses, which are clearly labeled and reported, but there is another cost that is less visible: trading costs. Active managers who churn their portfolios with frequent trading create explicit commission expenses and hidden implicit expenses from the price impact of their trading. When Roger Edelen, Richard Evans, and Gregory Kadlec tried to estimate how large this cost can be for U.S. mutual funds, they found it averaged about a percent per year, around the same size as the average mutual fund expense ratio. Additionally, they found that the associated trading costs from higher turnover funds resulted in lower returns. Of course, passive indexing tends to also have a low turnover.

Cremers, the same academic who introduced active share as a measure of identifying truly active managers using the active share statistic, had the idea of combining turnover with active share to identify the active managers who avoided frequent trading and tended to hold positions for more than two years. Using a sample of U.S. equity mutual funds over the 30-year period from 1984 to 2013, these long duration and high active share managers outperformed their benchmarks by approximately 2% per year before fees, and 1% per year after fees.

One of the major critiques of passive investing is that passive portfolios that follow a market cap weighted benchmark, as most do, tie the portfolio weights to market sentiment. The more investor excitement drives up the price of a stock, the larger its index weight becomes. This creates substantial risk for a passive investor. Those of us who've observed speculative manias know how badly this can end. In contrast, a value investor will tend to trim stocks that have subsequently appreciated in price or avoid them altogether. Our research shows that this creates portfolios with substantially less long-term risk. One way to see this is to consider the past 20 years of returns for the domestic mutual funds in Morningstar's active value category and compare them with those labeled as index funds. If you measure short-term risk using monthly investment horizons, the active value managers appear to have a high risk, as measured by beta, and lower

risk-adjusted returns. However, if you look at longer-term horizons, two or three years, the risk/benefits of value investing become much more apparent. As a result, the risk-adjusted returns for active value managers look significantly higher than those of index funds.

The last two characteristics that we believe are indicative of quality active managers relate to the culture of their firms. First, successful active managers are able to focus on a specific, well-defined investment approach. They want to be exceptionally good at a few things rather than trying to be good at all things to all people. They align the structure of their firm with the philosophy they follow. There's always a temptation to artificially increase the number of funds, showing a good track record by simply launching a large number of funds and then closing all those that underperform. Not only can this be misleading but it also signals a bad investment culture. In studying this, the successful fund families with a small number of funds outperform fund families with less focus by about two and a half percent per year.

The second firm characteristic is the alignment of interest between fund managers and their clients. We strongly believe that the best active managers invest alongside their clients. In 2004, the SEC required portfolio managers to disclose the dollar range of their personal investments in the mutual funds that they manage. Not surprisingly, when a group of academics analyzed this data, they found that higher portfolio manager investment was related to better fund performance.

We believe these six characteristics are important qualities in active managers. The academic research shows that they are historically correlated with higher long-term returns and lower long-term risk. However, there's also abundant evidence that individual investors lose sight of the long term and make poorly timed buy and sell decisions. Morningstar analyzed the data for U.S. mutual funds comparing the returns of a buy-and-hold investor to the actual returns of the average investor, accounting for the timing of their decisions to add to or remove money from mutual funds. Investors pay a substantial penalty for impatience, with returns that are about a percent lower than they would've achieved had they simply stayed put. Another study that took on this topic was titled "Timing Poorly: a Guide to Generating Poor Performance While Investing in Successful Strategies." Using slightly different data, these academics estimated the cost of poor timing to be twice as high. The active managers in their study showed returns that were competitive with the S&P 500, but the timing decisions of the individual investors lowered their actual returns by 2% per year.

Given the emphasis we place on long-term investing at Dodge & Cox, we would hope that our shareholders are similarly patient. We find compelling evidence that active managers can offer long-term returns that are superior to those of passive benchmarks. These active managers are characterized by their active portfolios with low fees and expenses. They have low portfolio turnover and they're conscious of valuations and portfolio risk. They're not only focused on an investment strategy, but they also have interests that are aligned with those of their clients.

You can benefit from these successful investment strategies if you, too, take a long-term investment approach, not being too quick to jump between one strategy or investment manager. We are very grateful for the relationship that we have with our long-term shareholders and thank you for joining us.

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