

# Active Share

## How Passive Is Your Active Manager?

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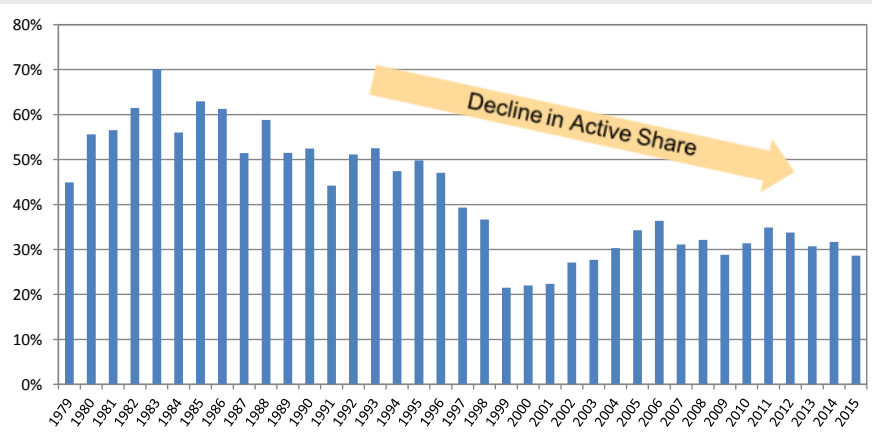
The lengthy bull market that ran from 1982 to 2000 led many allocators to only marginally scrutinize the investment process underlying actively managed products. Much of the analysis was centered on allocations across style and market capitalization. Out of this grew the nine style-box matrix where managers were scored based on market cap exposure (small, mid, large) and style (growth, value, core). In order to gather assets in the new style-box world, managers modified their processes. Relative performance became the ultimate goal. This simplified manager selection as allocators were able to use a top down method by first identifying a style box and then finding a manager that adhered to the constraint. This approach to manager selection led the market place to offer a proliferation of style-box centric products designed to minimize style drift. The objective was to gather assets by offering products that mirrored predetermined parameters such as market cap, growth, value or blend attributes. These products were first and foremost beta-centric, with only modest convictions manifested in the portfolio.

This trend is most apparent when the universe of managers is viewed through the lens of Active Share. Active Share is defined as the cumulative difference

between each security's portfolio weight and that of its passive benchmark expressed as a percentage. By definition, an index fund has an Active Share of 0% because it owns every position in the index at the same weight as the index. A portfolio with an Active Share of 50% indicates that 50% of the holdings in the portfolio are either weighted differently than the benchmark or are not in the benchmark. Generally portfolios with an Active Share of less than 60% are closet index products. Studies indicate that the average closet index portfolio has virtually no chance of outperforming its passive benchmark. Likewise, portfolios with high tracking error, or high factor exposures, tended to perform poorly as well - diversification still matters.

As the bull market raged and allocators demanded style box products, the percentage of assets in U.S. equity mutual funds with a high Active Share declined considerably. In 1983, 86% of U.S. equity mutual funds had an Active Share above 80% and these strategies contained 70% of all assets in U.S. equity mutual funds. In 2015, 57% of U.S. mutual funds had an Active Share north of 80% and these funds only held 29% of all assets in U.S. equity mutual funds (Exhibit 1).

Exhibit 1  
**Percent of Assets in U.S. Equity Mutual Funds with Active Share >80%**



Source: "On Active Share," by Martijn Cremers, Professor of Finance of the University of Notre Dame, April 26, 2016

The “lost decade” for broad U.S. equities (2000-2009) has led to disenchantment with active management in the non-small cap space. Consequently many allocators have turned to indexing the larger cap space to gain beta exposure. However, allocators are becoming more aware of the fact that, as a group, managers with a high Active Share and who are well-diversified, i.e. are not taking extraordinary factor bets, tend to add alpha in the large cap space. Increasingly, allocators are viewing active managers in a less monolithic fashion. In order to create a richer pool of alpha generating managers, allocators will be well served to divide the active universe into high and low Active Share pools. Those managers in the high Active Share pool will

garner the preponderance of interest whereas low Active Share managers will see their market share erode as their allocations are moved to either index funds or high Active Share managers. This provides a significant opportunity for a high Active Share, relatively low tracking error, concentrated manager, who can truly add value. Such an offering can serve as the alpha component to an otherwise indexed large cap mandate.

Vaughan Nelson’s investment process, which focuses on compounding client capital at 15% annually, has always exhibited a high active share profile while still being well diversified (Exhibit 2).

Exhibit 2  
**Vaughan Nelson Active Share\***

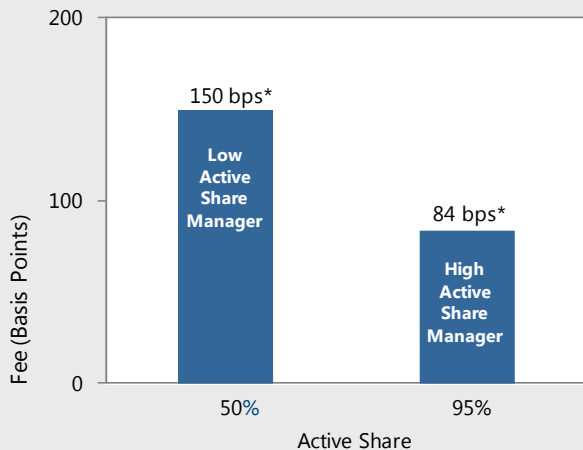
Strategy	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Small Cap Value	96%	95%	95%	93%	94%	94%	95%	95%	95%	95%
Value Opportunity	95%	95%	93%	91%	90%	90%	92%	92%	93%	96%
Select	-	-	-	99%	99%	96%	95%	95%	92%	91%

\* Average active share during calendar year.

Allocators are also seeing the benefit of bifurcating management fees by gaining beta exposure via a low fee index product and paying a high Active Share manager a traditional fee. Paying an active fee to a manager with a relatively low Active Share is typically an inefficient use of active management fees. For a manager with an Active Share of 50% and an annual fee of 80 basis points, the fee represents 150 basis points for the active positions in the portfolio. By definition, only 50% of the active portion of the portfolio can outperform the index, yet the 80 basis

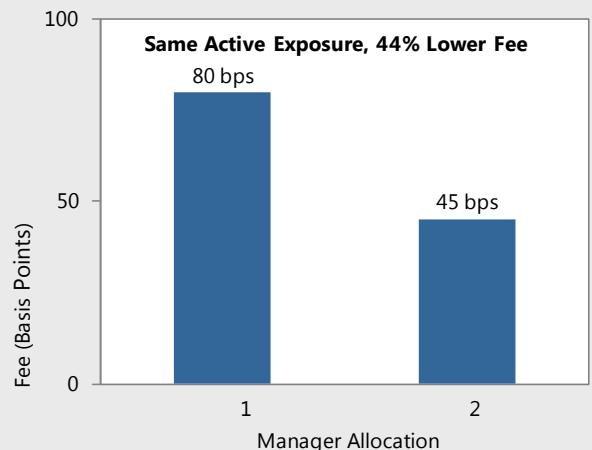
point fee is applied to the entire portfolio. A more efficient utilization of active fees can be attained by employing a high Active Share manager. By indexing 50% of an allocation at 10 basis points and hiring a manager with an Active Share of 95% at 80 bps, the overall fee is 45 bps. This results in a 44% fee reduction for essentially the same active/passive allocation as is the case with a 100% allocation to a closet indexer with a 50% active share (Exhibit 3).

Exhibit 3  
**Effective fee on Actively Managed Portion**



\* Assumes an 80 bps annual fee on total portfolio; 10 bps annual fee on passive portion

**A better way to optimize fees**



- 1 100% allocation to manager with 50% active share at 80 bps
- 2 50% allocation to an S&P 500 Index fund at 10 bps and 50% allocation to manager with 95% active share at 80 bps