

Investment View

Active Management: Andrew Slimmon Shares His Views

Andrew Slimmon is the lead Senior Portfolio Manager for Applied Equity Advisors. He is also a member of the Morgan Stanley Wealth Management Global Investment Committee. This Q&A captures key points he made on the topic of active portfolio management:

Results: Active managers have outperformed over time

Taxes: Tax efficiency is integral to active management

Stories: Active managers thrive on stock stories

Advisors: "Active advice" may also add potential value

Alpha: By definition, only active managers may deliver alpha

AUTHOR

**ANDREW SLIMMON**

Managing Director
440 South LaSalle Street
One Financial Place
Chicago, IL 60605

312-706-4568 / PHONE
312-777-2377 / FAX
312-218-0113 / MOBILE

Andrew.Slimmon@
morganstanley.com

Research suggests most active managers underperform. What is your view?

Andrew Slimmon (AS): I think it's important to distinguish between those who purport to be active and those who truly are active. Many self-proclaimed active managers may really be index-huggers. When they are removed from the equation, you are left with genuinely active managers who have outperformed.

What defines “truly active” managers?

AS: As referenced in a Barron’s article, Martijn Cremers, a professor of finance at the University of Notre Dame, states a truly active fund should have at least 80% of its portfolio different from the benchmark. Yet, in 2010, only about 25% of assets that were in U.S. funds met this “truly active” hurdle.¹

Among the funds purported to be actively managed in 2011, only 27% outperformed—roughly the same percentage that Cremers identified as genuinely active. In my view, the outperformers appear to be the truly active ones.²

“I think it’s important to distinguish between those who purport to be active and those who truly are active.”

So how do truly active managers stack up relative to their benchmarks?

AS: They have historically outperformed by significant margins. Although the research on historical active share performance can’t be used to predict future results, according to Cremers, funds with an active share of 80% or more outperformed their benchmarks by one to two percentage points a year. That’s the average.¹

In March 2013, a third-party research report produced comparable results. Managers with active shares over 80% outperformed by an average of 150 basis points annually before deducting fees, and those with active shares above 90% outperformed by an average of 225-250 basis points.³ Of course, the active share calculation has limitations: It is a snapshot at a point in time based on holdings and is most useful when measured frequently over time. Nevertheless, these studies suggest a correlation between active share and excess returns.⁴

¹ “Active Funds Come Out of the Closet”, Beverly Goodman, Barron’s, November 2012

² “Is Your Fund Manager Active Enough?”, Sarah Max, Barron’s, January 2013

³ “Taking a Closer Look at Active Share”, Erianna Khusainova, Lazard Asset Management

⁴ An article on Zephyr, a provider of analytical services to the investment industry, makes these observations about “active share” in an Active Share: What It Is and Isn’t: (a) Timeliness and availability of data may be limited. (b) single point-in-time data make it difficult to discern trends (c) benchmark specification should be appropriate (d) ideally the active share calculation will sync up the date of portfolio holdings with the date of index holdings (e) active share calculations do not tell you where the active risk is being taken or how concentrated that active risk is (f) historically speaking, on average, those managers with higher active share scores have tended to produce more excess return, though there is no guarantee of excess return (g) Also, the deduction of fees would reduce returns.

Why then do managers not take more active risk versus the benchmark?

AS: The answer lies in asymmetrical payoffs. A portfolio manager’s reward for outperforming the benchmark is not commensurate with the consequences for underperforming. Investors tend to harshly penalize managers who lag the benchmark by withdrawing funds. Thus, there is a high level of risk avoidance that comes in the form of index-hugging.

Explain how separate accounts offer greater opportunity for active management.

AS: It’s about tax management. Consider a pooled vehicle, such as an ETF or index fund. In that case, an investor owns shares in the fund but has no direct ownership of the underlying securities. Their account shows only one line item representing an interest in the fund. With a separate account, it’s different: The investor has direct ownership of individual securities, and their account statement shows a separate line item for each security in the account. This direct ownership makes it possible to engage in active strategies that can help reduce taxes.

When an investor buys shares in an ETF or index fund, they inherit the fund’s cost basis in the underlying securities—some of which could have been purchased years before at low prices. The result: An investor could wind up paying capital gains taxes on securities that have lost value since they bought the fund (*Display 1*).

But when an investor holds a separately managed account, the cost basis in any security, for tax purposes, is the price paid for that security when it was added to the portfolio. And each client account is separate, rather than being part of a larger pool—all of which allows for greater control over the tax consequences associated with specific security holdings (*Display 2*).

It sounds complicated.

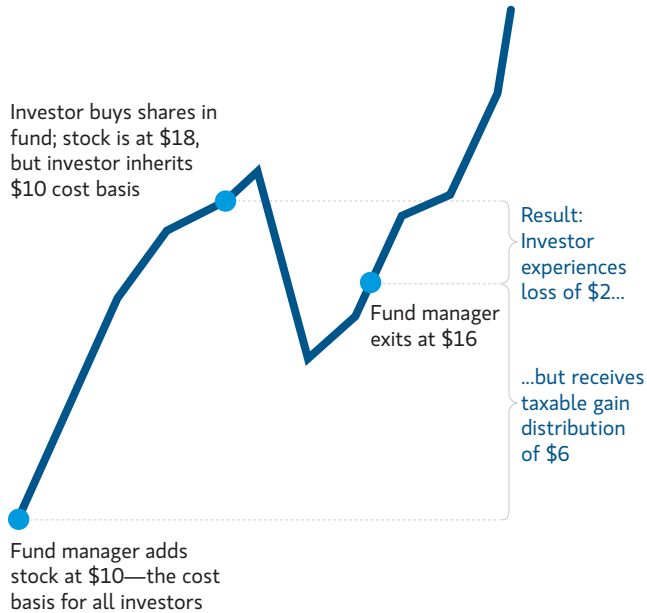
AS: Because each account is separate and distinct—versus pooled—clients can work with their financial/tax advisor to harvest available losses that can be used to offset gains elsewhere in their portfolio. Or they can identify highly appreciated securities to donate to maximize charitable gifts.

Certainly, ETFs or index funds may also be sold at losses or donated for gains. But there is no ability to look under the hood on a stock-specific basis; therefore, the opportunities for tax alpha—which can add significant basis points to after-tax returns—are limited.

Separate accounts: Direct ownership offers greater control over taxes

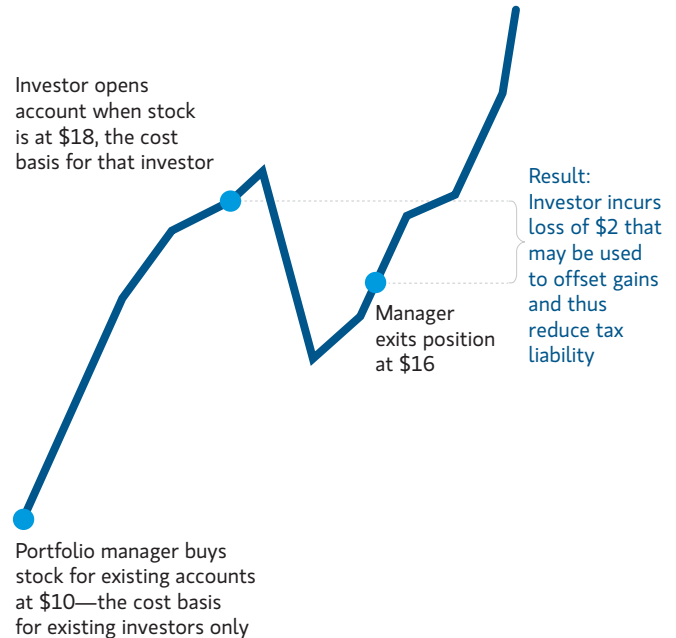
DISPLAY 1: INDEX FUND: STOCK HOLDING AND RESULTING TAX LIABILITY

(hypothetical illustration)



DISPLAY 2: SEPARATE ACCOUNT: SAME STOCK; DIFFERENT TAX LIABILITY

(hypothetical illustration)



That's a lot of effort directed toward tax efficiency.

AS: When I was a financial advisor, I remember getting phone calls in the days before April 15th from clients who needed to get cash out of their accounts to pay taxes. Those are painful withdrawals. So the more we can do to manage taxes, the better off clients will be.

As a portfolio management team, Applied Equity Advisors' primary goal is to deliver performance. But we have to be aware of the tax implications, too. We are mindful of turnover and trading without allowing tax consequences to drive investment decisions. It's a balance.

Though our role is to manage the overall investment strategy, rather than individual accounts, we have a very good idea of how stocks have done since they were originally purchased in the portfolio. And we recognize the need to be out of any losing positions for at least 31 days to avoid invoking the "wash sale" rule, which would disallow the tax loss.⁶

"There is a high level of risk avoidance that comes in the form of index-hugging."

You have said there is no substitute for knowing what you own. Can you expound on that?

AS: Simply put, every security in a separate account was purchased for its specific "story," and you can see that story unfold over time. Not so with ETFs and index funds that own thousands of securities across an entire market or sector.⁷ After 26 years in the business—12 of which were as a financial advisor working with clients directly—I've come to believe that knowing what you own leads to improved decision making. Conversations surrounding individual stocks reassure investors during volatile times because they are reminded of the original rationale for buying them. With ETFs or index funds, there is a whole kitchen sink of names, many of which investors may not know anything about. Without any high-conviction holdings to grasp onto, clients can be easily swept away by emotional reactions and end up buying or selling at the wrong time for the wrong reasons.

⁶ This represents how the portfolio management team generally implements its investment process under normal market conditions.

⁷ Mutual funds and ETFs may offer other benefits such as single-investment diversification, convenience, lower minimums, and lower fees.

There is data that supports the notion that investors who overtrade ETFs often have disappointing outcomes. One study examined all self-directed ETFs trades between 2005 and 2010 within a particular brokerage firm. When investors did not consult with an advisor, the ETFs they sold outperformed those they bought over the next month, over the next six months and over the next 12 months! (*Display 3*) The study does not necessarily reflect the experience of ETF traders at other brokerage firms during other time periods; nor does it compare the results of self-directed trading versus employing a financial advisor. It does show that—acting on their own over an extended period—this set of individuals timed their “buys” and “sells” poorly.

“Data supports the notion that investors who overtrade ETFs often have disappointing outcomes.”

Are you suggesting that consulting with an advisor could have prevented these outcomes?

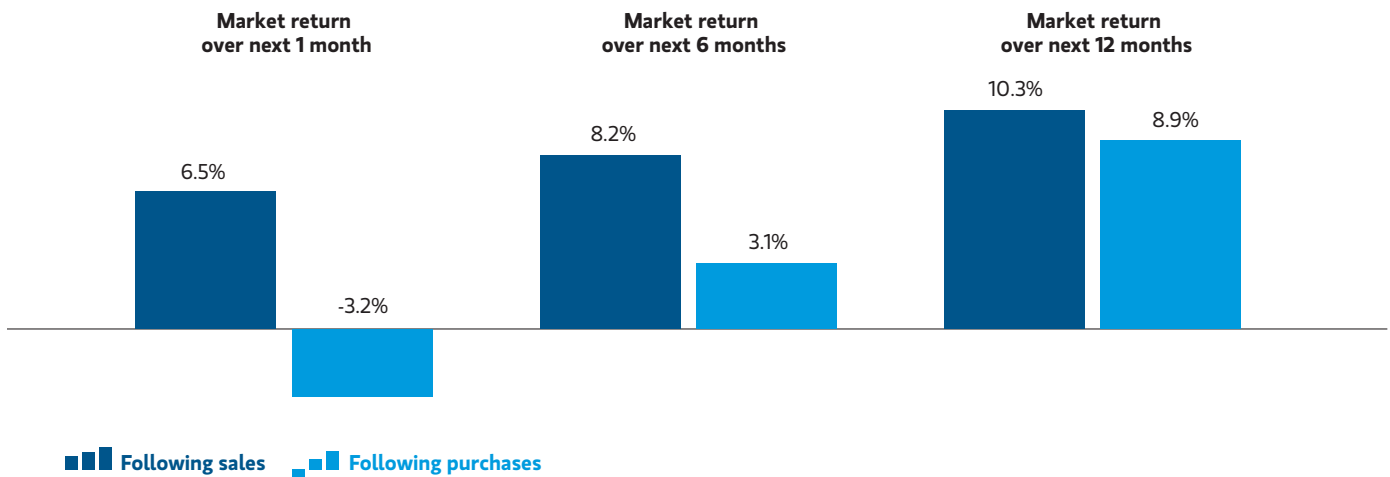
AS: I am suggesting that advisors have a role to play in active management—particularly in the areas of overall portfolio structure, asset allocation and timing. Whether a portfolio consists of active strategies or a combination of passive and active, advisors should be offering guidance as to when to enter or exit particular strategies. This type of dialogue may prevent emotional knee-jerk reactions that lead to subpar outcomes. Active advice on allocation and timing can potentially produce incremental alpha.

What role—if any—do you see for passive strategies, index funds or ETFs in a portfolio?

AS: There absolutely is a place for passive strategies and pooled vehicles within an asset allocation. Investments that justify only a small allocation or are intended to be held for short periods do not warrant direct ownership of individual securities within a separate account. Similarly, for asset classes that entail substantial risk—such as high yield bonds or emerging market equities—broad diversification through a pooled vehicle can help mitigate security-specific risk.

Display 3: Self-directed ETF trading may yield disappointing results

AVERAGE RETURNS FOLLOWING SALES AND PURCHASES OF ETFS (%)



Note: Study based on average of all self-directed investor's trading activity in ETFs from one of the largest brokerage firms in Germany between 2005 and 2010. MSCI All Country World benchmark index used to represent market returns.

Source: Utpal Bhattacharya, "The Dark Side of ETFs"

Past performance is no guide to future performance and the value of investments and income from them can fall as well as rise. Indices are unmanaged and not available for direct investment. They are shown for illustrative purposes only and do not represent the performance of any specific investment.

Final question: Should investors pay advisory fees if their portfolios hold only passive products?

AS: An index-only product with fees on top virtually guarantees underperformance. At least with actively managed strategies, there is the possibility of outperforming the benchmark.

Right now, investors are delighted to be making money again, but that will change. In the early 1990s, everyone was content with a rising stock market. By the late 1990s, they started focusing on keeping pace with the indices. Poor relative performance versus the indices, combined with greed, can lead investors to make irrational decisions in the later stages of a bull market. That's when the power of advice, combined with active management, comes into play. Together, they offer the greatest opportunity to make sound decisions and deliver long-term alpha over and above the indices.

“At least, with actively managed strategies, there is the possibility of outperforming.”

Display 4: **Advisory accounts offer multiple potential sources of alpha**

	POOLED VEHICLES			SEPARATE ACCOUNTS
	Passive without advice*	Passive with advice*	Active with advice*	Active with advice*
<i>Are there advisory fees?</i>	☐	☒	☒	☒
<i>Is there alpha potential...</i>				
...from portfolio allocation and timing decisions?	☐	☒	☒	☒
...from security selection?	☐	☐	☒	☒
...from tax management?	☐	☐	☐	☒

* The diagram above only refers to potential sources of alpha. When choosing an investment, other factors—including investment objectives, fees, expenses, liquidity, safety, taxes, guarantees or insurance—should also be considered. There is no guarantee that any of these investment vehicles will produce positive alpha from the potential sources indicated, and any of them could produce negative alpha (underperformance). All investment vehicles entail expenses. Investments that are actively managed typically have greater expenses than those that are passively managed within the same asset class. Advisory accounts entail fees that will reduce returns. The list is not exhaustive and is provided for informational purposes only.

About the Author

ANDREW SLIMMON

Managing Director

Andrew Slimmon is a Managing Director at Morgan Stanley Investment Management where he is the lead senior portfolio manager on all long equity strategies for Applied Equity Advisors. Andrew is also a member of the Morgan Stanley Wealth Management Global Investment Committee. He has more than 24 years of investment management experience. He began his career at Morgan Stanley in 1991 as an advisor in Private Wealth Management, and later served as the chief investment officer of the Morgan Stanley Trust Company. Prior to joining the firm, Andrew was a buy-side equity research analyst with ARCO Investment Management. He began his investment career as an analyst and then portfolio manager for Brown Brothers Harriman, a private bank. He is a regular guest on CNBC. Additionally, he has appeared on CNBC Europe and Bloomberg TV and is quoted regularly in the Wall Street Journal and Barron's, Bloomberg and Reuters. Andrew holds a BA degree in economics from the University of Pennsylvania and an MBA from the University of Chicago.

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⁸ Source: Assets under management as of December 31, 2015. Morgan Stanley Investment Management ("MSIM") is the asset management business of Morgan Stanley. Assets are managed by teams representing different MSIM legal entities; portfolio management teams are primarily located in New York, Philadelphia, London, Amsterdam, Hong Kong, Singapore, Tokyo and Mumbai offices. Figure represents Morgan Stanley Investment Management's total assets under management/supervision.

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