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 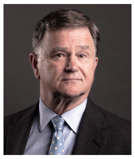 

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Don't Count Out Active Management

In 1974, the American Express Asset Management Company proposed a novel investment product that would hold shares of every company in the S&P 500 Index. The "Index Fund of America" promised to avoid the decisions and some of the costs associated with researching and selecting individual securities.[1] While this fund never got off the ground, the passive approach to investing eventually proved wildly popular as investors flocked to inexpensive funds that tracked rising markets. Today thousands of passive funds follow a bewildering variety of indexes—of which there are now over a million![2] Cheerleading for the passive approach has been led by investment theorists who characterize the stock market as a zero-sum game in which every active investor's gain is offset by another's loss.[3] After active managers' fees are taken into account, the theorists argue, active managers on the whole are predestined to fail to beat their benchmarks. Investors are increasingly buying this argument: over the last decade, equity mutual fund investors in the US have poured an estimated US$750 billion into passive funds even as they pulled about US$1 trillion from actively managed funds.[4]

Investors are in a difficult place. In choosing passive management, they minimize costs and the risk of underperformance while giving up any chance of outperformance. If they opt for active management, they have the opportunity to beat a benchmark index but also face a strong likelihood of underperformance, especially after fees. Investment theory offers little help. The zero-sum game arithmetic cited by supporters of the passive approach, for example, applies only to active managers as a group. Though the argument speaks volumes to the likelihood of a randomly selected manager beating its benchmark, it says little about the ability of a carefully selected manager to do so. In fact, while many managers do not outperform, some do. Our view is that active management *can* work for the benefit of investors. Making it work is our mission. The challenge for investors who seek to benefit from active management is to identify markets where stock picking is potentially effective, to select managers who show signs of skill, and then to stick with their approach long term.

Stacking the Odds in Your Favor

The pursuit of skilled managers begins by understanding where active managers have demonstrated the most and the least success. In practice, not all indexes are equally difficult to outperform. Most studies favoring passive investing have been based on analysis of large-cap US stock funds due to the US market's long unbroken history and the availability of stock, fund, and index return data. They have shown that the available quantity of information and the human energy devoted to researching US large-cap companies make the market in their stocks relatively efficient, so that few active managers are able to beat the S&P 500.

In contrast, active managers have experienced more success when not confined to large-cap US stocks. Investment universes that stretch across borders and include less prominent companies provide greater opportunities to take advantage of market inefficiencies. A recent study of global equity portfolios from 2002–2012 found that active managers on average outperformed their benchmarks by 1.2–1.4% a year before fees.[5] Other research found that the majority of institutional portfolios of non-US equities generated excess return, net of fees, versus their indexes for the 15-year period ending March 31, 2017.[6]

Identifying Skill Not Luck

Even in markets where the average active manager adds value over an index after fees, choosing a manager who produces average results would hardly count as a big success. An investor must identify those who will outperform in the future and by a significant margin.

A manager's success at picking investments is always a combination of luck and skill. Luck waxes and wanes, but skill can lead to long-term outperformance. The challenge is distinguishing between the two. It becomes harder as unskilled managers are squeezed out of the industry, shrinking the variations of skill among the remaining managers, and leading luck, paradoxically, to play a greater role in their relative results. Countless studies have proved what the advertisements warn: past performance is no guarantee of future results. In fact it's worse—past performance alone has little to no predictive power. Rather than trying to divine differences in skill from results, an investor's time is

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[1] "Marketplace: Fund to Invest in S. & P. 500," *The New York Times*, February 23, 1974. In this year, a few other firms were also working to develop index funds. However, the first did not launch until 1976, when Vanguard introduced the First Index Investment Trust based on the S&P 500.

[2] "Financial-Market Index-Makers are Growing in Power," *Economist*, August 24, 2017.

[3] The zero-sum game assumes that active and passive investors are working in the same closed system of securities. In reality, markets and the indexes that track them are not static. New listings, bankruptcies, and mergers regularly are sources of change. Index designers also make changes of their own volition. In addition, most active managers are under no obligation to invest in solely index-constituent stocks.

[4] Morningstar. Estimated net asset flows of US mutual funds for 10 years through September 30, 2017.

[5] David Gallagher et al., "Global Equity Fund Performance: an Attribution Approach," *Financial Analysts Journal* 73, no. 1 (2017): 56–71.

[6] Ruchir Sharma, "What They Don't Tell You About Passive Investing," *Morgan Stanley Investment Insight* (2017).

better spent studying the differences in a manager's approach to discern the existence and sources of competitive edge.

The most obvious requirement for outperformance is high active share, which measures a manager's willingness to invest differently than the benchmark index.[7] Also important is the discipline to stick with decisions even in the face of short-term setbacks. Martijn Cremers of the University of Notre Dame explored these characteristics in his recent article, "Active Share and the Three Pillars of Active Management: Skill, Conviction, and Opportunity." His analysis of US long-only retail mutual funds from 1990 to 2015 found that, on average, funds with high active share *and* long holding duration outperformed their benchmarks. The average fund in the top quintile of both active share and holding duration beat its benchmark by 188 basis points annually and beat its counterpart in the corresponding bottom quintiles by 311 basis points.[8] High active share and patience are apparently among the ingredients required to outperform, but they are by no means sufficient.

To reap excess returns a manager must have a competitive edge at developing insights and converting them into profitable investments.[9] At Harding Loevner, our edge is based on an investment process that reflects our understanding of human decision-making. We look for and try to overcome biases that might hinder our investment decisions. One example is confirmation bias, which behavioral psychologists define as the tendency to look only for information that reinforces what one already knows or believes. Because this bias is often compounded in groups, we have created a process where every investment choice is made by a single individual who is held accountable for the decision and its consequences. We also strive to retain the benefits of group collaboration by encouraging our research team to question and challenge ideas. Our culture—which we call collaboration without consensus—is at the heart of our edge. It leads us to build portfolios significantly different from their respective indexes, while conviction in our process gives us the courage to maintain our long-term perspective when our approach inevitably will be out of favor.

After investors have identified a skilled manager, they must stay the course to realize the benefits. But it's not easy. The difference between a portfolio and its benchmark index not only provides the opportunity to outperform, but also opens the door to underperformance. Successful managers, regardless of their skill, will underperform their benchmarks for significant periods. In an analysis of the top quartile of active international equity managers for the decade ended September 30, 2017, every manager spent at least one three-year period below the benchmark.[10] Many investors cannot stomach a year's underperformance, much less three years. In fact, there is evidence that underperformance may lead investors to abandon skilled managers at inopportune times. As a result, they miss out on positive returns they would have received had they stayed put.[11]

We Believe in Active Management

Investors can benefit from both passive and active management: passive funds provide access to markets at low cost, and some active managers can identify mispriced securities to generate excess returns. At Harding Loevner, we invest actively across global, developed, and emerging markets, where there has been ample scope for successful active investing. We are relentless in trying to improve our competitive edge, which has delivered superior long-term results to our clients.

To see how our active approach translates to investment insights and actions, we invite you to read the strategy commentaries on our website.

We thank you for your support and your trust.

Sincerely,

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Simon Hallett, CFA

Ferrill D. Roll, CFA

[7]Active share is equal to the proportion of portfolio assets that is invested differently from the benchmark.

[8]Martijn Cremers, "Active Share and the Three Pillars of Active Management: Skill, Conviction, and Opportunity," *Financial Analysts Journal* 73, no. 2 (2017): 61–79.

[9]Different skilled managers may have different competitive advantages, but they ultimately boil down to four key sources of edge: informational, analytical, behavioral, and organizational. For further discussion of how these sources of edge pertain to our investment process, please see our October 2016 letter available on Harding Loevner's website.

[10] eVestment. Based on net of fees performance for managers in eVestment's ACWI ex-US Large Cap universe relative to the MSCI ACWI ex-US Index for 10 years through September 30, 2017.

[11]Russel Kinnel, "Mind the Gap: Global Investor Returns Show the Costs of Bad Timing Around the World," *Morningstar Manager Research*, May 30, 2017.

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