Active is: Quantifying the value of active

Measuring how active managers are

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Summary

How "active" is active asset management? There are a number of variables that investors can use to assess how active their portfolio is – including so-called active share – but what ultimately matters is the quality of a manager's decisions and the alpha they generate.

Key takeaways

- The concept of measuring the "activeness" of an investment strategy has gained considerable prominence among investors over the past decade
- Active share is a popular way of identifying managers who might be sticking too closely to their benchmark, but there's not necessarily a link between a fund's active share and outperformance of its benchmark
- Active share is one of a number of metrics that should be used collectively to create a holistic picture; none should be used in isolation

Investors expect value for money when they pay an active asset manager to generate investment outperformance on their behalf, yet a recent survey indicated that only 23% of investors think that actively managed portfolios are worth the cost.[1]

The onus is on the asset management industry to demonstrate the value it is designed to offer, by delivering performance alpha and also what we call "client alpha" – the value that asset managers can add through a long-term, strategic relationship with their investors.

As they consider the value of active asset management, most investors will judge managers on the outperformance they generate; but many investors will also be eager for proof that their manager is managing actively. One way to assess that is to examine "active share".

What is active share?

But what exactly is active share, does it really indicate how active a manager is, and how can investors use it to inform their decisions?

Specifically, it's calculated as the percentage of stocks in a portfolio, based on position weights, that differ from those in the benchmark index that it follows. So if a portfolio has an active share of 80%, one-fifth of its holdings will mirror those of its benchmark holdings, while the remaining 80% will be different. The higher the active share, the more "active" the manager is.

"Active share" first became a buzzword among investors following a 2009 study by Yale financial academics Martijn Cremers and Antti Petajisto. Their report suggested that funds with a high active share were significantly more likely to beat their benchmark than those that are closer in line with the index.

Examining 2,650 US equity funds from 1980 to 2003, they found that funds with an active share of 80% or higher beat their benchmark indices by around 1.5 percentage points per year on average, after fees.

In the 2009 study, which covered US equity funds, Cremers and Petajisto suggested that a portfolio's active share could be considered high if it was 80% or above. Unfortunately, interpreting active share is not that simple; a fund's active share alone does not definitively quantify how active any particular manager is. It doesn't tell you how a portfolio's style is concentrated, or how diverse it is.

Further, while the performance of a fund with a high active share will be more likely to deviate from that of its benchmark, that deviation could just as easily come in the form of underperformance as outperformance.

The structure of the underlying benchmark in particular is also critical. For example, some US equity portfolios are benchmarked against the Dow Jones Industrial Average, which contains just 30 stocks, and some against the S&P 500. The two groups of funds are likely to have very different active shares due to the marked difference in the structure of their benchmarks, even though in reality their degree of active intervention might not be too dissimilar.

Meanwhile, some biotech indices may look to be well diversified, containing around 200 stocks, but a mere handful of firms may account for over 50% of their market capitalisation, and this has big implications for biotech funds' active shares. The sector or strategy also matters: a large-cap portfolio is likely to have a significantly lower active share than an all-cap or small-cap strategy, which have more stocks available in their fund universe.

What's more, the nature of active management means that a low active share can sometimes be a good thing – what really matters is the quality of a manager's decisions and, ultimately, the alpha they generate.

Part of a bigger picture

That said, active share can be useful in identifying managers who are sticking too close to their benchmark, but it is most useful when considered in conjunction with other indicators.

While a strong link between active share and outperformance is unproven, many investors still regard active share as a useful way to determine whether their active manager really is earning their fees. Distinguishing truly active strategies from those so-called "closet trackers" that hug their index.

How we monitor active share at Allianz Global Investors

While we keep a close eye on the active share of our portfolios, it is just one of several important indicators. Others include:

- Sharpe ratio - average return earned in excess of risk-free rate per unit of volatility
- Tracking error - a measure of how much a strategy's returns differ from those of its benchmark
- Information ratio - performance relative to a fund's benchmark divided by its tracking error
- Factor exposures - variations in factors like liquidity, market capitalisation, dividend yield, etc

All of these variables provide important insights into how a portfolio is being managed.

For example, a portfolio may have a high tracking error, but this might be the result of factor exposures rather than a high active share. Tracking error is also perceived as a measure of activity, but is heavily affected by underlying volatility in the market.

As with any of these measures, seeking a high active share isn't automatically the right ambition in isolation. Take the FANG stocks – Facebook, Amazon, Netflix and Google. They account for a very large proportion of several indices and have posted strong returns in recent years. Any portfolios not holding these stocks are likely to have significantly underperformed their benchmarks over this time.

Meanwhile, in a risk-off environment it may be a good idea to reduce risk, which could be reflected in a lower active share. But before being hasty in deciding that a passive strategy might offer equivalent outcome with lower fees, investors need to consider that it's perfectly possible for a fund with a relatively low active share to outperform its benchmark by a wide margin. So while a portfolio's active share may be important to consider, the quality of the decisions its manager is taking is of greater consequence.

Active share is a useful measure of how active a portfolio is over time and in different market conditions, and it can help identify managers who might be sticking too close to a benchmark. But it's not much use to say a portfolio's active share should be any arbitrary target figure. It depends on all kinds of different details such as the asset class, the benchmark it's following, and the market backdrop.

The various measures of how actively a portfolio is managed all contribute to a comprehensive picture. But what's more important is that managers have conviction in their holdings and the alpha potential they're able to generate as a result, that the chosen strategy aligns with clients' desired outcome, and that they perceive the price they pay to be fair.

1) Staying active: AllianzGI survey of 490 institutional investors, conducted by Oxford Economics

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Summary

Impact investing's recent growth looks set to continue, coupling social and environmental benefits with financial returns to help meet investors' evolving demands.

Key takeaways

- With investors increasingly wanting their capital to have a positive real-world influence, the topic of impact investing is moving into the mainstream

- Impact investing is defined by its intention to generate a positive, measurable social or environmental impact through investment, and the ongoing measurement of the impact alongside a financial return
- Impact strategies exist across a broad range of industries and geographies

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