Active Share: Finding "Value-for-Money"

Active Share is useful in the right context. Used out of context, we believe it can lead to misunderstanding of the prevalence of closet indexing and of the "value-for-money" delivered by active managers.

Active Share is a simple measure of how much a portfolio's holdings differ from a benchmark index. When comparing the Active Share of active managers, we analyzed only traditionally managed active portfolios[1] and investigated how many were "closet indexers" (i.e., charging active fees but with portfolios close to the index).

The answer for international portfolios was "none" and for U.S. portfolios, "very few." This *does* depend on where the Active Share cut-off is set between active management and closet indexing. In our example (Exhibit 1), Active Share of below 50 is set as closet index territory; just 1% of U.S. portfolios cross that line.

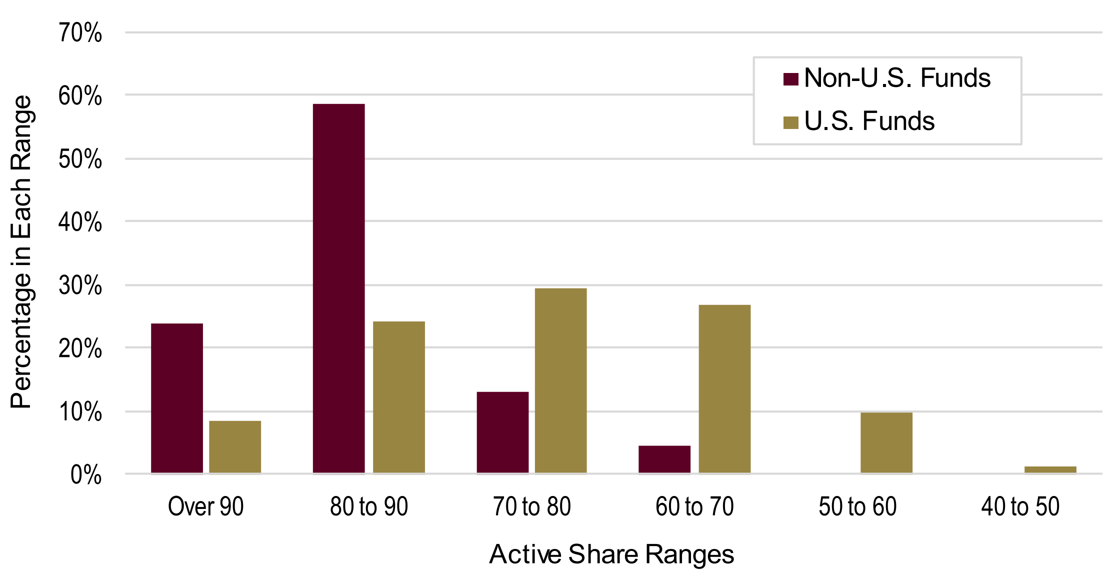
Closet indexing among active managers is very rare.

Value-for-Money Keys

1. Closet indexing among active managers is very rare.

2. There *is* a correlation between Active Share level and fees charged. We urge caution with funds with Active Share lower than the fees (in basis points).

Exhibit 1: Very Few Funds Are Closet Indexers*
Dispersion of Active Share by % in Each Range, U.S. and Non-U.S. Funds



*Closet indexers' Active Share <50

Source: Morningstar Direct, Brandes Institute. Data as of June 30, 2018. Note: data includes only traditional active funds (256 U.S.; 177 Non-U.S., combining 108 EAFE funds and 69 ACWI ex U.S. funds).

...the higher the Active Share, in general, the higher the fee.

...be wary of large-cap portfolios that have Active Share lower than their fees.

Do active managers charge fees that don't reflect their Active Share? If there is no correlation between Active Share and fee, are some clients paying their active managers too much?

Value-for-Money Formula =

$$\frac{\textit{Active Share}}{\textit{Fee (in basis pts.)}}$$

The good news is that we do find a correlation between Active Share and fee; the higher the Active Share, in general, the higher the fee. It's not perfect: for U.S. funds, the correlation between Active Share and fee is 44%. For international funds, the correlation is significantly lower (21% for EAFE funds and 16% for ACWI ex-US). It's important for investors to understand their portfolio's "value-for money": the ratio of Active Share divided by fee. In particular, investors should know if their portfolios are among the poorest value-for-money funds: those in the lowest quartile of that ranking. Our analysis suggests a simple rule-of-thumb[2]: if Active Share is lower than the basis point fee, beware!

Are portfolios in the bottom quartile for "value-for-money" because they have Active Share that's too low or fees that are too high? For most, it's because their fees are high—not because their Active Share is too low. Exhibit 2 shows that six times as many U.S. portfolios were in the bottom quartile just because of high fees versus those because of low Active Share (thirty versus five). The equivalent ratio for non-U.S. portfolios was twenty versus one (not shown here). Of 67 U.S. portfolios in that bottom quartile, 62 had above average fees; only 37 had below average Active Share.

Exhibit 2: Fees Rather than Active Share Push U.S. Portfolios into the 4th Quartile Ranked by "Value-for-Money"

		Active Share	
		Below Average	**Above Average**
FEE	Above Average	32 Portfolios	30 Portfolios
	Below Average	5 Portfolios	0 Portfolios

Source: Morningstar Direct, Brandes Institute. Data as of June 30, 2018.

- Northwest Quadrant: High fee & low Active Share both contribute to the portfolio being 4th quartile
- Northeast Quadrant: High fee & high Active Share mean the fee puts the portfolio in the 4th quartile
- Southwest Quadrant: Low fee but low Active Share can result in 4th quartile ranking, but for a few
- Southeast Quadrant: Low fee and high Active Share mean no 4th quartile portfolios here

We conclude that closet-indexing is hard to define and even harder to find. And while Active Share has a positive correlation with fees, it is primarily high fees, not low Active Share, that puts portfolios into the lowest value-for-money quartile. A useful rule-of-thumb is to be wary of large-cap portfolios that have Active Share lower than their fees.

[1] Data is based on peer groups of traditionally managed active large cap equity portfolios. These are managed by portfolio manager/analyst teams primarily using fundamental analysis and exclude enhanced index, systematic, and smart beta portfolios, as well as multiple manager or multi-strategy approaches. Peer groups are limited to portfolios that declare the same benchmark. The U.S. peer group includes over 250 U.S. portfolios benchmarked to the S&P 500, and the two non-US peer groups include over 170 portfolios benchmarked to MSCI international indices (EAFE and ACWI ex-US).

[2] We found that this simple "rule-of-thumb" identified funds in the fourth quartile of the value-for-money ranking for both US and non-US large cap equities. Note that this may not be an appropriate test for other types of equity funds.

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Basis point: 1/100 of 1%.

Correlation: A measure of the extent to which two variables move in relation to each other.

The S&P 500 Index with gross dividends measures equity performance of 500 of the top companies in leading industries of the U.S. economy.

The MSCI EAFE Index with net dividends captures large and mid cap representation of developed market countries excluding the U.S. and Canada.

The MSCI ACWI ex USA Index with gross dividends captures large and mid cap representation across developed and emerging markets excluding the United States.

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