

# Defense of Active Management

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Presented by:

**Douglas Roman, CFA, CMT**

PNC Capital Advisors

Managing Director

215-585-5106

Douglas.Roman@pnc.com

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# Arguments For and Against Active Management

There are many key points of comparison for portfolio managers:

<b>Passive Management</b>	<b>Key Feature</b>	<b>Active Management</b>
Generally lower than active management	<b>Investment Management Fees</b>	Generally higher than passive management
Generally tax efficient	<b>Tax Efficiency</b>	Depends on the investment manager
No	<b>Potential for Above-Market Returns</b>	Yes
Yes, after incorporating fees	<b>Potential for Below-Market Returns</b>	Yes
No	<b>Potential for Down Market Protection</b>	Yes
Seeks to replicate the performance of the benchmark	<b>Decision Making Process</b>	Seeks to capitalize on market conditions

Source: Baird

# Certain Environments Appear Favorable to Active Management

These environments include:

- Top-Down vs Bottom-Up
- Correlations
- Downside Capture

Top performers have a greater probability of beating the benchmarks

# Efficiency Across the Assets Classes

The degree of efficiency and excess return varies across different asset classes

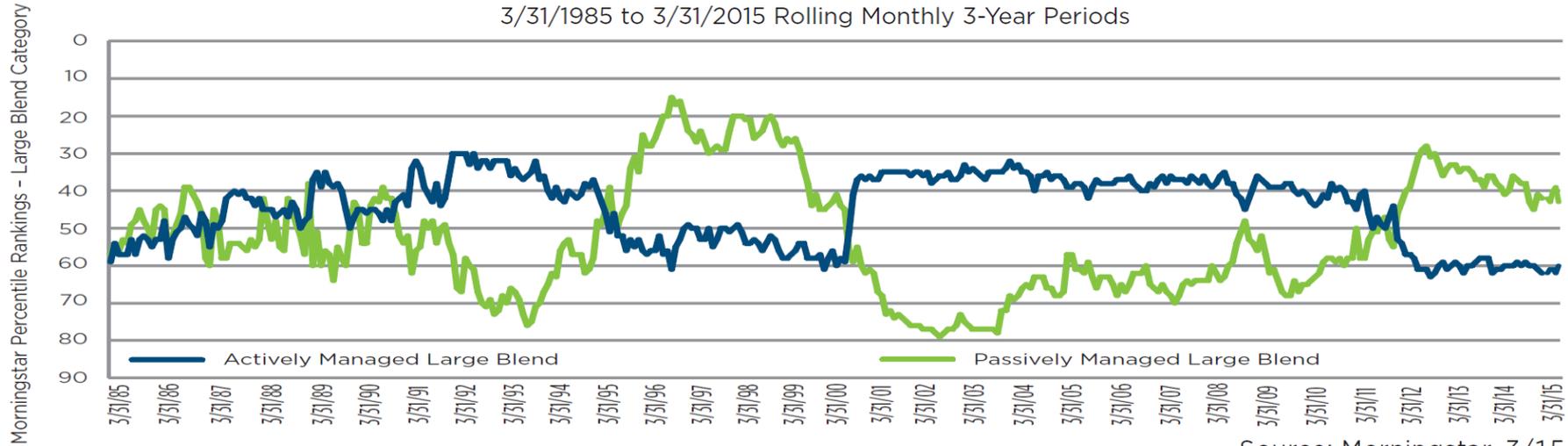
Asset Class	% of Periods Median Fund Produces Excess Return	Efficient (favoring passive) or Inefficient (favoring active) Asset Class	Market Assets (% Active / % Passive)
High Yield Bond	16%	Efficient	91% / 9%
Taxable Fixed Income	18%	Efficient	77% / 23%
Emerging Markets	32%	Efficient	54% / 46%
Mid Cap Core	36%	Efficient	50% / 50%
Tax Exempt Fixed Income	37%	Efficient	97% / 3%
Real Estate	40%	Mixed	63% / 37%
Mid Cap Value	43%	Mixed	84% / 16%
Large Cap Value	44%	Mixed	87% / 13%
Mid Cap Growth	51%	Mixed	95% / 5%
International Core	57%	Mixed	65% / 35%
Small Cap Growth	59%	Mixed	88% / 12%
Large Cap Growth	60%	Inefficient	91% / 9%
International Value	62%	Inefficient	85% / 15%
Large Cap Core	63%	Inefficient	40% / 60%
Small Cap Value	65%	Inefficient	69% / 31%
Small Cap Core	73%	Inefficient	59% / 41%
International Growth	88%	Inefficient	99% / 1%

Source: Baird

# Outperformance is Cyclical

## Active and Passive Outperformance Trends Are Cyclical

3/31/1985 to 3/31/2015 Rolling Monthly 3-Year Periods



Active Managers Have Generally Outperformed in High Dispersion Markets  
S&P 500 Index (1985 - 2014)

	Home Runs	% of HR	% Active Outperform
2001	322	63%	73%
2000	305	59%	79%
1992	269	53%	66%
2002	272	53%	65%
2004	264	52%	57%
2010	253	50%	41%
2009	258	50%	60%
2005	243	48%	76%
2011	232	46%	24%
2014	232	45%	24%
1993	226	45%	66%
1994	227	44%	34%
1986	211	43%	57%
2007	218	43%	61%
1988	210	42%	65%

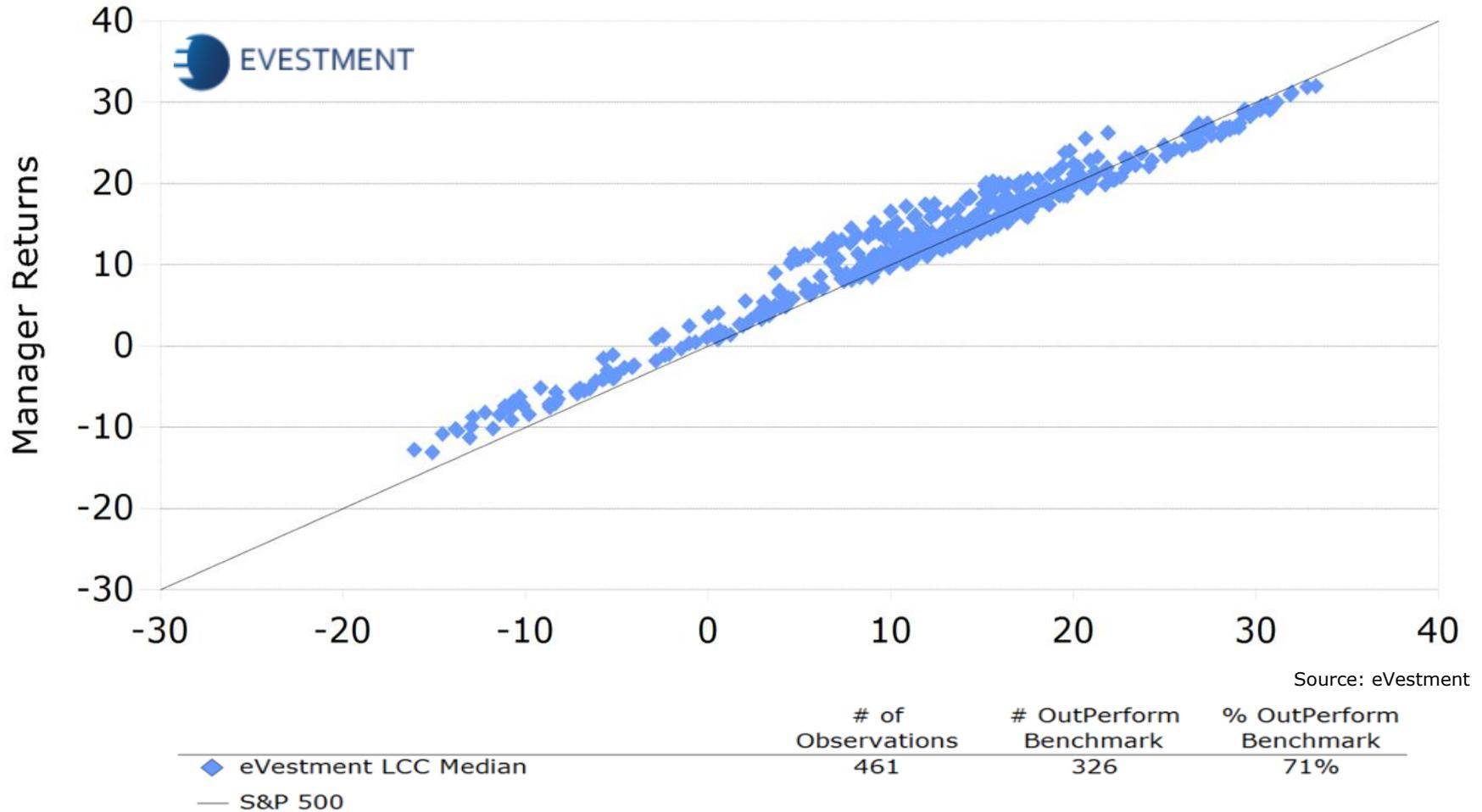
Source: Morningstar, 3/15

	Home Runs	% of HR	% Active Outperform
2003	209	41%	51%
1991	205	41%	57%
1987	201	41%	41%
1990	203	40%	50%
2013	198	39%	53%
1985	186	38%	62%
2012	182	36%	48%
2006	180	36%	47%
2008	184	35%	47%
1989	175	35%	35%
1997	155	30%	29%
1996	151	30%	38%
1999	135	26%	43%
1995	125	25%	22%
1998	114	22%	22%
<b>Average</b>	<b>212</b>	<b>42%</b>	

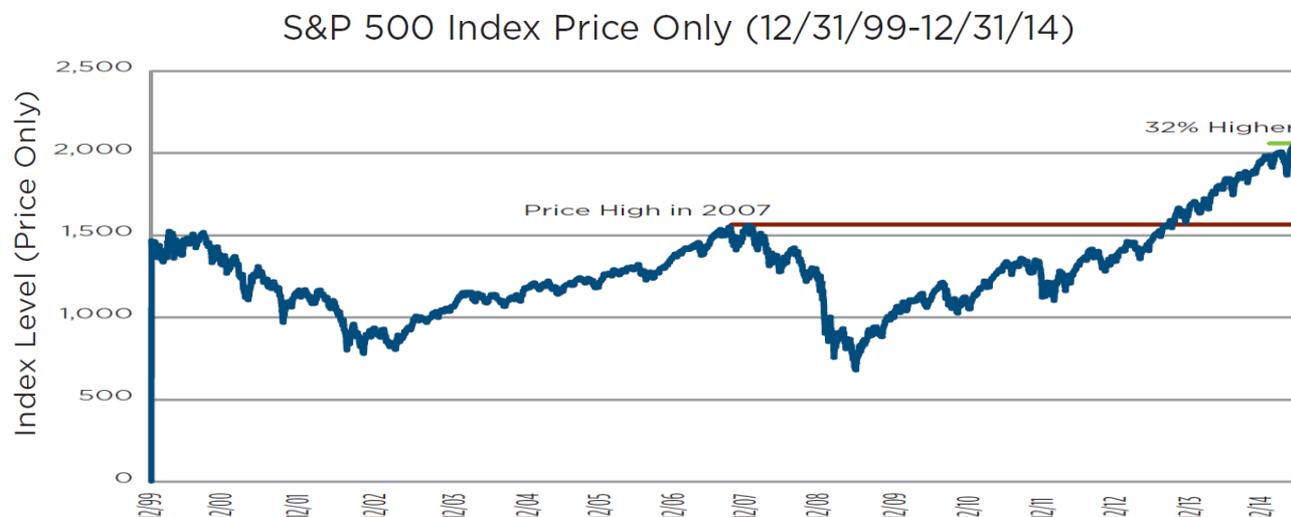
Source: Morningstar, 3/15

Past performance is not indicative of future results. Indices are unmanaged and not available for direct investment.

# Rolling 3 Year Returns Since Inception



# Equity Valuations Have Risen Steadily for Six Years



Source: Morningstar, 3/15

S&P 500 Sectors	30 Yr avg P/E	Current P/E	% Change
Consumer Discretionary	17.61%	20.28%	15%
Consumer Staples	20.26%	22.85%	13%
Energy	15.67%	13.40%	-14%
Financials	14.00%	17.49%	25%
Health Care	22.01%	23.11%	5%
Industrials	17.27%	19.07%	10%

S&P 500 Sectors	30 Yr avg P/E	Current P/E	% Change
Information Technology	23.62%	19.26%	-18%
Materials	18.49%	21.14%	14%
Telecommunication Services	19.99%	23.56%	18%
Utilities	14.69%	20.36%	39%

Source: FactSet, 3/15

What does Smart Beta tell us?

# Smart Beta Works!

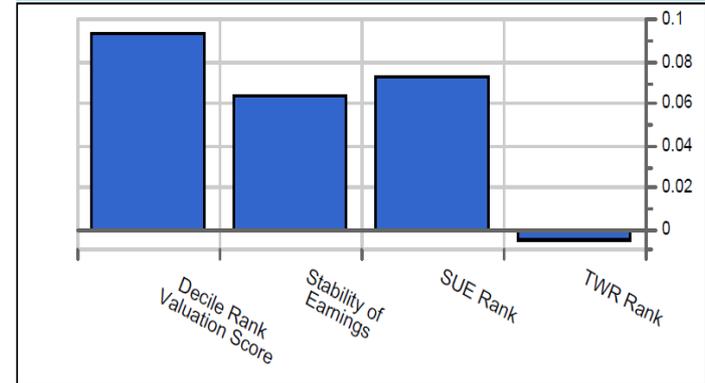
## FACTSET { Alpha Testing Factor Summary }

Factor 1 Decile Rank Valuation Score      Factor 3 SUE Rank  
 Factor 2 Stability of Earnings              Factor 4 TWR Rank

First - Last Fractile Cumulative Return



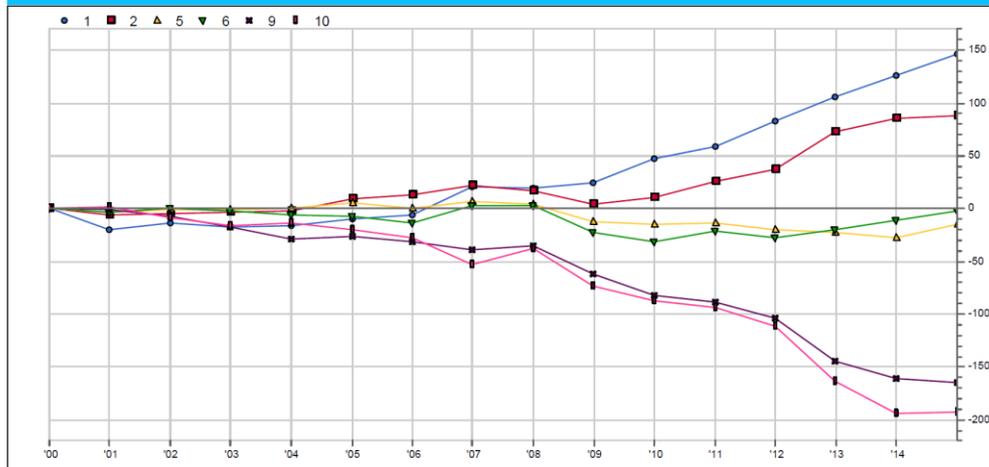
Average Information Coefficients



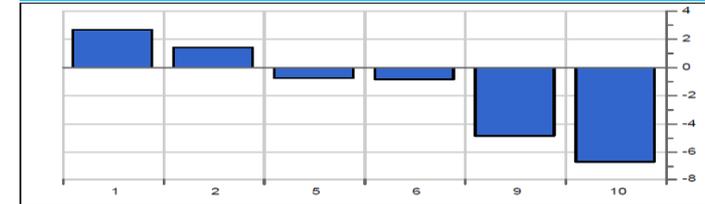
## FACTSET { Alpha Testing Model Summary }

Factor 1 SUE

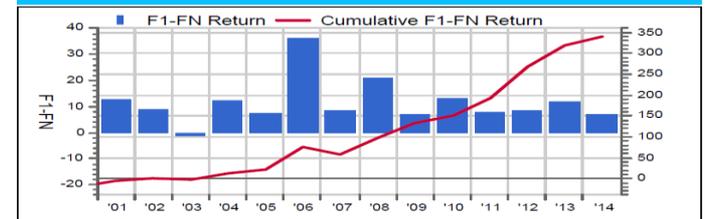
Cumulative Excess vs. Bench by Fractile: SUE



Ann Excess vs. Bench: SUE



First - Last Fractile Return: SUE



# Breakdown of Portfolio Return

**Portfolio Return =**

Asset Return – Fees – Transaction – Tax ± Manager Contribution – Behavioral Effect



# Examples of Behavioral Effect

These cognitive biases include:

- Anchoring
- Availability Heuristic
- Confirmation Bias
- Overconfidence

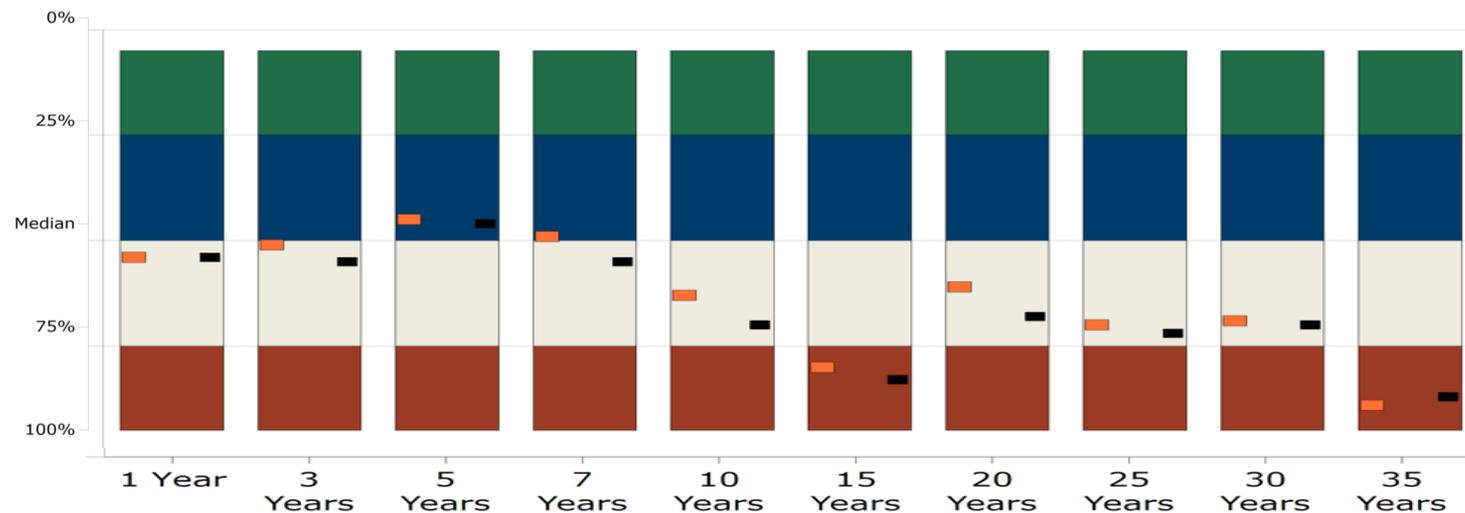
# Possible Trends

- Smart beta takes shares from passive management
- Active management learns from smart beta
- Process over collective genius
  - Active managers must do a better job removing behavioral issues
- Active managers focus on:
  - Factor Investing
  - Libertarian Paternalism

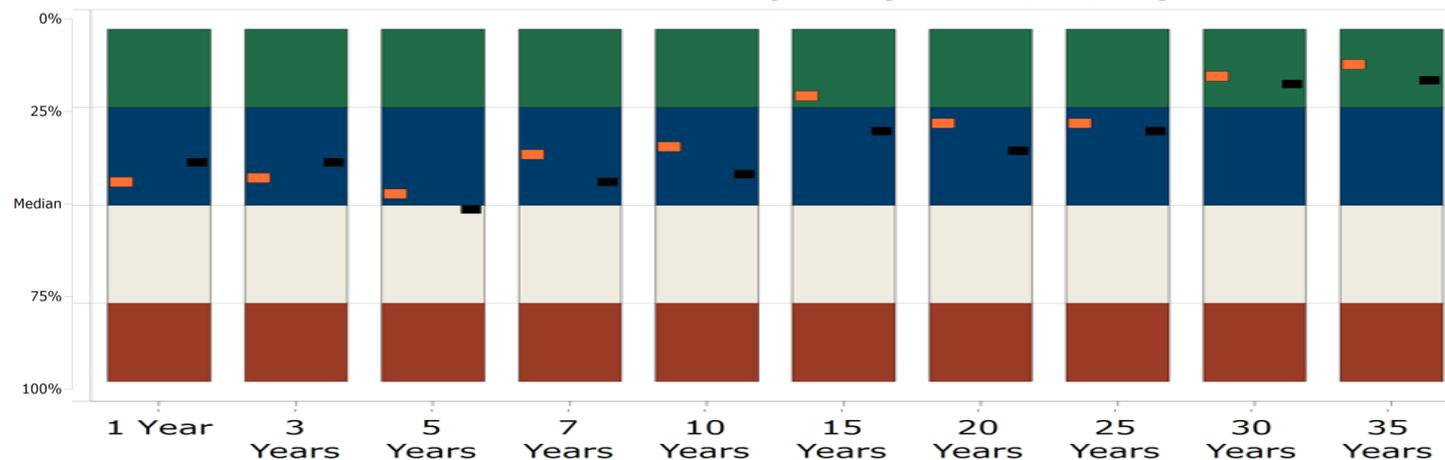
# Appendix

# eVestment - Large Cap Core Universe

## Annualized Returns (As of 9/30/15)



## Downside Market Capture (As of 9/30/15)

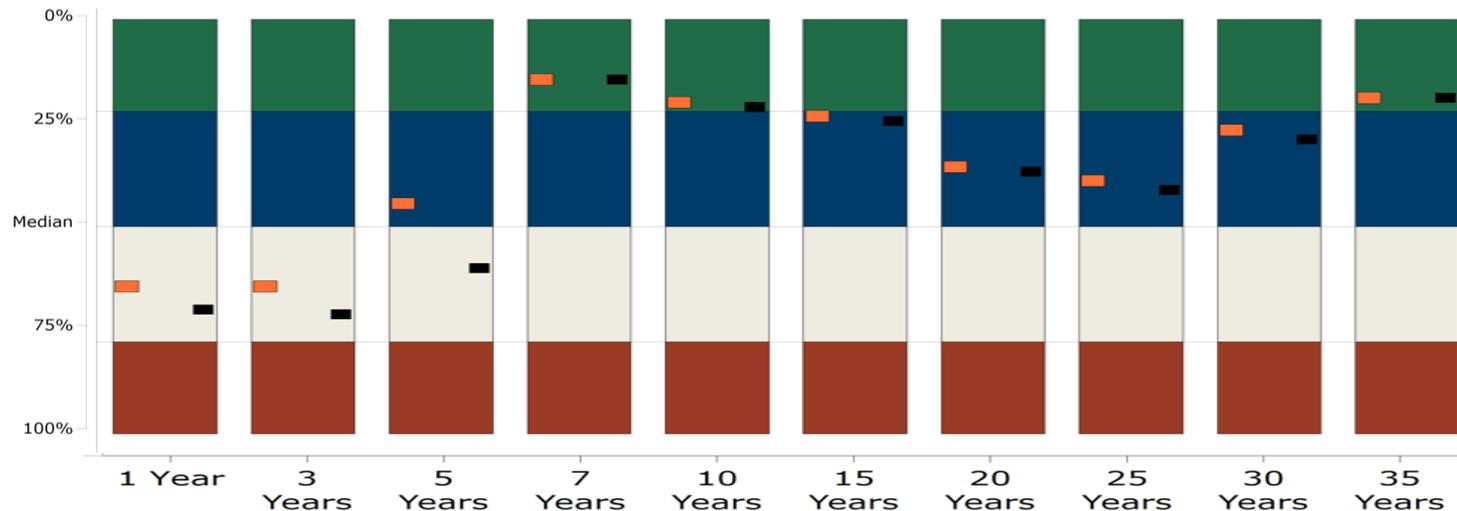


■ S&P 500

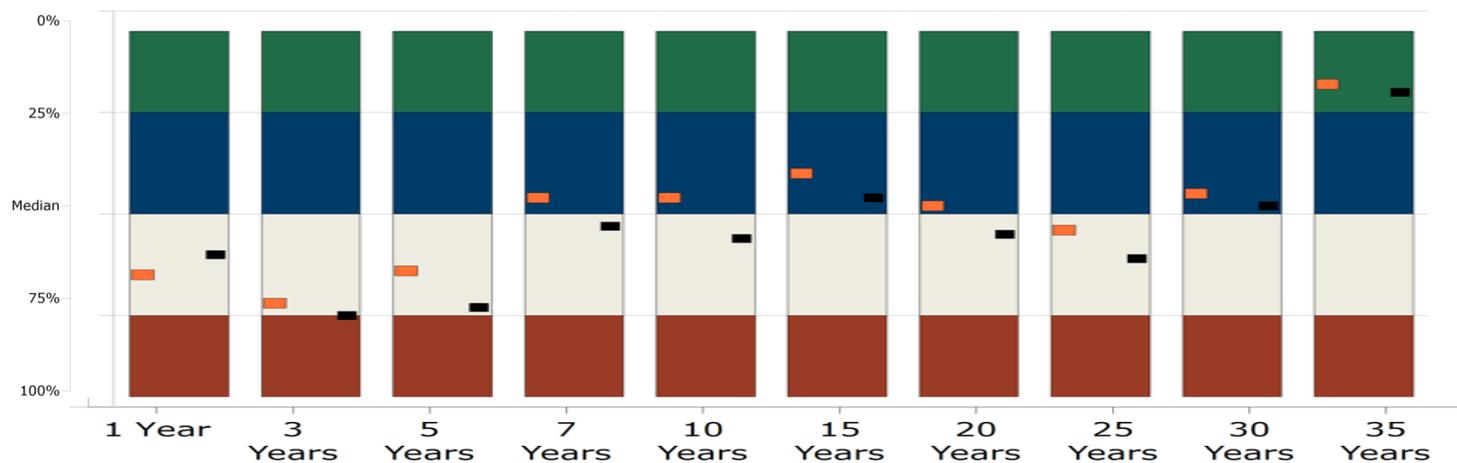
■ Russell 1000

# eVestment - Large Cap Core Universe

## Max Drawdown (As of 9/30/15)



## Standard Deviation (As of 9/30/15)

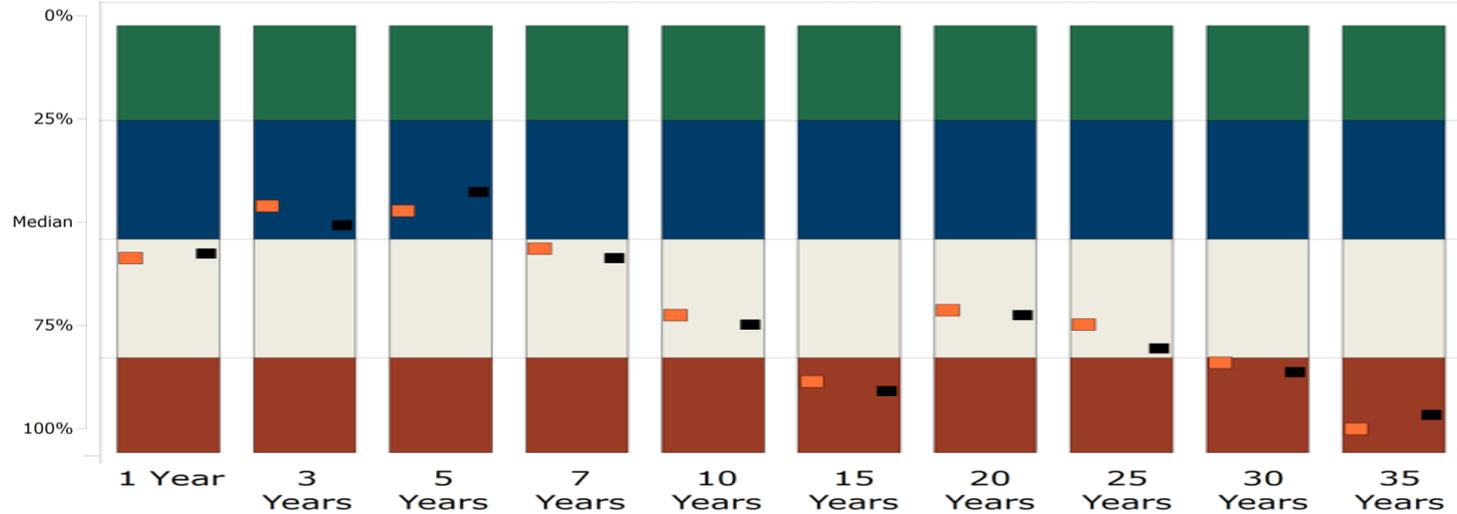


■ S&P 500

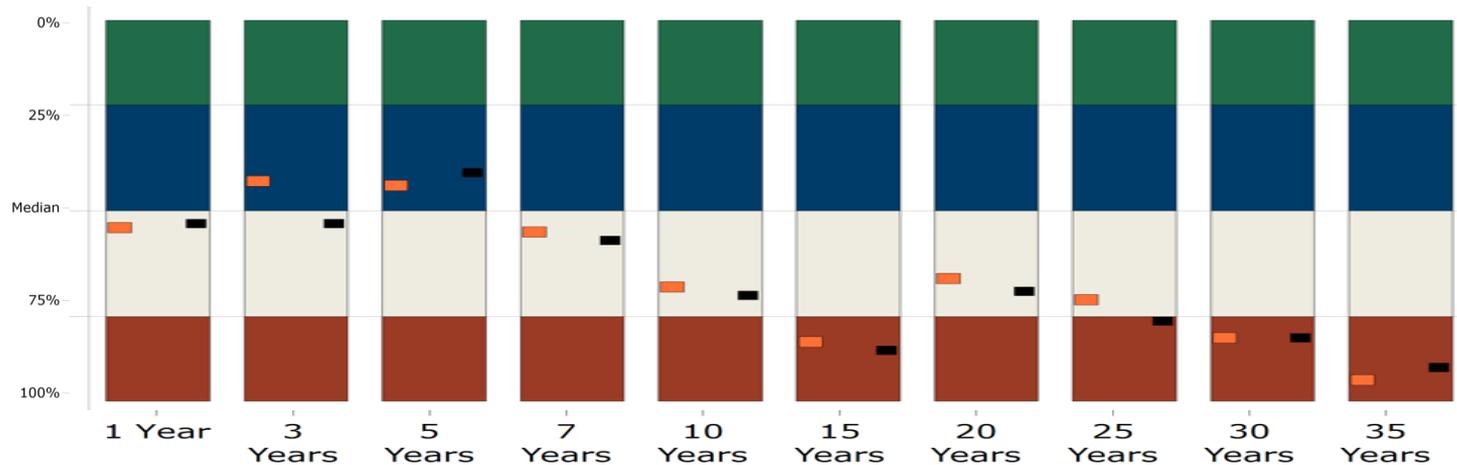
■ Russell 1000

# eVestment - Large Cap Core Universe

## Sharpe Ratio (As of 9/30/15)



## Sorinto Ratio (As of 9/30/15)



■ S&P 500

■ Russell 1000