FRANKLIN TEMPLETON INVESTMENTS

Beyond Bulls & Bears

ALTERNATIVES

Active Opportunities in a Passive World

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Investors have heard the drumbeat for years that the days of actively managed mutual funds are numbered. After all, some experts maintain, the performance of active funds, especially after fees are removed, typically fall short of those of passive index funds, especially when the stock market is on an upswing. But Norman J. Boersma, Cindy L. Sweeting and Heather Arnold of Templeton Global Equity Group™ contend, with apologies to Mark Twain, that reports of the demise of actively managed funds have been greatly exaggerated. And, with the help of some prominent academics, they make the case for staying active.

"Going passive" is something we hear a lot about these days. It's easy to understand why; buying an index fund seems to remove much of the guesswork from investing. With so many active managers to choose from—nearly all of whom claim superiority—how will investors know if they've selected the right one? Far easier to just buy "the market," right? And don't mutual funds collectively underperform their benchmarks after fees anyway? Why pay higher active fees for all this uncertainty and potential disappointment when you could instead just buy an index fund and lock in the market's (fee-adjusted) return?

This train of thought has propelled the growth of the passive fund industry. The press has also helped; headlines like "The Decline and Fall of Fund Managers" (*Wall Street Journal*, 8/22/2014), "Farewell to the Fund Manager?" (*Financial Times*, 10/10/2014) and "The End of Mutual Funds Is Coming" (*Fortune*, 1/24/2012) leave little room for interpretation. We haven't seen such journalistic conviction about the demise of a market mainstay since *Businessweek* pronounced the "Death of Equities" in 1979 (the S&P 500 has since risen almost 19-fold).[1] Even Warren Buffett, who amassed a fortune through active investing and entrusts Berkshire Hathaway's vaunted equity portfolio to two hedge fund managers, has recently recommended buying an index tracker.

Passive's Problems Can Be Active's Opportunities

As the passive segment of the market grows, we at Templeton believe the opportunities for active investors should only get better. While global equity markets as of the end of December 2014 still offered great value in our opinion (especially compared to generally expensive, low-yielding fixed income assets), that value is becoming increasingly selective. After a prodigious rebound from 2009 lows, the beta[2] rally and future performance could become more alpha-driven[3] and stock-specific, in our view. Indiscriminately buying the market in such an environment seems a dubious strategy to us.

Nor are the problems with passive funds merely situational. We find a number of structural limitations to these strategies that could result in value destruction over time. Consider the most basic premise of investing: buy low and sell high. Yet, passive funds tend to do just the opposite. Many of these products are market capitalization-weighted.[4] To stay in line with benchmark allocations, passive funds buy more of the stocks that get bigger while selling the stocks that shrink. By doing so, they are perpetually rotating away from

cheaper stocks that have underperformed and into more expensive stocks with likely limited upside. (Funds that rebalance based on historical volatility do a similar thing.) Investors buying an index fund are exacerbating supply and demand imbalances by perpetuating momentum.

Because passive funds take no view of business fundamentals or valuation, they bear significant and unnecessary investment risks, in our view. For example, investors buying a global index fund in 1989 would have had the bulk of their investment (44%) in Japan at the absolute worst time to buy Japanese stocks.[5] A decade later, they would have had nearly 25% of their investment in technology companies that were grossly overvalued.[6]

This focus on yesterday's winners means that capital typically gets allocated in passive vehicles dependent on size, not expected returns or growth rates. We think allocating capital online slots in this manner perpetuates overvaluation, erodes competition and impoverishes free market capitalism. And, of course, not everyone can "go passive." Without active managers practicing due diligence and facilitating price discovery, there is no market for an index tracker to track.

Ultimately, this behavior may be self-curtailing, as the inefficiencies created by passive's growing market share increase opportunities for active managers to allocate capital where it is expected to be most productive. Finally, passive products often guarantee underperformance versus the market after fees. For us, this is a non-starter. We will not achieve the goal of maximizing real return potential over time if we are compounding underperformance into perpetuity. You could buy pork belly futures or old baseball cards or vintage cars and at least theoretically have a chance of beating the market; but not an index fund. We think locking in underperformance seems a tall price to pay. It's hard to maximize potential wealth creation in the long term by being penny-wise and pound-foolish.

Debunking Myths: The Value of Active Management

Very little of this information has made its way into the passive/active debate. Instead, the main talking point in support of passive funds is that "active managers on average fail to beat the benchmark after fees." But, this is less a critique of active management than it is the recognition of a simple mathematical reality. To paraphrase Nobel laureate William

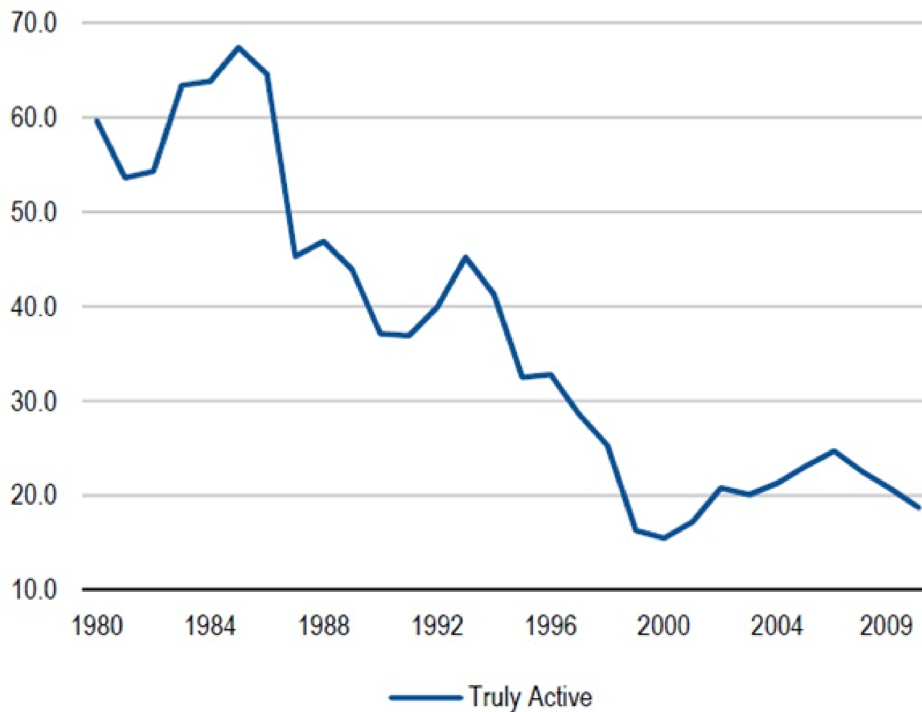
Sharpe in *The Arithmetic of Active Management*, the cumulative sum of all investments equals the market return, which nets out to underperformance after fees. Yet, somehow this simple adding-up constraint has been misappropriated as a rhetorical pillar of the campaign against active management.

Keep in mind also that the “active management industry” includes managers who aren’t really all that active. In a seminal 2009 study, Yale professors Martijn Cremers and Antti Petajisto devised a measure called “Active Share” to gauge “activeness” in managers. Active Share simply measures how different a portfolio is from its benchmark. A pure index fund would mirror its benchmark and have an Active Share of zero. A fund that held none of the securities found in its benchmark would have an Active Share of 100. What was surprising about Cremers and Petajisto’s findings wasn’t how few managers beat the benchmark, but rather how few actually seemed to be trying.

The professors found that up to one-third of US mutual funds had low enough Active Share to be considered “closet indexers.” These are portfolios that hug their benchmarks in an effort to protect relative performance in a volatile and competitive marketplace. The primary risk in looking different than the benchmark is that performance will deviate markedly from the benchmark. Of course, deviating from the benchmark is the only way a portfolio can outperform. Yet, Cremers and Petajisto found that the share of assets held in truly active funds (with sufficiently high Active Share) had fallen from 60% in 1980 to under 20% in 2009.

Assets in Active Funds Have Plunged

% of US All-Equity Mutual Fund Assets Held in Active Funds, 1980–2009



Source: Petajisto, Antti, "Active Share and Mutual Fund Performance," *Financial Analysts Journal*, vol. 69, no. 4 (2013): 73–93.

This is remarkable in light of the study's primary conclusion: Truly active funds (defined as funds with Active Share of 80 or greater) do outperform their benchmarks on average even after fees and expenses. Professor Cremers has since gone on to update the study with the finding that long holding periods are nearly as important as high Active Share to securing investment outperformance. Yet, the current vogue, as evidenced by the popular press and industry fund flows, seems to be away from long-term managers specializing in active security selection.

Again, this flies in the face of academic research. To quote Massachusetts Institute of Technology professors Mark Kritzman and Sebastien Page's 2003 study, *The Hierarchy of Investment Choice*: "Security selection is the most important investment choice, and skill as a security selector has the greatest value."

Our message is simple: Active managers with distinctive, contrarian styles and long-term investment horizons can prove beneficial. This approach is not only supported by academic research; it is firmly rooted in empirical evidence.

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From Dr. Michael Hasenstab, learn more about our active management perspective.

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1. Source: Bloomberg LP. The cumulative total return of the S&P 500 for the 35-year period ended 11/30/2014 was 1,847%. See www.franklintempletondatasources.com for additional data provider information. Indexes are unmanaged, and one cannot invest directly in an index. **Past performance is no guarantee of future results.**

2. Beta is a measure of the risk to an investment from exposure to general market movements.

3. Alpha is a risk-adjusted measure of the value that a portfolio manager adds to or subtracts from a fund's return.

4. Market capitalization is the total value of all of a company's outstanding shares. It is calculated by multiplying a company's shares outstanding by the current market price of one share. This figure is used to determine a company's size.

5. Source: FactSet. As measured by the MSCI World Index as of 12/30/1988. See www.franklintempletondatasources.com for additional data provider information. Indexes are unmanaged, and one cannot invest directly in an index. **Past performance is no guarantee of future results.**

6. Source: FactSet. As measured by the MSCI World Index as of 6/30/2000. See www.franklintempletondatasources.com for additional data provider information. Indexes are unmanaged, and one cannot invest directly in an index. **Past performance is no guarantee of future results.**

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