Russell Investments

Viewpoint

Russell Research

By: Daniel Mussett, Head of Consulting, Russell New Zealand

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Active management of global equities: is it worth it?

Investors should periodically review their fundamental approach to the management of their assets. For broad asset classes, such as New Zealand equity or global bonds, a key question is whether the assets should be managed:

- passively, where a market index is tracked at comparatively low cost, or
- actively, where a manager is tasked with adding value above a market index.

In this article, we provide an update on this question with regard to global equity specifically.

In 2010 the answer was "yes"…

In 2010 Russell Investments produced a research article that set out a comprehensive framework for deciding between active and passive investment for a wide range of asset classes.[1] The case for employing an active approach was considered justifiable on five possible grounds:

1. No readily replicable index is available
2. The index is at odds with the investor's objectives
3. The standard index is inefficiently constructed
4. The investment environment favours active management
5. Skilled managers can be identified

Our paper showed that grounds 4 and 5 justified the use of active management for global equity. This was because both the median manager and well-ranked managers were able to demonstrate that they could generate returns comfortably in excess of their benchmark indices in the recent past. In addition, we made the important point that excess returns must be large enough to justify management fees charged by active managers. Proven expertise in identifying active managers who will outperform was judged to be critical for global equity.

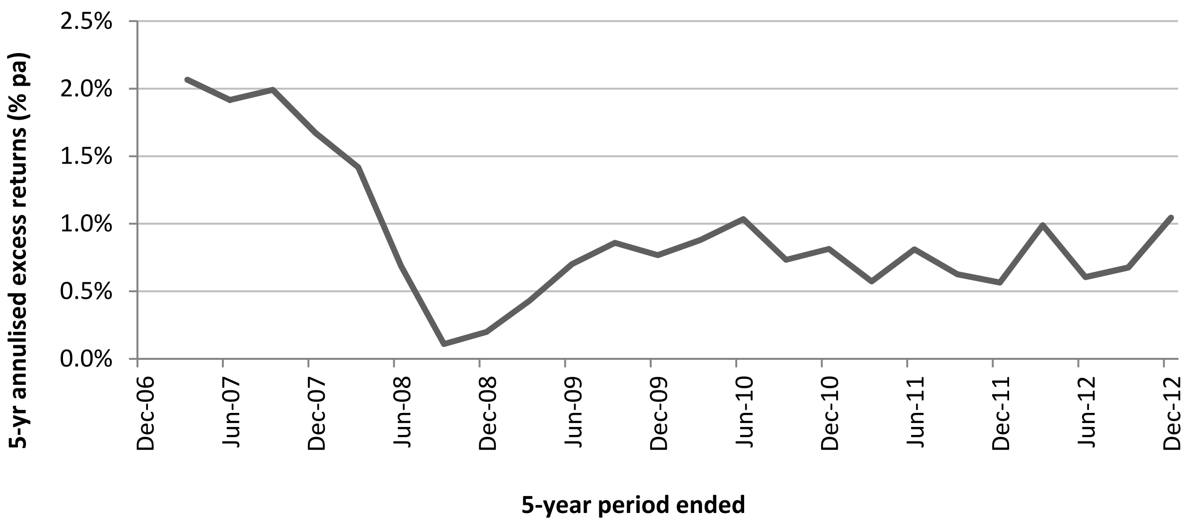
[1] Ansley, C., *The Active versus Passive Decision for New Zealand Investors*, Russell Research article, February 2010

…and the answer in 2013 is still "yes"

We have revisited the performance histories in order to check whether the case is still clear for global equity. And the numbers still tell a promising story.

In the chart below, we plot the annualised, average excess returns over rolling five-year periods across all managers ranked 'Hire' by Russell's manager researchers.[2] It is well-known that managers in general were greatly challenged by the events of the Global Financial Crisis, which was in the height of its throes in 2008. This is reflected in the noticeable fall in average value-add at this point in the chart.

However, since then, the best managers have recovered as a group, and have delivered returns comfortably in excess of benchmark over the ensuing years. For the 3- and 15-year periods ended 31 December 2012, Hire-ranked managers delivered average excess returns of 1.5% and 2.1% p.a., respectively. Results like these represent a solid margin above typical fee levels.



It is worth noting, as always, that past investment performance is not a reliable guide to future performance.

Other considerations

In the above, we have considered the case for active management purely on the basis of the numbers from past experience. For some investors, however, the case is not so clear cut.

A passive approach may simply not be feasible due to a desire or imperative to invest in a certain way in global equity. A good example is where commonly-applied forms of responsible investment are in place, (e.g., active screening or exclusion strategies). In this case, a passive approach is fundamentally at odds with the investor's goals (cf: ground 2 above) and such approaches are, by definition, active.

[2] 'Hire' is the top research ranking that Russell assigns on a four-point scale of Hire, Retain, Review and Terminate.

Investors who wish to establish bespoke exposures might also be challenged to implement on a passive basis because the investment product or instruments they need simply do not exist. This might be the case where a regional or industry sector approach is desired, or where a certain investment style or market segment is being targeted (e.g., low volatility or small capitalisation exposures).

Finally, the task of appointing and monitoring active managers requires time and effort. In other words, a fairly robust ‘governance budget’ is required to support this activity. Investors who are unwilling or unable to commit the necessary resources themselves can still benefit from an active approach by outsourcing manager selection activity to a skilled third party, such as a multi-manager provider. Otherwise, a passive approach is a valid choice.

Conclusion

Generally speaking, active management for global equity remains a worthwhile pursuit for investors who have access to proven manager selection expertise. In certain cases, a passive approach is simply infeasible. Where the investor’s governance budget is inadequate, or where outsourcing has been ruled out, passive investment could be suitable.

Russell Manager Research: Hire List Performance Disclosures

Source

This article contains data as provided by internal Russell applications. These applications are populated with data collected from individual managers by BNY Mellon then provided to Russell's Research Database. The data is not thoroughly verified by Russell and although deemed reliable, its accuracy is not guaranteed by Russell Investments or its affiliates. Most data is gross of advisory fees, but net of fee data is utilised where gross of fee data is not available.

Note: In some cases money managers do not provide data on their products, therefore a reader should be aware that the representations may be misleading; performance of hire lists may be higher or lower than represented.

Hire ranked does not imply that such products have been placed in any Russell funds or products.

Excess Returns

Each product in our hire lists is compared to the relevant Russell assigned benchmark and universe to determine product level excess returns for each quarter. All product level quarterly excess returns are compound excess returns. Product level quarterly excess returns are then averaged across all products in the hire list to determine an average hire list quarterly excess return. Averages are only calculated for hire lists that consist of at least three hire rank products for the given quarter. The average quarterly excess returns by hire list are then annualised to determine the hire list 5-year annualised rolling excess returns. Each 5 year annualised return requires 20 contiguous quarters of non-missing quarterly averages. If the 5 year annualised average excess return for a hire list is greater than zero, then the hire list is considered to have outperformed over that time period.

Note: Benchmarks are total return (they include the reinvestment of dividends) and cannot be invested in directly.

Representation

No client of Russell Investments has been able to achieve the represented performance due to the fact that the hire lists and universes are comprehensive composites that cannot be invested in directly. The hire lists and universes in Russell's research database that are used in this material (presentation) cannot be purchased or held by any client. These manager products are available for our consulting clients and internal portfolio managers to use in the construction of portfolios for our fund and separate account clients.

Past performance is not indicative of future performance.

Timing

Data on the slide is Preliminary (Performance ending 31 December 2012, last updated 19 February 2013). Manager products are included and excluded as our product ranks change over time; not all products are continually Hire-ranked over these indicated time periods.

The information presented is for illustrative purposes only and expires on April 15th of 2013.