



Why active?

THE POWER OF INDEPENDENT THINKING



- In a world where it's unclear where rates will go next and historical relationships between asset classes are changing, independence, flexibility and vision are critical to seize opportunities, as well as to manage risks.
- In such an environment, how can a portfolio manager add value? Through active choices, careful research and market expertise, among others.

Inside: [7 reasons to seek active management today.](#)

It's been said that monkeys throwing darts at a list of stocks could construct a portfolio better than the experts. What's often overlooked is that when that idea was put to the test by some Wall Street reporters years ago, the professional managers did indeed outperform the darts.

While the debate over the value of active management continues, what is clear to all is that investors have access to a wider range of active strategies than ever before — from traditional buy-and-hold to “next generation” active investments that take a more flexible approach. That's an important distinction in today's market environment, where those legendary monkeys would likely find their task growing harder. After a protracted period of indiscriminate gains that buoyed stocks and bonds across the board, more volatile times could lie ahead, making it more difficult to simply ride the wave of surging asset prices. In such an environment, the advantage may go to those keen and capable to dig deep enough in order to find opportunity.

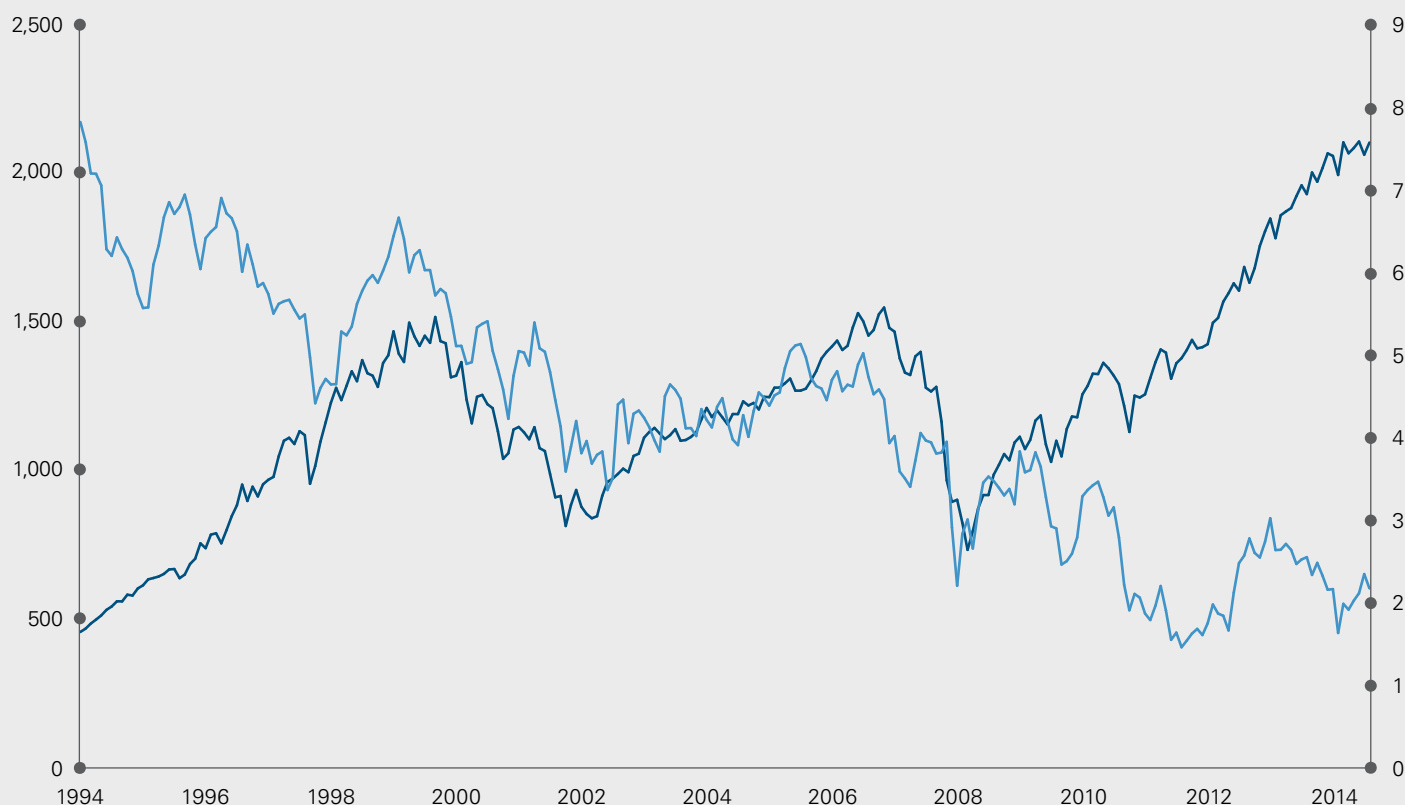
Seven reasons to choose active management today

1. See the world as an opportunity

Because active managers typically do not seek to match the allocation of a benchmark index, they are not necessarily constrained to certain industries or asset classes. When a particular country, stock or bond looks attractive, an active manager with a flexible mandate can tactically increase exposure to those assets. In contrast, passive equity strategies must replicate the distribution of stocks and sectors in the index, with a bias for traditional areas such as banks, utilities and industrials; and, in the case of bonds, to investment-grade securities. That lack of flexibility, for example, would have led many passive or benchmark-tracking investors to miss European High Yield bonds,¹ whose 34% return over the past three years make them the best-performing fixed income asset class over that period; or UK inflation-linked securities, the second-best performer, also omitted from leading index.

Figure 1: How long can the U.S. bond and stock rally last?

— S&P 500 Index (left)
— U.S. Treasury 10-yr yield (% , right)



Source: Bloomberg as of 26 August 2015. **Past performance is no guide to future returns and may not be repeated.**
This information is provided for illustrative purposes only and does not reflect the performance of an actual investment.

¹ **High Yield bonds** are subject to increased risk of default and greater volatility due to the lower credit quality of the issues.

2. Manage risk

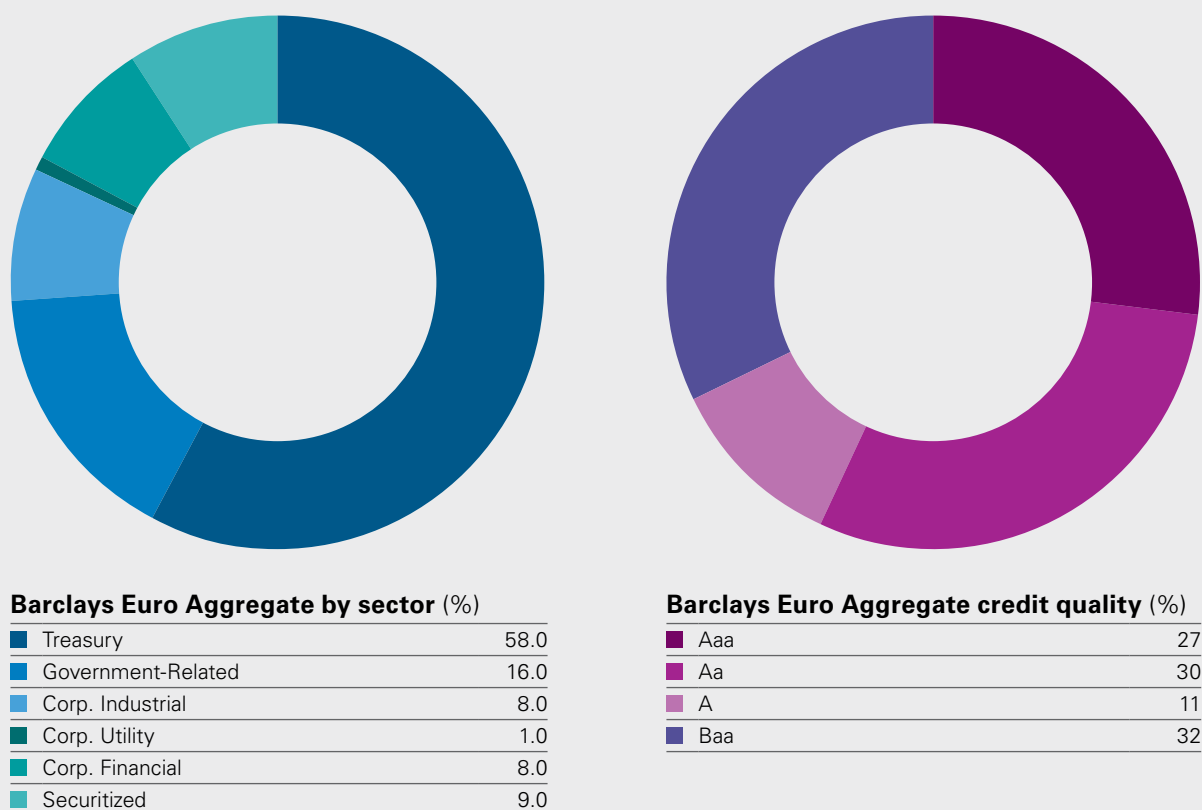
Having the flexibility to ignore a falling knife could have come in helpful for active managers this year. Energy has been a drag on many indices as Brent oil has more than halved in one year, to trade at c. \$48 dollars a barrel at present. This has happened amid slower-than-expected economic growth in the U.S., Europe and Japan, and after a significant slowdown in China. Flexible managers could have either picked another investment with better prospects, or increase its allocation to cash. According to Hargreaves Lansdown,² the average UK active fund manager, for instance, was 4% ahead of the FTSE All-Share index as of August 20, and so far this year, given their reduced exposure to the oil and gas producers that make up 10.1% of the index.

3. Manage volatility

The equity and high-yield sell-offs seen in August after China unexpectedly devalued the yuan are a reminder of how intertwined global markets have become. In principle, that could have been exploited or avoided by active managers, depending on the circumstances. For example, volatility could have been mitigated by leaving the most volatile sectors to focus on more stable ones. In Figure 3, we see that an index is formed by multiple sectors and companies, which have often moved in different directions. While a passive approach is stuck with an index's volatility an active manager could avoid an index's most volatile components.

Volatility, however, can also be used as an opportunity to add securities to a portfolio at reduced prices. In some cases, such as unconstrained strategies, active managers may also have the possibility of going short,³ or betting that a certain asset will decline in value — generating a gain if that is indeed the case.

Figure 2: Unconstrained managers are not tied to stringent rules. On the contrary, leading bond benchmark indices focus on a few sectors or credit ratings, leaving other areas of the Fixed Income market behind.



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² *Financial Times*, 26 August 2015.

³ **Short selling** refers to the practice of selling securities or other financial instruments that are not currently owned, with the intention of subsequently repurchasing them ("covering") at a lower price. In the event of an interim price decline, the short seller will profit, since the cost of repurchase will be less than the proceeds received upon the initial (short) sale. Conversely, the short seller will incur a loss in the event that the price of a shorted instrument should rise prior to repurchase.

Investments in small-cap and mid-cap companies involve a higher degree of risk and volatility than investments in larger, more established companies.

International investments are subject to special risks including currency fluctuations, social, economic and political uncertainties, which could increase volatility. These risks are magnified in emerging markets.

4. Leverage expertise

Specialised knowledge especially matters in areas where research is not as widely or easily available, such as real estate, smaller or lower rated companies, or emerging markets — sectors usually ignored by leading indices, precisely for being seen as too obscure or risky. Ignoring them, however, can be a drag on return, since the best-performing assets are often not those most widely followed or held. So far in 2015, for example, the world's best performing indices are Venezuela, Italian mid-caps, China small and mid-caps and Jamaica, according to Bloomberg data through August 26.

Expertise also pays off not only in remote areas, but also in industries where a high level of specialisation is needed, such as technology, healthcare or biotech. Portfolio managers focusing on those industries often have PhD. backgrounds in those areas that give them an advantage. Active asset managers spend great amounts of time and resources in selecting and keeping such individuals — whose skill will hardly be matched by an index-tracking fund.

Active managers⁴ also spend time running correlations and studying the economic sentiment and environment in order to decide which sectors offer opportunity. These factors tend

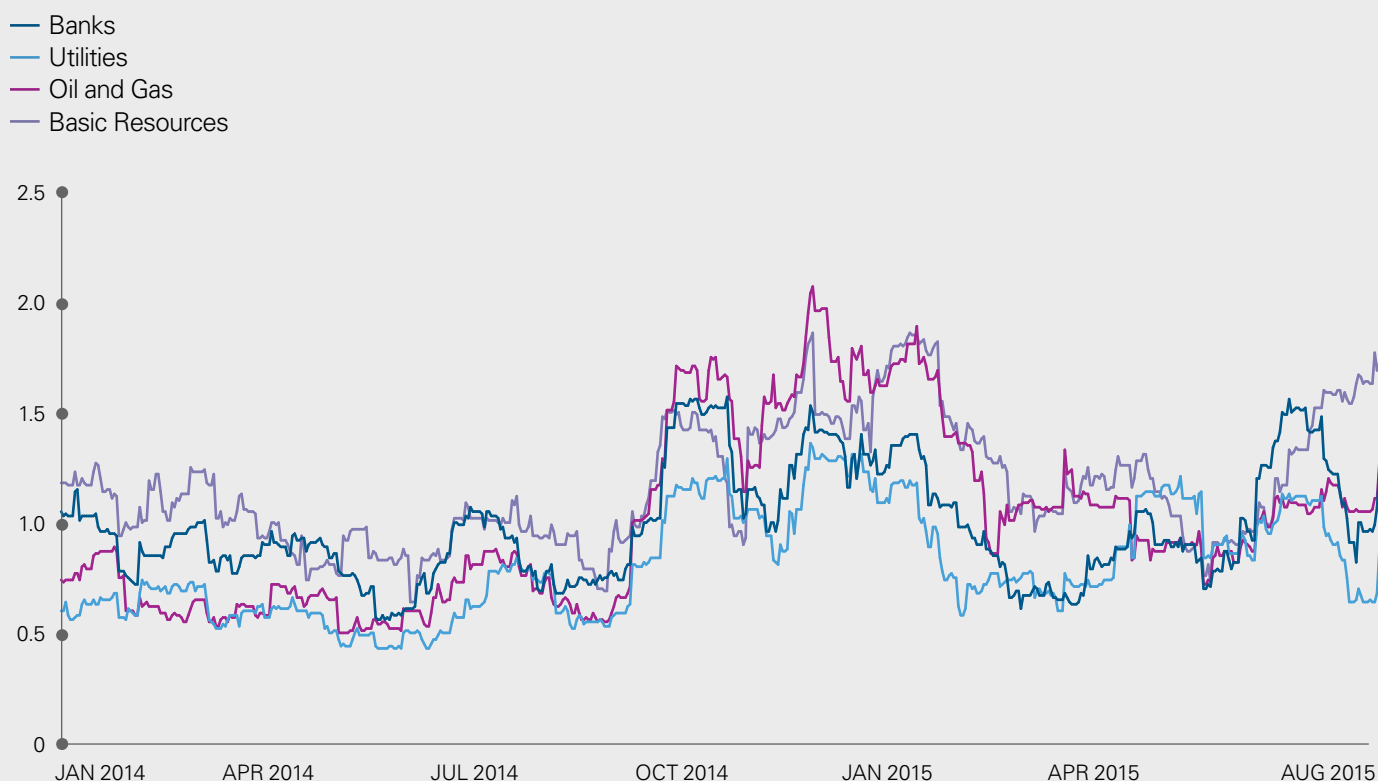
to be ignored by equity tracker funds, as benchmark indices select their members according to stock-specific criteria such as market value or price.

In the complex world of fixed income, expertise is crucial. Unlike stocks, bonds tend to be more influenced by external factors, such as currency exchange rates or a country's interest rate prospects, and not only by the fundamentals of a specific security. In 2014, for example, expertise on the US economy paid off as people expected the economy to gain traction, generating inflation and leading to higher long-term rates. This never happened and the yield curve flattened, rewarding managers who took that view (as shown in Figure 4).

5. Dig deeper

Active managers may regularly visit companies in order to gain insight and form a view about a company's value and prospects. Better knowledge may help managers foresee corporate events that could help foster gains, such as the prospect for future merger and acquisition (M&A). In Europe, the M&A market has surpassed the 0.8 trillion U.S. dollar volume so far this year, en route to match last year's U.S. \$1.078 trillion mark. This is a sharp increase from the low levels seen in 2009, following the financial crisis.

Figure 3: Not all sectors are equal: standard deviation, 30-day rolling average (%)



Source: Bloomberg as of 26 August 2015. **Past performance is no guide to future returns and may not be repeated.** This information is provided for illustrative purposes only and does not reflect the performance of an actual investment.

⁴ Active management and diversification do not assure a profit or protect against a loss. All investments involve risk, including possible loss of principal.

6. Diversify broadly

Leading indices are capitalisation-weighted, which results in a bias toward the highest-valued stocks, or in the case of fixed income, the largest issuers of debt.

Active management offers investors the possibility to invest in non-conventional areas to diversify a portfolio, such as sustainable companies, funds of funds, or even education-focused securities.

Active managers' expertise in mid-cap stocks can also turn into an effective diversifier, especially in situations such as the one seen in August, when stock markets plunged amid China woes. Midcaps, instead, tend to be more domestically-focused and less vulnerable to foreign exchange or global swings.

7. Be flexible

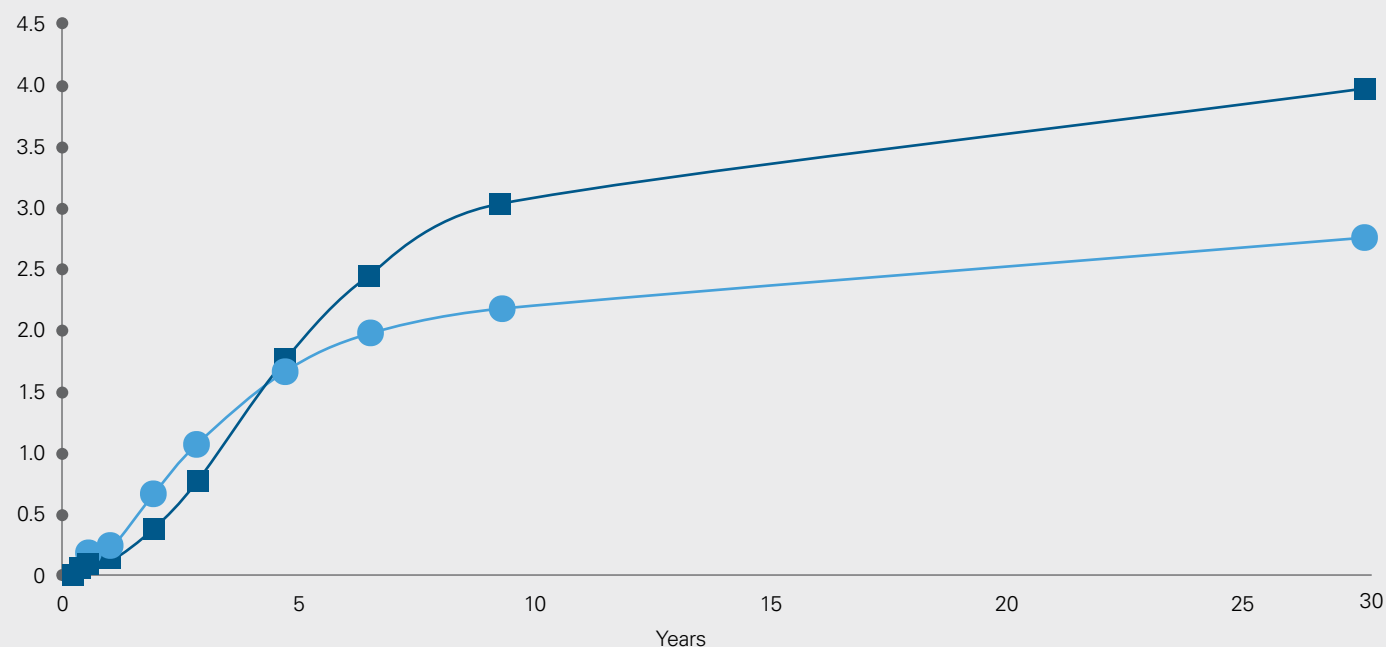
Investors' needs change with times, influenced by their age, their personal situation or the macroeconomic environment. In times of low bond yields, such as now, income may become a bigger concern for many investors, while during expansionary times, capital gains may be more sought after. In any case, an active manager that is sensitive to his or her client needs will have more resources available to try to meet them.

Conclusion

With so many benchmark-tracking funds chasing the same assets, there is room for active managers to find opportunity in those areas overlooked by the majority. That may include under-researched securities and sectors; looking at mainstream asset classes with a new approach; or a critical eye. Whichever the case, their flexibility represents an advantage for investors seeking to adapt quickly to today's fast-changing investment environment.

Figure 4: U.S. yield curve flattener in 2014 — Contrarianism paid off (%)

● I25 U.S. Treasury Actives Curve 12/31/14
■ I25 U.S. Treasury Actives Curve 12/31/13



Source: Bloomberg as of 26 August 2015. **Past performance is no guide to future returns and may not be repeated.** This information is provided for illustrative purposes only and does not reflect the performance of an actual investment.

Definitions

The **Federal Reserve Board** (“Fed”) is responsible for the formulation of U.S. policies designed to promote economic growth, full employment, stable prices, and a sustainable pattern of international trade and payments.

Gross Domestic Product (“GDP”) is an economic statistic which measures the market value of all final goods and services produced within a country in a given period of time.

The **forward P/E ratio** is a stock’s (or index’s) current price divided by its estimated earnings per share (or estimated index earnings), usually one year ahead.

The **S&P 500 Index** is an unmanaged index of 500 stocks that is generally representative of the performance of larger companies in the U.S. An investor cannot invest directly in an index. Unmanaged index returns do not reflect any fees, expenses or sales charges.

The **Barclays European Aggregate Bond Index** is an unmanaged index of European investment-grade fixed-income securities.

A **credit rating** is a measure of an issuer’s ability to repay interest and principal in a timely manner. The credit ratings provided by Standard and Poor’s, Moody’s Investors Service and/or Fitch Ratings, Ltd. typically range from AAA (highest) to D (lowest). Please see www.standardandpoors.com, www.moodys.com, or www.fitchratings.com for details.

Standard deviation is a measure of the dispersion of a set of data from its mean or average.

The **yield curve** shows the relationship between yields and maturity dates for a similar class of bonds.

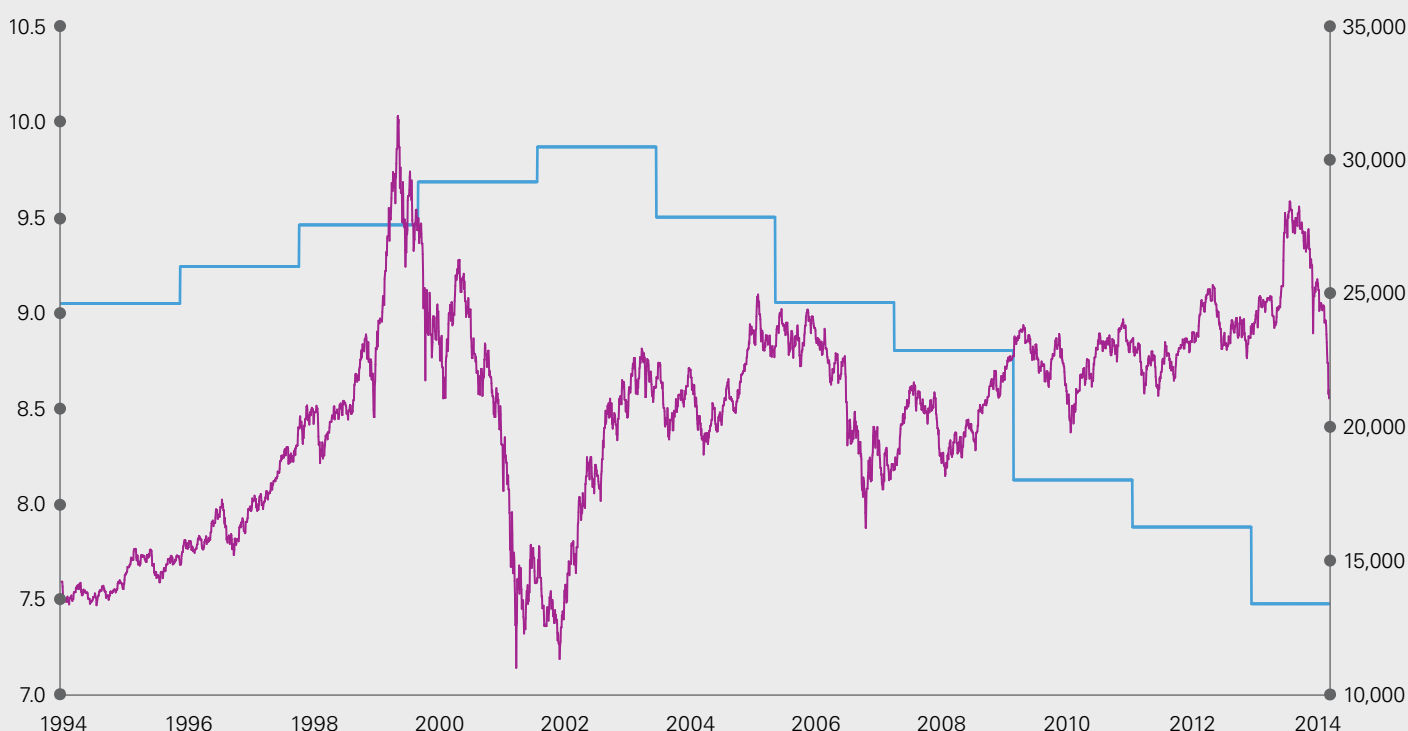
The **EURO STOXX 600 Index** provides a Blue-chip representation of supersector leaders in the Eurozone.

What’s the problem with benchmarks

Benchmark indices often distort the reality they are intended to represent. For example, the Chinese economy grew at double-digit rates for years, while the country’s stock market remained dormant. Chinese stocks only started to explode last year, when China was already in a slowdown.

Figure 5: Stock indices: a real mirror?

— China GDP, growth rate (% , left)
— HIS Index (right)



Source: Bloomberg as of 26 August 2015. **Past performance is no guide to future returns and may not be repeated.** This information is provided for illustrative purposes only and does not reflect the performance of an actual investment. The Hang Seng Index is a free-float capitalization-weighted index of a selection of companies from the Stock Exchange of Hong Kong.

Investment risks

The opinions and views expressed herein are subject to change and are not intended to be relied upon as a prediction or forecast of actual future events or performance, or a guarantee of future results, or investment advice.

Common stocks generally provide an opportunity for more capital appreciation than fixed-income investments but are subject to greater market fluctuations. Investments in small-cap and mid-cap companies involve a higher degree of risk and volatility than investments in larger, more established companies.

Past performance is no guarantee of future results. An investor cannot invest directly in an index. Yields represent past performance and there is no guarantee they will continue to be paid.

Fixed income securities are subject to interest rate and credit risk, which is a possibility that the issuer of a security will be unable to make interest payments and repay the principal on its debt. As interest rates rise, the price of fixed income securities falls.

International investments are subject to special risks including currency fluctuations, social, economic and political uncertainties, which could increase volatility. These risks are magnified in emerging markets.

Outperformance does not imply positive results

U.S. Treasuries are direct debt obligations issued and backed by the “full faith and credit” of the U.S. government. The U.S. government guarantees the principal and interest payments on U.S. Treasuries when the securities are held to maturity. Unlike U.S. Treasury securities, debt securities issued by the federal agencies and instrumentalities and related investments may or may not be backed by the full faith and credit of the U.S. government. Even when the U.S. government guarantees principal and interest payments on securities, this guarantee does not apply to losses resulting from declines in the market value of these securities.

Active Management does not ensure gains or protect against market declines.

Yields and dividends represent past performance and there is no guarantee they will continue to be paid.

Tracking a benchmark index also means that investors have a bigger exposure to the sectors with the highest weight in the index, which may not always be the best idea. Consider the 19 sub-sectors.

Best-performing subsectors (%)

	Return (%) Aug 1995–Aug 2015	Index weight	Index weight rank
STXE 600	158.03%	–	–
STXE 600 Chemicals	448.30%	5.1	7
STXE 600 HealthCare	400.44%	12.9	2
STXE 600 Personal & Household Goods	400.24%	7.6	4
STXE 600 Food & Beverages	384.12%	6.2	6
STXE 600 Auto & Parts	267.40%	3.2	13
STXE 600 Financial Services	232.80%	1.9	19
STXE 600 Construction & Materials	206.51%	2.5	15
STXE 600 Industrial Goods & Services	190.37%	10.8	3
STXE 600 Telcoms	150.75%	4.9	8
STXE 600 Travel & Leisure	140.43%	1.9	18
STXE 600 Utilities	108.76%	4.1	10
STXE 600 Retail	96.08%	3.3	12
STXE 600 Insurance	92.86%	6.4	5
STXE 600 Oil & Gas	90.19%	4.8	9
STXE 600 Basic Resources	87.90%	2.0	16
STXE 600 Real Estate	77.79%	1.9	17
STXE 600 Technology	73.42%	3.4	11
STXE 600 Media	71.19%	2.9	14
STXE 600 Banks	53.26%	14.3	1

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Brandywine Global
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