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THE POWER OF ACTIVE MANAGEMENT

THERE'S NO SUBSTITUTE FOR SKILL

The value of active management through market cycles

IN BRIEF

- As markets become more short-term focused, potentially more volatile and increasingly more complex, the skill of active managers may help investors navigate these conditions more effectively.
- We believe skilled active managers are those who can demonstrate conviction through high active share and long holding periods, add value in volatile markets and collaborate on investment decision making.
- Active managers with a higher degree of skill have shown the ability to outperform over time.

If a trend is a pattern of gradual change and skill is the ability to do something well, which is of greater value to investors? To manage growing investment challenges and continuously find opportunities through changing market conditions, we would argue for active skill over passively following market trends.

And yet as more assets have flowed into passive strategies, it seems that investors may have discounted the value that skilled active managers offer. Trends can be very enticing, particularly in continuously rising, monolithic markets. In all likelihood, however, passive investors who follow them haven't considered whether simply accepting what the market has to offer can actually help them accomplish their objectives without undue risk. As markets grow more difficult to navigate, investors will find they need access to more skill — not less.

Skill is at the very core of active management. It is the ability to exploit market inefficiencies, actively select securities, take on certain risks intentionally and create longer-term value than what can be achieved by simply following market trends. But that skill varies widely — a point we believe has gone unrecognized in recent claims that active managers in general cannot outperform their benchmarks. Many active managers have, in fact, outperformed over full market cycles. With requisite expertise, active managers can potentially add value when the markets are

inefficient, manage against volatility and navigate changing market cycles effectively.

Signs of active management skill

We consider outperformance through changing market cycles to be the result of active management skill. While active skill is reflected in different capabilities, we believe some signs of that skill could be any one or more of the following behaviors:

- **Demonstrating conviction** — through low portfolio turnover and high active share (differentiated significantly from the benchmark)
- **Adding value in volatile markets** — using active security selection to distinguish solid companies from those that are less stable and exploiting opportunities to find good entry points for investment
- **Integrating research and rewarding collaborative thinking** — which drives research through multiple perspectives and fosters a culture of information sharing

In our view, the more active managers exhibit these types of behaviors, the greater likelihood they have the skill to outperform through changing market cycles. We believe the success of such managers relies on their expert research and repeatable process, rather than on short-term phenomena such as market momentum.

Unlike trends, which come and go with time, active skill is more durable, and arguably of greater value, particularly as the capital markets grow more difficult to navigate. Passive investors choose to accept full market risk and face significant headwinds. Even for average active managers, the markets' increasing short-termism, potential for volatility and growing complexity may prove challenging when it comes to identifying opportunities while minimizing risks. We expect these market forces to persist. And while we see them as challenges, we also see them as opportunities for skilled active managers to source alpha.

Demonstrating conviction

We see powerful forces that have driven markets and investors to become very short-term focused. From our perspective, there is a much greater emphasis today on the most recent data point, even if it isn't material to the long-term value of a company or asset. News flow, a constant stream of analyst earnings estimates and incentives geared toward short-term performance, have in our view diverted

attention away from long-term value and shortened investment time horizons.

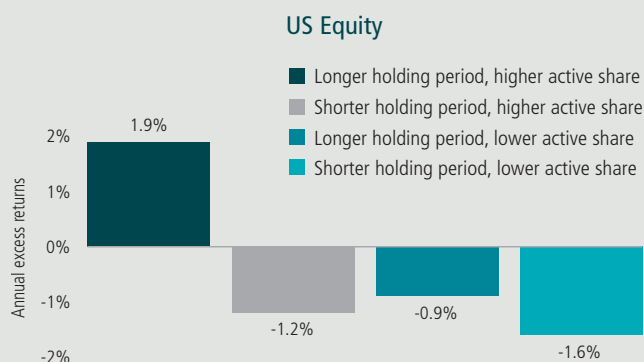
Today, both professional and individual investors are holding stocks for ever-shorter periods of time — on average less than eight quarters.¹ This is despite the fact that in a recent survey conducted by MFS, 68% of respondents said investors are too focused on short-term investment returns (12 months).² From our standpoint, however, it's difficult for active managers to profitably trade markets so frequently because stocks tend to move in tandem in the short term and the opportunity to add value after trading costs is limited.

We believe active managers can combat short-termism by developing and maintaining their long-term convictions. Those who do it well have higher active share — more differentiation from their selected benchmark — and lower portfolio turnover. The analysis — both third party research and our own — of managers with high active share and low portfolio turnover shows that these managers have historically outperformed their selected benchmarks over longer time periods (Exhibits 1A and 1B).

In the Cremers study (Exhibit 1A), which looks at active manager excess returns in US equity strategies, we see that managers who had high active share and held positions for longer periods outperformed the benchmark by 1.9% per year on average.

Exhibit 1A: The benefits of a long-term active approach

Excess returns of US equity mutual funds by holding period and active share 1995–2013



Source: Martijn Cremers and Ankur Pareek, 2014, "Patient Capital Outperformance: The Investment Skill of High Active Share Managers Who Trade Infrequently," Working Paper. Annualized returns relative to the fund's self-declared benchmark where available, otherwise benchmark that minimizes active share selected. US equity mutual funds 1995–2013. Returns holdings-based, net of all fees (including 12b-1) but excluding sales charges. Active share calculated by summing the absolute difference in weight of each holding in the portfolio versus the index and dividing by 2.

Our analysis covered global equities using Morningstar world stock funds with the MSCI World Index as their primary benchmark, to represent the broadest investment universe. We found that managers who combined higher-than-average active share³ and lower-than-average portfolio turnover outperformed the MSCI World Index by roughly 2% annually over the past 20 years and outperformed during all periods shown (Exhibit 1B). In this study, we considered only funds that existed over the full time period shown (as of 31 December 2014), excluding funds that have merged or were liquidated. All four holding period/active share categories had the same survivorship bias, which likely improved the results shown. Importantly, however, the higher active share/longer holding period strategies outperformed the other three classifications over all horizons shown.

In fact, for those managers with the insight to tap the opportunity, the markets' short-term focus becomes a "time arbitrage" opportunity. By lengthening their investment time horizon, such managers can find abundant investment prospects where there is greater return dispersion among securities in a market as represented by the MSCI World Index, shown in Exhibit 2.

An active manager's ability to develop such conviction matters. Among US investors surveyed, 67% pointed to active security selection as the most important attribute when considering an active manager.²

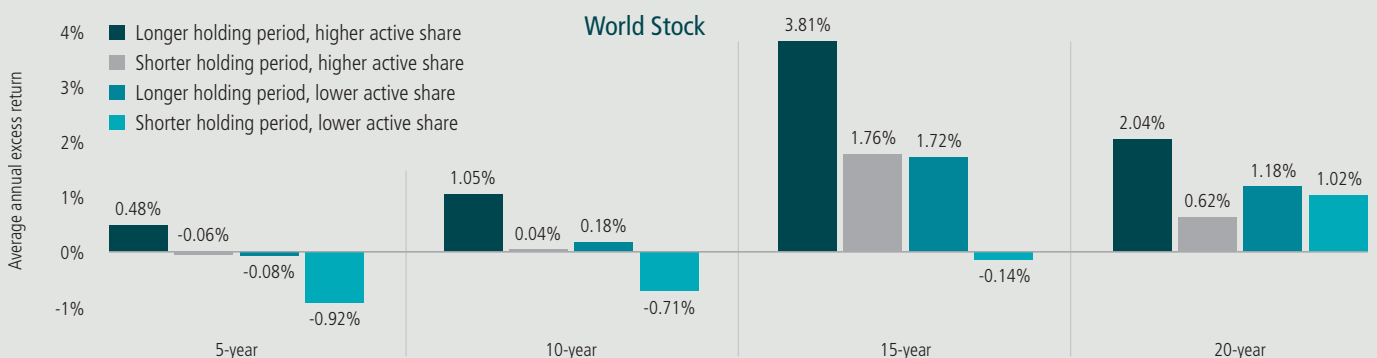
Dispersion, defined in this context as the performance difference or "spread" over any given period between the best and worst companies, can impact the potential for active managers to outperform and drive the differences in their results year to year. In short, dispersion presents significant opportunities for active managers to add value. To understand how, consider the S&P 500 Index in 2009. The difference between one of the best performers, Auto Nation, up 94%, and one of the worst, AIG, down 4%, was 98%.⁴ For active managers, the opportunities are in owning more companies at the top of the list while not owning the ones at the bottom.

Contrast the dispersion in 2009 with a year such as 2014. The spread between a company such as Apple (up 40%) and General Motors (down 12%) was only 52%, or about half of the spread in 2009.⁵ This cycle is what helps active managers recognize the value of holding the right companies over time.

By holding the right companies for longer periods, active managers can focus on meaningful investment signals that point to sustainable earnings growth in the medium-to-long term, which helps them post strongly differentiated performance relative to their benchmarks. Importantly, some active managers are better able to exploit dispersion than others, as illustrated in Exhibit 3. In our analysis, we examined the dispersion of the MSCI World Index over the past 25 years, looking at years when dispersion was in the top quartile (average of 105%) or bottom quartile (average of 62%). We then reviewed the results of both top-quartile

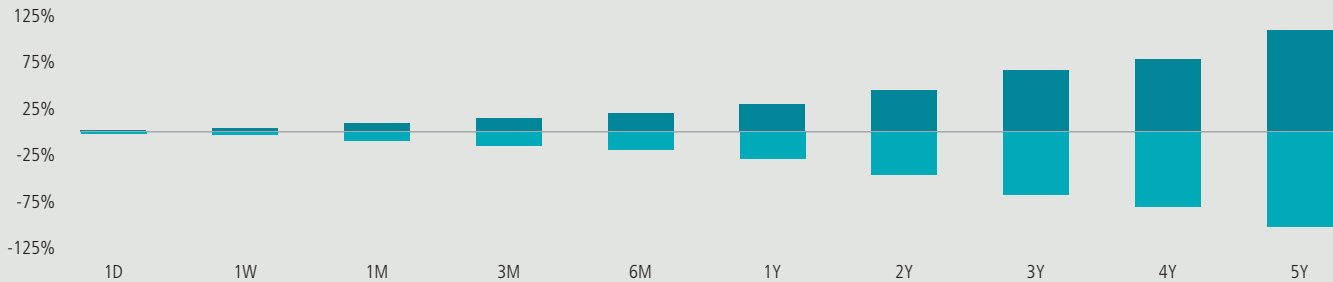
Exhibit 1B: The benefits of a long-term active approach

Annual excess returns by holding period and active share



Source: Analysis based on Morningstar data as of 31 December 2014. Morningstar World Stock funds (surviving funds only) with MSCI World as primary benchmark. Cohorts created by grouping fund based on higher or lower than average active share and turnover. Oldest share class with extended performance used where available. Excess returns net of all fees (including 12b-1) but excluding sales charges. Analysis excludes index and funds of funds. Turnover ratio used as a proxy for holding period. Excludes funds which did not report turnover or holdings data as of 31 December 2014. Active share calculated by summing the absolute difference in weight of each holding in the portfolio versus the index and dividing by 2.

Exhibit 2: MSCI World total return dispersion around mean return 2010–2015

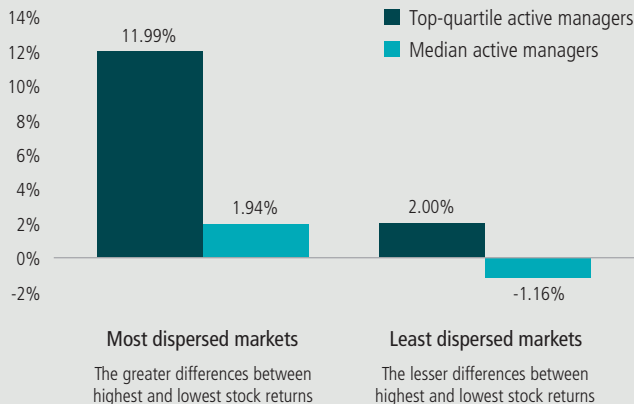


Source: Factset. MSCI World holdings as of 31 March 2010. Forward total cumulative return dispersion around the mean return in USD depicting the 10th to 90th percentile range. Holdings-based returns calculated before fees.

and median active managers in those environments. We found that the top quartile of active managers added value in both types of markets, including 11.99% excess return in the more dispersed markets. The median manager was not able to take advantage of the most dispersed markets to the same extent.

Exhibit 3: Dispersion influences active returns

Excess returns of global equity active managers based on dispersion in MSCI World 1990–2014



Source: Analysis based on Factset and Morningstar data. Market dispersion based on the calendar year return difference between companies at the 10th and 90th percentile from 1990–2014. Calendar years with market dispersion in the top and bottom quartile considered more or less dispersed, respectively. Top quartile and median taken from the Morningstar World Stock category. Excess returns, net of all fees (including 12b-1) but excluding sales charges, calculated against the MSCI World NR USD. Analysis covers all share classes and includes funds that have since been liquidated or merged but excludes index funds. Most dispersed markets (1993, 1997, 1998, 1999, 2000 and 2009) had average dispersion of 105%. Least dispersed markets (1994, 2005, 2010, 2011, 2012 and 2014) had average dispersion of 62%.

Adding value in volatile markets

Markets are much more prone to instability today because of more volatile liquidity dynamics in the markets, unsustainably

high levels of global debt and a continuing stream of geopolitical crises. The level of central bank policy intervention we've seen is historically unprecedented and, in our view, somewhat unpredictable.

Rising market volatility is especially problematic for investors who are unaware of its potential damage and thus have not secured active risk management. Passive investors don't seem to understand the true meaning of taking full market risk. In a survey conducted by MFS, nearly two-thirds of investors thought their stock index funds were safer than the market.⁶

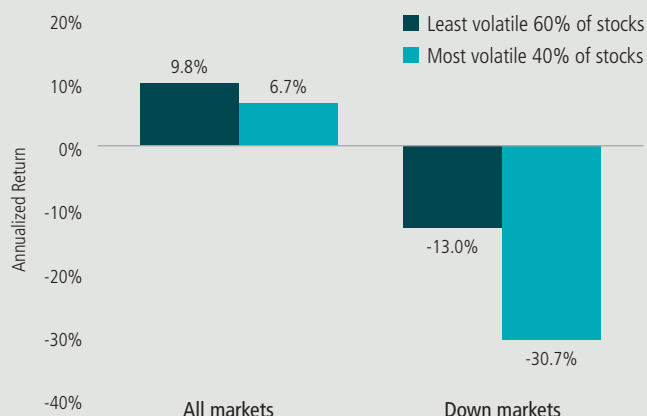
The trouble is that volatility has a very real mathematical impact on returns and diminishes the rate at which an investment grows over time. Suppose an investor has a \$100,000 portfolio that experiences a minus 15% return this month and a 15% rebound next month. The portfolio's value would have fallen to \$85,000 with the 15% drop, but it would have only risen to \$97,750 with the 15% rebound. The \$2,250 loss incurred is the volatility drag.

That volatility drag could be especially painful for investors who take on additional risk expecting to be compensated with higher returns. As shown in Exhibit 4, the most volatile stocks generally underperform in all market environments and significantly underperform in down markets, so these investors are frequently disappointed.

Volatility may be challenging for investors, but it creates opportunities for active managers. Those with skillful research capabilities can take advantage of the volatility in the marketplace around headline events, such as quarterly earnings announcements, buying selectively to find good value, even when others are feeling defensive. As patient

Exhibit 4: Investors are not always rewarded for risk

Global comparison of the most volatile and least volatile stocks 1990–2014



Source: Factset. Analysis using data from global stocks 1990–2014. Proprietary universe includes 1,000 North America, 600 Europe, 400 Japan, 200 Asia Pacific stocks. Down markets occurred during the following periods: January 1990–December 1990, April 2000–March 2003, November 2007–February 2009 and May 2011–May 2012.

investors, skilled active managers can choose to own higher-quality, lower-volatility stocks rather than chase short-term performance from more volatile stocks.

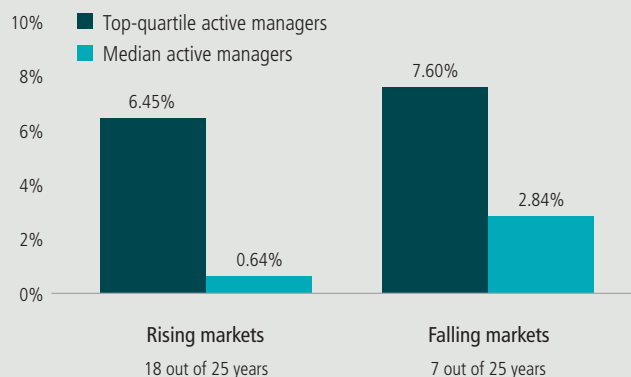
Moreover, these active managers can avoid taking full market risk, intentionally avoiding companies and segments of the markets where risk is overpriced. For example, they can avoid passive managers' bias toward the largest companies, firms which have historically underperformed the market over the long term. Over the past 25 years, the returns from the 25 largest companies have trailed the broader market by over 30% on a cumulative basis.⁷

While active managers in general seek to add value in both rising and falling markets, some have outperformed more on the downside, as shown in Exhibit 5. In our analysis, we examined the results of the MSCI World Index over the past 25 years, looking at the returns of the top-quartile and median managers when markets both rose and fell in a given year. As illustrated in Exhibit 5, we found that top-quartile managers added value in both types of markets, including 7.6% excess return on average in falling markets over the period shown.

To outperform in falling markets, active managers must have differentiated risk management. It should be an important part of their investment process, rather than an overlay, using active

Exhibit 5: Active managers add value in rising and falling markets

Excess returns of global equity active managers 1990–2014



Source: Analysis using Morningstar data. Rising and falling markets based on calendar year returns when the MSCI World NR USD rose or fell (1990–2014). The top quartile and median taken from the Morningstar World Stock category. Excess returns, net of all fees (including 12b-1) but excluding sales charges, calculated against the MSCI World NR USD. Analysis covers all share classes and includes funds that have since been liquidated or merged, but excludes index funds. Falling markets are 1990, 1992, 2000, 2001, 2002, 2008 and 2011.

security selection to view risk from multiple perspectives before adding a security to a portfolio. Through a strong risk framework, they must manage risk on several levels, from the security to the portfolio to the firm. Investors consider this capability a high priority. Among US respondents to the MFS survey, 83% pointed to a firm's active risk management process as the most important trait of a skilled active manager.²

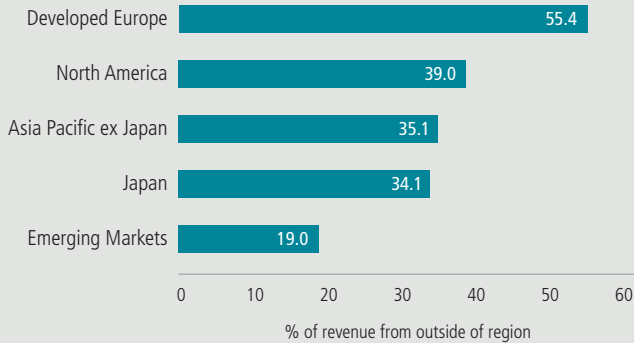
Integrating research and rewarding collaborative thinking

The world's financial markets are becoming more complex given the globalization of business models, the explosion of information and the disruption caused by innovative technologies. Globally, as shown in Exhibit 6, one-third of revenues are now sourced outside of the average company's home region. This presents a challenge — and the need for more expansive research to understand the related impacts on value chains and the competitive landscapes.

Adding to that complexity are incredible innovations and new technologies that will continue to impact competitive positions and industry margins. Some, such as artificial intelligence, robotics and biotechnologies, may create new growth networks, but will also disrupt well-established industries. The ability to conduct expert research and understand those impacts on a global scale will, in our view, further separate the best investment opportunities from the market's passive returns.

Exhibit 6: Globalization of revenues

Major regions derive more than 1/3 of their revenue from outside their home region



Source: MSCI data as of 31 December 2014. Revenue from outside of home region for MSCI ACWI companies.

With so much information in the marketplace and the need to understand companies on a global basis, we believe that active managers need an analysis advantage — a collaborative culture combined with a long-term perspective. That is best accomplished through an integrated research platform with teams of experts collaborating on investment decision making and risk-assessment, and a philosophy of foregoing short-term performance in pursuit of longer-term value.

To us, this means that skillful active security selection is critical. It relies on an active manager's ability to operate in local markets around the world, working to understand the forces that impact opportunities in different regions. With the benefit of an integrated, global research platform, the firm's analysts can share information and vet ideas across

geographies, capital structures and disciplines. This is how skilled active managers can assess market dynamics and communicate what they see in one corner of the world to a colleague sitting in another, leading to more timely and effective investment decisions.

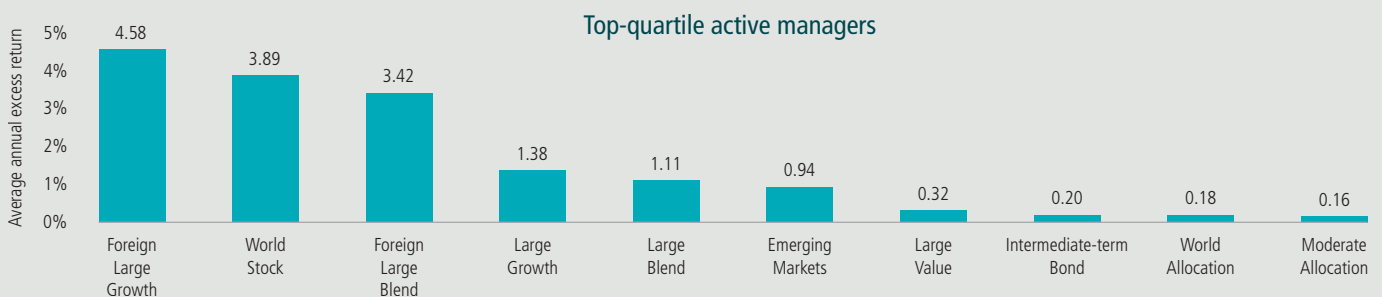
The outcome: Outperforming over time

If active managers exhibit some of the behaviors we associate with skill — demonstrating conviction, adding value by seeking to mitigate the impact of market volatility and fostering collaborative thinking — the ability to outperform over time should be a natural progression. Many active managers have this ability to outperform. In Exhibit 7, we compared the performance of the top-quartile active managers to the relevant benchmarks across the 10 largest asset categories. Across the board, we found that active managers in this category outperformed from 1990 to 2014.

The choice at present between trend and skill, or between passive and skilled active management, seems to have depended on the investment environment. The upward trend of the market over much of the past six years has led passive investors to believe markets are efficient and that market returns are the most desirable. However, as trends change, accepting what the market has to offer may underwhelm expectations and force investors to constantly search for another way to meet their objectives. With its potential to identify broader opportunities and manage against risk, skilled active management could be a solution for investors more interested in navigating through market cycles than following the latest trend.

Exhibit 7: Active managers add value across the board

Average excess returns for largest 10 categories, 1990–2014 (5-year incremental periods)



Source: Analysis based on Morningstar data (net of fees), using active managers in 25th percentile. Analysis covers all share classes and includes funds which have been liquidated or merged. Returns are net of all fees (including 12b-1) but exclude sales charges. Average performance calculated based on 5-year periods from 1990–2014, specifically 1990–1994, 1995–1999, 2000–2004, 2005–2009 and 2010–2014. Excess returns calculated in USD vs. the MSCI EAFE NR (Foreign Growth), MSCI World NR (World Stock), MSCI EAFE NR (Foreign Blend), Russell 1000 Growth (Large Growth), S&P 500 (Large Blend), MSCI EM NR (EM), Russell 1000 Value (Large Value), Barclays US Agg Bond (Intermediate-Term Bond) and 60/40 S&P 500/Barclays US Agg Bond (World Allocation and Moderate Allocation).

Endnotes

¹ Ned Davis Research. Data as of 31 December 2014.

² MFS Active Management Sentiment Study, April-June 2015.

³ While active share captures security differences relative to the benchmark, it can also capture structural biases, such as moving down the capitalization spectrum or off-benchmark. The average annual excess return will capture performance due to all differences relative to the benchmark, not only security selection.

⁴ Illustration uses the spread between the best and worst one-year company returns within the S&P 500 Index as calculated at the 10th and 90th percentiles to avoid outliers. The stocks used as examples are not meant to represent the current holding of any MFS product.

⁵ Ibid.

⁶ 2014 MFS DC Pulse Survey: The Retirement Equation.

⁷ Factset. Calculated using 25 largest companies rebalanced quarterly. These constituents represent 29%–44% of index market capitalization. Index starts at 100 on 31 December 1990.



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