AMG Funds

ActiveEDGE Series

Perspective

When Active Management Matters Most

Summer 2015

Executive Summary

The Case for Active Management: Taking a Closer Look

In recent years active management has come under more scrutiny than ever before. The reason is clear; of late most active managers, particularly those focused on large-cap stocks, have struggled to beat their benchmarks.

Some in the investment community have concluded from this recent underperformance that active managers can no longer add value, or that investors should build portfolios exclusively from passively managed index funds.

Upon taking a closer look, our analysis suggests that:

- **Experienced active managers have tended to outperform relevant benchmarks under market conditions that favor risk management.**
- **Less efficient markets may offer more opportunities for experienced active managers to outperform their benchmarks.**
- **In recent years, active managers have faced headwinds to generating alpha, which have included low market volatility and low borrowing costs.**
- **Boutique active managers possess specific characteristics that may position them for strong relative performance. These managers have historically generated strong excess returns relative to indices and the returns of non-boutique managers.**

When Active Managers Excel

To determine the conditions under which active management has outperformed relative to passive benchmarks, we looked closely at historical performance over the last business cycle. We examined the returns of actively managed funds with portfolio management tenure of ten years or longer. Long-tenured portfolio managers typically have experience navigating more than one full market cycle, which may also position them to outperform going forward.

Experienced Large-Cap Active Managers Have Outperformed More Often than Not

A look at large-cap active managers indicates that they have outperformed more often than not. In addition, certain market conditions appear to have favored active management.

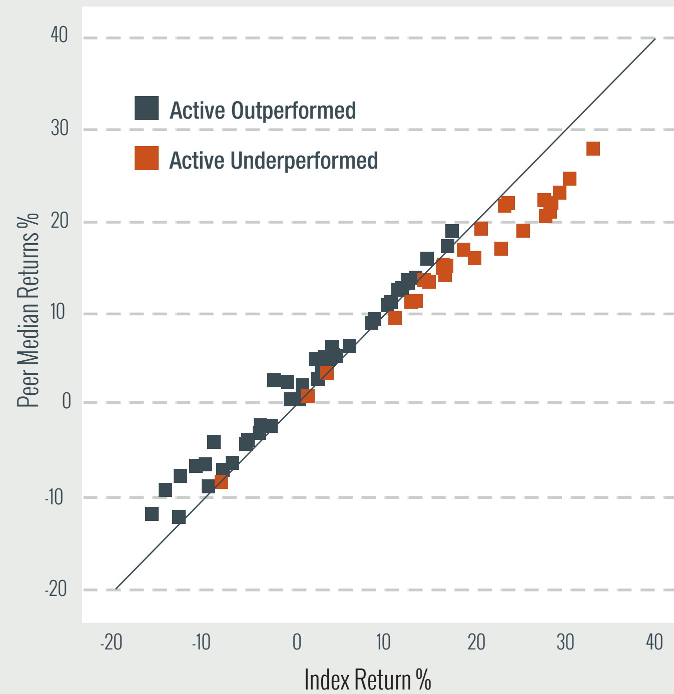
Figure 1 plots median long-tenured, actively managed large-cap fund three-year rolling returns over the 20-year period ending March 31, 2015 against the S&P 500 Index. In periods when the market suffered declines greater than 10%, the median long-tenured active large-cap manager posted the greatest outperformance. In periods of less severe losses, and in low-to-moderate growth periods, active managers also generally outperformed.

Only in the most robust bull markets did the median active manager suffer underperformance. In market periods with gains above 20%, the median active manager consistently underperformed the S&P 500 Index. These markets occurred in approximately 17% of the three-year periods examined.

In all, there were 69 periods in the past 20 years for which we obtained data. 20 years was selected for being long enough to cover a range of market environments, without being so long as to become overly skewed by a survivorship effect. In 41 of those periods (59%) the median active manager outperformed the benchmark.

Figure 1

The average long-tenured active large-cap manager tended to outperform in certain market environments



Sources: AMG Funds, Morningstar.

The above chart plots median actively managed large-cap funds, with manager tenure of greater than 10 years (longest-tenured portfolio manager), annualized three-year rolling returns (with a quarterly frequency) over the 20-year period ending March 31, 2015 against the S&P 500 Index returns. Dark gray plot points indicate periods of outperformance and orange plot points represent underperformance. The distance of the points from the diagonal line indicates the degree of over- or underperformance. The fund category used is the Morningstar large-cap fund universe, including growth, value and blend categories. Performance is net of fees. Past performance is no guarantee of future results.

Experienced Active Managers in Less Efficient Markets Realized Even Stronger Results

The outperformance record for experienced active managers in less efficient markets has typically been stronger than for large-cap domestic equities.

Small-cap equity funds are a good example. Outperformance history for actively managed small-cap funds shows a similar pattern to that of large-cap funds, but the frequency and magnitude of excess return is significantly higher in this asset class.

Figure 2 plots the median long-tenured, actively managed small-cap fund three-year rolling returns over the 20-year period ending March 31, 2015 against the Russell 2000 Index. The median small-cap fund outperformed the Index in 71% of the periods—or 49 out of the 69 periods.

Active manager outperformance is strongest in down markets, as was the case with large-cap funds.

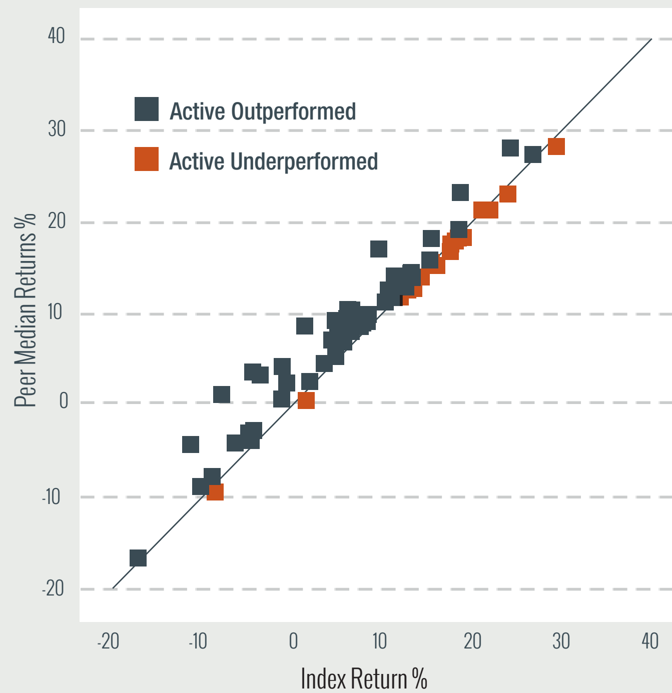
Small-cap managers also outperformed in low-to-moderate growth markets when market gains were positive, but below 20%. In these periods as well, the magnitude of the median fund outperformance over the Index was substantially greater than was the case under similar circumstances for large-cap managers.

By and large, only in strong bull markets when market gains exceeded 20% did small-cap active managers underperform the benchmark. But for small cap, in only 6 periods, or 9% of the total number of periods examined over the 20-year timeframe, did returns exceed 20%.

Notably, in virtually all periods of underperformance, the gap with the benchmark was modest.

Figure 2

The average long-tenured active small-cap manager outperformed its index 71% of the time



Sources: AMG Funds, Morningstar.

The above chart plots median actively managed small-cap funds, with manager tenure of greater than 10 years (longest-tenured portfolio manager), annualized three-year rolling returns (with a quarterly frequency) over the 20-year period ending March 31, 2015 against the Russell 2000 Index returns. Dark gray plot points indicate periods of outperformance and orange plot points represent underperformance. The distance of the points from the diagonal line indicates the degree of over- or underperformance. Included are all funds in the Morningstar small-cap fund universe, including growth, value and blend categories. Performance for the funds is net of fees. Past performance is no guarantee of future results.

Both small-cap and international funds present a compelling story during down markets.

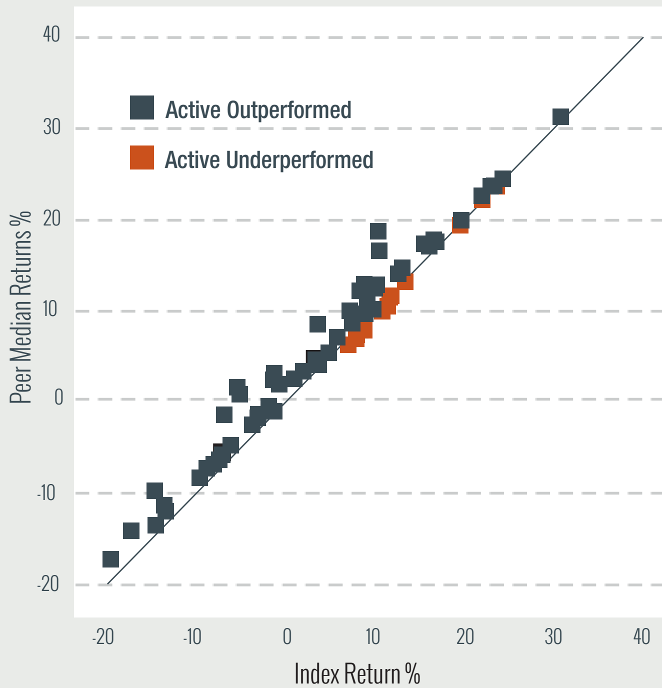
International stocks also illustrate a compelling performance story.

Figure 3 shows the median long-tenured, actively managed international fund three-year rolling returns for the 20-year period ending March 31, 2015 versus the returns of the MSCI EAFE Index. Similar to small-cap funds, active manager outperformance for international funds in down periods was evident, as well as in low-to-moderate growth markets when returns were below 20%. In this case, the magnitude of outperformance was greatest in low-to-moderate growth scenarios. However, in all cases of negative return periods, actively managed funds outperformed the MSCI EAFE Index. For this asset class, the median long-tenured active international manager outperformed the Index 81% of the time, or 56 out of 69 periods.

For international funds, periods of underperformance were generally dispersed across the periods of strong performance and across the data set the weakest period of underperformance was limited to -1.2%, relative to the Index.

Figure 3

The average long-tenured active international manager outperformed its index 81% of the time



Sources: AMG Funds, Morningstar.

The above chart plots median actively managed international funds, with manager tenure of greater than 10 years (longest-tenured portfolio manager), annualized three-year rolling returns (with a quarterly frequency) over the 20-year period ending March 31, 2015 against the MSCI EAFE Index returns. Dark gray plot points indicate periods of outperformance and orange plot points represent underperformance. The distance of the points from the diagonal line indicates the degree of over- or underperformance. Included are all funds in the Morningstar foreign large-cap universe, including growth, value and blend categories. Performance for the funds is net of fees. Past performance is no guarantee of future results.

Understanding the Current Headwinds for Active Managers

We have shown that particularly under specific market conditions active managers have provided alpha. But in certain stages of very strong bull markets, active managers have lagged benchmarks. Why? The primary reason is that bull markets typically have a distinct set of characteristics that make it difficult for managers to find opportunities to add alpha.

Low Volatility, Cheap Money, and Higher Correlations/Lower Dispersion

Bull markets are characterized by low levels of volatility; a market feature that has been evident over the last few years. By definition, less volatility means fewer or smaller price movements in market securities. The recent market environment has been marked by higher correlations across stock prices. This, in turn, limits opportunities for active managers to add value beyond the market gains—that is to say, produce alpha.

The relative calm of the recent bull market is highlighted in the following, striking, statistics. Through March 31, 2015, the S&P 500 Index demonstrated nine straight quarters of positive returns. The only other time such a consistent upward run has occurred in the Index since 1970 was in 1995-1998 when it enjoyed a record fourteen-quarter run. Volatility in the S&P 500 Index has been similarly muted. The last S&P 500 Index decline greater than 10% was in the summer of 2011† when the S&P 500 Index fell by nearly 19%. Since the end of 2011, the S&P 500 Index has experienced only two quarters of negative returns and both were well under 5%. Active managers tend to target high-quality companies with a focus on risk management in seeking to produce strong performance. Figures 1-3 illustrate that this focus has historically performed more favorably in more volatile markets. With so few drawdowns, this has been difficult to accomplish in such a trending environment.

Another factor that has caused equity valuations to converge and alpha opportunities to diminish has been cheap money, which has resulted in lower dispersion among top and bottom performing stocks. An extended low interest rate environment lifts all company valuations—including those which under more typical liquidity conditions might be more susceptible to market volatility.

Furthermore, higher correlations and reduced dispersion among equities are additional headwinds that active managers have experienced over the last few years. When stock price correlations are higher and dispersions are lower, active managers' stock-picking skills are less rewarded, as all prices tend to move closer together.

[Active managers tend to target high-quality companies with a focus on risk management in seeking to produce strong performance.]

† March 2, 2011 to October 3, 2011. The S&P 500 Index fell by 18.6% during this period.

What Happens When Markets Shift?

History suggests that bull markets do not continue indefinitely. If the market corrects, headwinds impacting active management's relative performance may reverse. Equity market volatility may increase if the Federal Reserve begins to raise short-term interest rates and/or macro risks emerge.

In such a circumstance, index investors will likely suffer the full weight of the correction since no active decisions will be made or repositioning undertaken to mitigate the risk. In contrast, experienced active managers are poised to potentially benefit from a return to a more normal dispersion among companies' valuations, which should offer up significantly more opportunities to recognize and add value. Figure 4 below, illustrates the excess returns achieved by experienced active managers during market corrections.

Figure 4

Long-tenured actively managed large-cap fund performance during down markets since 2000

Market Event	Top	Bottom	Drawdown (cumulative %)		Excess return (basis points)	% of long-tenured funds that outperformed
			S&P 500	Median large-cap long-tenured fund		
Dot-Com Bust	9/4/2000	10/9/2002	-47.4%	-40.1%	735	67%
Global Financial Crisis	10/10/2007	3/9/2009	-55.3%	-53.3%	200	66%

Source: Morningstar, S&P 500 Index
Manager tenure of 10 years or longer. Performance for the funds is net of fees.

Past performance is no guarantee of future results.

Boutique Asset Managers May Add Significant Value

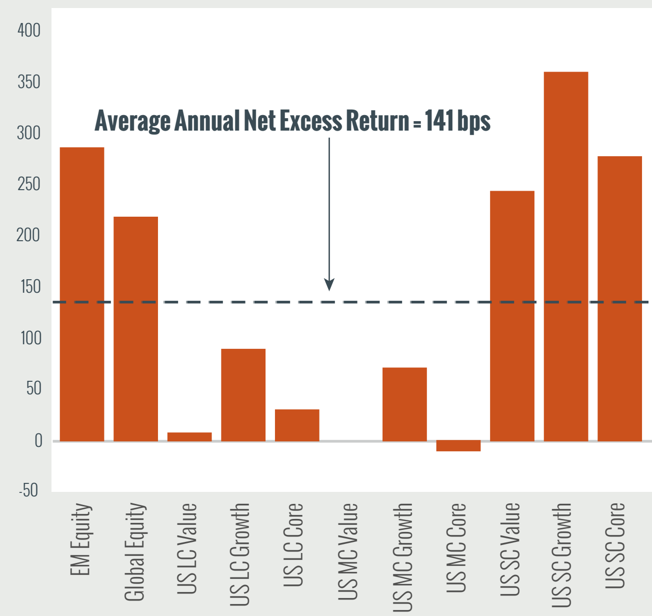
All active managers are not alike. Investment philosophies and processes vary, as does the experience and acumen of the managers at the helm. Investors are faced with the daunting challenge of selecting the best performing managers for their portfolios; managers who have the greatest promise of delivering significant alpha in bull and—perhaps more importantly—in bear markets.

A recent analysis[1] of institutional managers suggests that an important subset of active managers – active boutique investment managers[2], have outperformed their non-boutique peers and consistently delivered significant net excess returns versus indices over time. To illustrate, this study looked at the one-year rolling gross returns for institutional strategies during the trailing 20-year period ending December 31, 2014, less estimated average boutique fee rates for each asset category. The results are shown in Figure 5.

The data show that after expenses, boutique institutional managers had an average annual net excess return over relevant indices of 141 basis points. Excess returns were highest in non-core asset classes reaching as high as 300 basis points in small-cap growth funds and well over 200 basis points in emerging markets and global equity. Boutique excess returns were also favorable in several large- and mid-cap categories as well.

Figure 5

Boutique institutional managers outperformed their indices



Source: AMG proprietary analysis and classification of firms. Firms represented include AMG Affiliates. MercerInsight MPA™ database utilized for return data. Net returns estimated by taking one-year rolling gross returns for institutional strategies during trailing 20-year period ending 12/31/14 less estimated average boutique fee rates based on available data for each product category. Primary indices include MSCI EM, MSCI World, Russell 1000 Value, Russell 1000 Growth, S&P 500, Russell Midcap Value, Russell Midcap Growth, Russell Midcap, Russell 2000 Value, Russell 2000 Growth, Russell 2000.

Past performance is no guarantee of future results.

[1] The Boutique Premium, AMG

[2] Boutique investment managers examined had at least 10% principal ownership; investment management was the sole business, managed less than $100 billion in AUM, and were not exclusively Smart Beta or Fund-of-Funds.

Core Boutique Characteristics Position Them to Outperform

Characteristics that help position boutique active managers for investment success include:

Alignment of interests	Direct equity ownership ensures that key principals have a vested interest in the long-term success of the firm. Many of the most talented investment professionals in the world are drawn to the boutique structure where the incentive system allows them to own the results of their investment performance.
Multi-generational management	The presence of a multi-generational management team, including a succession plan, is another core foundation of boutiques, ensuring that key principals will continue to remain highly involved and motivated.
Entrepreneurial culture with partnership orientation	Key partners control the daily operations of the boutique firm and are actively involved in business planning and building an enduring franchise. Great investors are more likely to be drawn to boutiques that offer an entrepreneurial culture and allow them to have a direct impact on the future success of their business.
Investment-centric	A boutique has an investment-centric organizational alignment, typically geared to a distinct investment philosophy (e.g., value-oriented with strong focus on purchasing securities below their intrinsic value) with a highly focused investment process (e.g., bottom-up stock picking). These investment considerations have primacy at a boutique, which is more likely to manage towards optimal risk-adjusted returns, often setting capacity limits to remain nimble in its investment approach.
Commitment to building an enduring franchise	Key principals are committed to the long-term growth and success of the firm, often signaled by their willingness to sign multi-year employment agreements. A stable, long-term environment is ideal for generating investment success, and a group of principals bound together by long-term equity may be best-positioned to deliver this success.

Conclusion

Although active managers have found it difficult to keep pace with benchmark returns in the current bull market, our research shows that historically, funds with experienced managers—those with tenures of at least 10 years—have generally been successful in outperforming their benchmarks. This has especially held true in periods of high market volatility and downside risk, when active managers have been better positioned to protect investors from market losses and leverage buying opportunities. Also, less efficient markets such as small-cap and international markets appear to provide the greatest opportunity for active managers to outperform.

In identifying active managers most likely to outperform, our research points squarely at boutique managers. Within the active manager universe, boutique managers have tended to perform better than both their benchmark indices and the majority of their non-boutique manager peers. This is most likely due to the characteristics of boutique managers that include a focus on investment management, a high percentage of firm equity ownership among managers, and a culture of commitment to the long-term success of the firm.

DISCLOSURES

S&P 500 Index
The S&P 500 Index is a capitalization-weighted index of 500 stocks. The S&P 500 Index is designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

MSCI EAFE Index
The MSCI EAFE Index (Europe, Australasia, Far East) is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the U.S. & Canada. The MSCI EAFE Index consists of the following 21 developed market country indices: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Hong Kong, Ireland, Israel, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland and the United Kingdom.

MSCI Emerging Markets Index
The MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets. The MSCI Emerging Markets Index consists of the following 23 emerging market country indices: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Greece, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Peru, Philippines, Poland, Qatar, Russia, South Africa, Taiwan, Thailand, Turkey and United Arab Emirates.

MSCI World Index
The MSCI World Index is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed markets. The MSCI World Index consists of the following 23 developed market country indices: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Hong Kong, Ireland, Israel, Italy, Japan, Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, the United Kingdom and the United States.

Russell 1000® Value Index
The Russell 1000® Value Index is a large-cap value index measuring the performance of the largest 1,000 U.S. incorporated companies with lower price-to-book ratios and lower forecasted growth values.

Russell 1000® Growth Index
The Russell 1000® Growth Index is a market capitalization weighted index that measures the performance of those Russell 1000® companies with higher price-to-book ratios and higher forecasted growth values.

Russell Midcap® Value Index
The Russell Midcap® Value Index measures the performance of those Russell Midcap companies with lower price-to-book ratios and lower forecasted growth values. The stocks are also members of the Russell 1000® Value Index.

Russell Midcap® Growth Index
The Russell Midcap® Growth Index measures the performance of the Russell Midcap companies with higher price-to-book ratios and higher forecasted growth values. The stocks are also members of the Russell 1000® Growth Index.

Russell Midcap® Index
The Russell Midcap® Index measures the performance of the 800 smallest companies in the Russell 1000® Index, which represent approximately 25 percent of the total market capitalization of the Russell 1000® Index.

Russell 2000® Index
The Russell 2000® Index is composed of the 2000 smallest stocks in the Russell 3000® Index and is widely regarded in the industry as the premier measure of small-cap stock performance.

Russell 2000® Value Index
The Russell 2000® Value Index is an unmanaged, market-value weighted, value-oriented index comprised of small stocks that have relatively low price-to-book ratios and lower forecasted growth values.

Russell 2000® Growth Index
The Russell 2000® Growth Index measures the performance of the Russell 2000 companies with higher price-to-book ratios and higher forecasted growth values.

The Indexes listed above are unmanaged, are not available for investment and do not incur expenses.

All investments are subject to risk including possible loss of principal. Investments in small-cap companies may involve higher risk than investments in larger, more established companies. Investments in international securities are subject to certain risks of overseas investing including currency fluctuations and changes in political and economic conditions, which could result in significant market fluctuations.

Investors should carefully consider a Fund's investment objectives, risks, charges and expenses before investing. For this and other information, please call 800.835.3879 or visit www.amgfunds.com for a free prospectus. Read it carefully before investing or sending money.

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