Manage through market cycles, not for the moment

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Investors have a tougher job today than ever before. They're taking more risk than in decades past in order to achieve similar returns. And they're doing so against a backdrop of geopolitical and market uncertainty – things they cannot control but still must take into consideration. Understandably, that sense of uncertainty, coupled with the need to take more risk, is driving investors to focus on what is tangible and easy to measure in an effort to gain some sense of control. Often this has resulted in a more short-term outlook and a move away from active management.

Consider the damage that a short-term focus can have on investor returns. The constant information flow and analyst earnings estimates can often trigger reactive investing. We can't help but think that, in this noisy and frantic world, people are missing the issues that really matter. Over the past two decades, we've seen markets and investors move away from investing for the long term, overwhelmed by an excess of short-term information and often under pressure from stakeholders and regulators to monitor and report over ever-decreasing time frames. In addition, the focus on costs and fees has been relentless, with less attention sometimes being paid to value for money, which is so much harder to quantify. In this increasingly short-term world, investors are hard-pressed to achieve long-term results.

Most of the criticism levelled at the active management industry in recent years points to average active managers' inability to consistently beat their benchmarks, net of fees. And while that might be true for average managers, there are skilled active managers who have consistently outperformed their benchmarks over a full market cycle.

In addition, armed with deep research platforms and enough patience to let their good ideas play out, skilled active managers have perhaps the greatest capacity to win the war against an investor's most powerful enemy these days – market short-termism. We believe investing effectively throughout market cycles takes the support of skilled active managers.

Signs of skill

Clearly, some active managers have more skill than others. A keen ability to exploit market inefficiencies, actively select securities and take risks intelligently are just some of the characteristics. These are the active managers who can potentially outperform throughout market cycles. But what to make of the common argument that skilled managers can't be distinguished from average?

It's entirely possible to spot skilled active managers through certain behaviours. One is high-conviction investing, demonstrated through managers' low portfolio turnover and high active share (i.e. their portfolios are significantly different from their benchmarks). Managers who are willing to make significant investments beyond the index that serves as their benchmark – commonly referred to as active share – and hold those investments for long time periods have outperformed over time. According to a study by Martijn Cremers and Ankur Pareek, portfolios with high active share and long holding periods outperformed their benchmarks by more than 2% points over the 24-year period starting in 1990.[1]

We believe skilled managers should also be able to add value in volatile markets, using sophisticated research to separate good companies from bad and finding good entry points for their investments. And they're good team players – sharing information and working collaboratively to develop multiple research views aimed at generating the best investment ideas for clients.

Patience pays off

Skilled active managers will turn their backs on short-term market "noise" – even giving up some short-term performance to give their best investment ideas time to pan out. In fact, these managers use the market's short-termism to their advantage. By lengthening their time horizons, skilled active managers can find abundant investment prospects where there is greater return dispersion in a market – the spread between the best- and worst-performing companies. Determined to hold the right companies for longer periods, these managers concentrate on meaningful investment signals that point to sustainable earnings growth in the medium to long term. This can drive strongly differentiated performance.

As managers, we also need to do everything we can to embed long-term behaviours in our teams. This is achieved by creating a culture of long-termism and reinforcing it with compensation structures. Lots of deferred compensation is still linked to short-term performance numbers, when in fact a meaningful amount of compensation should be linked to longer-term performance outcomes.

In addition, firms need to ensure that business practices are focused on long-term outcomes. For example, by taking the short-term pain from capacity management for the long-term benefit of clients and therefore the firm. More broadly, the strategy of the firm needs to be based on a stewardship culture rather than on a sales culture.

Action over reaction

A long-term approach is also highly relevant to the environmental, social and governance (ESG) conversation. We believe ESG is often misconstrued as more of a social/responsible investment decision. That has driven some investment managers to respond with a relevant product set. In reality, ESG is much more about trying to invest in good businesses rather than bad – finding those with true long-term value by understanding what factors (e.g., good management, effective capital allocation and superior products and services) are material to a company's sustainability and competitive advantage. Integrating those considerations into the investment process – whether you're an investment manager selecting securities or an asset owner selecting an investment manager – can reduce risk and potentially improve returns over time. But it takes patience and robust research to understand what is material over the long term.

The value of expertise

Market short-termism will continue to stir up battles over which product will garner the most alpha under prevailing conditions. But for those with long-term objectives, skilled active management might be one important ally for winning the war.

1. Martijn Cremers and Ankur Pareek, 2015, 'Patient Capital Outperformance: The Investment Skill of High Active Share Managers Who Trade Infrequently', Working Paper. Annualised returns are compared to the stated benchmarks of the US equity mutual funds included in the study from 1990 throughout 2013; otherwise, benchmarks that minimise active share selected. 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.