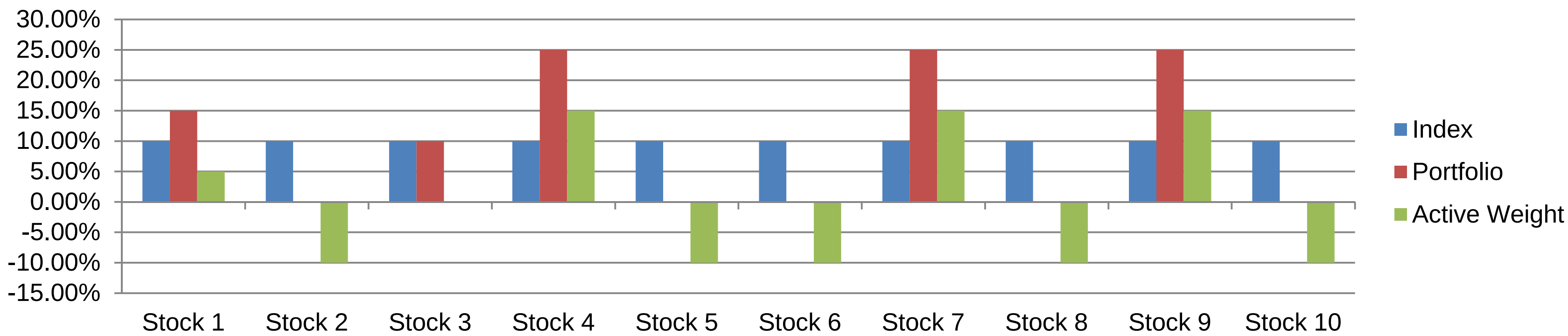
Second Quarter 2013 Knowledge College

Introducing Active Share

The active versus passive debate of how to invest has been going on for quite some time. A supporter of passive investing would say that paying for active management is a losing proposition because active management does not consistently add value over time. Therefore, the passive investor should instead focus on getting the most efficient (least expensive) exposure to reduce fee drag of the investment. While we have dedicated time and research to this topic alone (see The Next Chapter in the Active versus Passive Debate), we would like to take a different approach here when discussing “active” management.

Active management previously was defined as any investment process that was implemented with the design of outperforming a specific benchmark. In this Knowledge College we are going to discuss types of active management by introducing active share as a concept and contrasting it with tracking error, a measure commonly referred to as a means of quantifying active management.

Figure 1



What is Active Share?

Active share is a measure that was introduced in the academic paper “How Active Is Your Fund Manager? A New Measure That Predicts Performance” written by K.J. Martijn Cremers and Antti Petajisto in 2009. The premise is simple: to outperform a benchmark net of fees, a portfolio must be different from the benchmark. In their paper Cremers and Petajisto formed a new definition of how to define “different.” Historically, tracking error was looked to as a measure of quantifying how active an active manger is. Tracking error is defined as the standard deviation of excess return of a portfolio from its benchmark. This measure shows us how volatile a portfolio’s excess returns are compared to a benchmark. Active share, by contrast takes a more intuitive approach to defining “different.” It compares the holdings of a portfolio to that of its benchmark and quantifies the differences. For a portfolio that cannot short or lever stocks, its active share will always be between 0% and 100%. If a portfolio has a 0% active share, it is identical to the index. If a portfolio has a 90% active share, it is 90% different from (i.e., 10% overlap with) the index. Active share takes into account not only holdings overlap, but also the weighting of holdings in a stock. In Figure 1 above, there is a 10 stock equal weighted index in blue. The portfolio, in red, only holds 5 stocks at different weightings from the index. The green is the active “bet” with each holding. Quantifying the green bars into a value between 0% and 100% is the active share of the portfolio.

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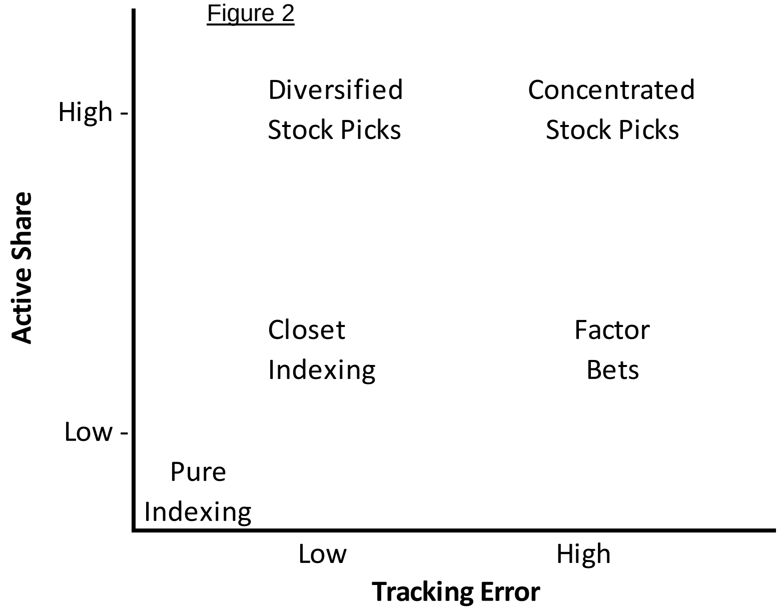
How is Active Share Different from Tracking Error?

Differentiating a portfolio from its benchmark generally can be done in two different ways (or a combination of both): factor bets or stock selection. Factor bets are allocations in a portfolio where the portfolio manager is buying stocks based on the ideas that entire sectors and/or industries will outperform the broader market. By choosing the right sector at the right time, the portfolio manger hopes to outperform the benchmark net of fees. Stock selection is when the portfolio manager owns stocks outside of the benchmark or owns different weightings of stocks than are in the benchmark (as shown in Figure 1). These two different active management styles are each captured by tracking error and active share differently. Tracking error has a greater sensitivity to factor bets, while active share differentiates stock picking from factor bets. Figure 2 displays how various portfolios can be categorized based on both their active share and tracking error.

Figure 2



Types of Active Management

Diversified stock picks are those portfolios that have a low tracking error, but a high active share. The portfolio owns different weightings and/or securities from the benchmark, but does not have large deviations from the industries or sectors. Factor bets are the opposite. They have similar weights and holdings to the benchmark, but have large differences in industry or sector allocations from the benchmark. Combining high active share with high tracking error produces a concentrated stock picks portfolio that has different securities and/or weightings than the benchmark and different industry or sector allocations. Lastly, closet indexing are active management portfolios that exhibit both low active share and low tracking error.

Why does this matter?

When DiMeo Schneider & Associates conducts research on active management investment products, we can differentiate portfolios based on their active management style and quantify historically a portfolio manager's willingness to differentiate from the benchmark and success in doing so. Also, by conducting this type of research we can work to avoid investing in "Closet Indexers." It is our opinion that these investments are less likely to produce positive excess returns to the benchmark after charging an active management fee because of their low differentiation.

Conclusion: Different is Better

No portfolio manager or consultant can guarantee positive excess returns. What we can say with high confidence is that if a portfolio is allocated similarly to a benchmark that after fees it is less likely to outperform the benchmark over time. By quantifying both the level of active management and the type of active management, we are not only better able to seek portfolios with a higher likelihood of positive excess returns, but also help correctly guide a client to the right type of active management based on their unique objectives.