



# The Merits of Active Investment Management

Jeff Munroe, Chief Investment Officer  
Newton



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In this paper, we consider in more detail one of the areas that we touched upon in our recent paper about our *all change* theme — the attractiveness of ‘active’ investment strategies versus ‘passive’ approaches. The debate about the merits of active and passive investment management has received much attention recently in the aftermath of the global financial crisis and in light of the failure of a number of active strategies to meet investors’ requirements during that crisis.

The *all change* theme considers the implications of the aftermath of the financial crisis for financial markets and economies, its key contention being that both the supply of, and demand for, credit around the world are likely structurally to be reduced in the years ahead. The likely consequences of changes in credit conditions are wide-ranging but, while they give rise to threats, we believe also that they generate opportunities for investors.

We recognize that, in some situations, passive approaches may be appropriate for some investors (for example in seeking to match assets and liabilities via bond investments). However, we believe that there is a strong case for most investors to employ a proven active approach in pursuance of their investment objectives.

## We argue in this paper that:

- Investors are usually served best by proven active investment management
- In the *all change* world, in particular, an emphasis on simple and transparent, actively managed investment solutions may be essential in allowing investors to navigate a challenging environment and maximize opportunities
- There are some significant flaws in the arguments that purport, on return grounds, to justify the switching of investors’ assets from active to passive funds
- The concept of ‘market efficiency’ (which is cited by proponents of passive investing as one of the key rationales for shunning active forms of investment management) is erroneous
- Passive funds do not ‘neutralize’ risk, but may introduce significant ‘concentration risk’ and benchmark risk (and, in relation to exchange-traded funds, counterparty risk) to investors
- Active management allows ‘risk’ to be managed appropriately in the context of investors’ specific objectives

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## Introduction

During the global financial crisis that began in 2007, volatility in financial markets rose sharply and asset prices weakened precipitously. The crisis exposed the frailties of many investment approaches which, far from controlling investors' risks, actually served in places to amplify them. Among other things, investors' fortunes were damaged by the inadequate research of some of the products in which they invested, by the use of financial instruments that were inadequately understood, and by the use of excessive borrowing by some market participants. In the aftermath of the crisis, we believe many investors will consider whether their investment strategies remain appropriate and some will consider switching wholly or partially from an active approach to a passive approach.

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We think that investors are right, given the turmoil in financial markets (and given the unfavorable implications of much of the 'innovation' in the provision of asset management services in recent years), to consider carefully the strategies via which they seek to fulfill their various investment objectives. However, it is our conviction that in doing so they may be mistaken to suppose (as some commentators have suggested) either that 'passive' investment approaches would have been effective in avoiding the pitfalls that occurred in recent years or that passive investing will be more appropriate than active investing in meeting investors' objectives in the future. The debate about the respective merits of active and passive approaches has continued for the three decades since the inception of the first passive investment vehicles, which were funds that sought to track or replicate the performance of some of the larger equity indices in the more developed markets. Frequently, however, the findings of studies commissioned to consider the case for one or other approach have been muddied by the use of skewed statistics, by the questionable association of outcomes and causes, and by the disingenuous extrapolation of past events.

We seek in this paper to set out the arguments, as we see them, for investors to harness the expertise of proven active investment managers. In particular, we believe that such expertise should be highly valuable in the *all change* world in which economic activity and the availability of credit are constrained. It is not our intention to try to make a definitive case for all active forms of investment management over all forms of passive management. Indeed, for some investors in some circumstances, for example in relation to asset and liability matching via bonds, the use of some form of passive investment approach may be beneficial.

### **In setting out these arguments, we will address:**

- 1) Definitions of 'active' and 'passive' investment management
- 2) Fundamental considerations, including:
  - the concept of market efficiency
  - concepts of 'risk', including index concentration
  - the nature of investment returns
  - trustees' duties
  - costs
- 3) The implications of the *all change* world
- 4) The characteristics of effective active management

## Definitions

Before considering the case for active forms of investment management, it is worthwhile trying to formalize some definitions of 'active' and 'passive' approaches. Definitions of each approach vary and, given the multitude of investment products and services now available to investors (some of which blend elements of active and passive approaches), it might be more accurate to regard investors' options as akin to a spectrum rather than a binary choice between 'active' and 'passive' investment management. However, the following is broadly true of each type of approach:

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### Active

- Active investment managers aim broadly to fulfill clients' objectives by taking views about investment prospects (whether in relation to the outlook for economies, companies, industries, currencies, etc.) and by using their insights to make deliberate choices in selecting securities in clients' portfolios.
- Active managers seek usually to outperform a particular benchmark, but the objectives they are set need not always be relative. Unconstrained approaches may be managed in the absence of a benchmark; and absolute-return approaches may be managed to meet a particular (perhaps cash-related or wage-growth-linked) target.
- At Newton, we invest with a global, thematic perspective and we believe that our approach is key to identifying the forces of change in financial markets and benefiting from those forces on behalf of our clients. However, the active investment approaches of different investment firms differ widely.

### Passive

- Passive investment managers seek in general to match the return and risk characteristics of an index (or part of an index) by mirroring its composition. On the whole, passive approaches do not entail any intentional choice of investments on the part of the investment manager.
- Passive approaches are sometimes referred to as 'tracking' or 'indexing' approaches, although they do not necessarily involve the full replication of an index. A passive approach may entail 'partial replication', which involves holding a representative sample of shares in an index and may be used when it would be difficult or expensive to buy all stocks in an index. It may also entail 'synthetic replication', which involves the use of derivatives (usually swaps) to provide index returns.
- Traditionally, passive funds took the form of index mutual funds, but over the last few years there has been growth in a new form of investment vehicle—exchange-traded funds (ETFs). These are usually passive in nature and their units are traded in the same manner as shares on a stock exchange.

## Fundamental considerations

The advocates of passive investment approaches essentially argue two key points, the second of which they say flows from the first:

- i. That markets are 'efficient'
- ii. That, because markets are efficient, it is impossible for an investment manager to outperform consistently and investors therefore should adopt a passive approach

Our conviction is that neither point is accurate, and we explore each in turn below. In addition, we consider a number of other areas in relation to the debate about the merits of active and passive forms of management, including:

- Concepts of market efficiency
- Concepts of 'risk', including index concentration
- The nature of investment returns
- Trustees' duties
- Costs

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The efficient market hypothesis ignores the overwhelming importance of emotive behavior (fear and greed being the most obvious elements of such behavior) in investors' decision-making.

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### The concept of market 'efficiency'

#### **The efficient-market hypothesis**

The 'efficient-market hypothesis' holds that there can be no over-valued or under-valued securities because at all times markets 'discount' fully all known factors that might influence the pricing of securities.

At any point in time, we recognize that some markets are likely to be more efficient than others (for example, large-cap markets in general are more efficient than small-cap markets, and developed markets are generally more efficient than developing markets). However, it seems absurd to think that any market is entirely efficient because that would seem to imply to us not simply the availability of all relevant information that might influence the fortunes of particular securities, but that investor psychology and behavior are entirely rational in the interpretation of that information.

Investors have access to more information than ever (owing in large part to technological advances), but information without perspective is of limited value. Market efficiency would require that investors, having harnessed all necessary information and having adopted an approach that affords them perspective on such information, also act rationally. The efficient market hypothesis ignores the overwhelming importance of emotive behavior (fear and greed being the most obvious elements of such behavior) in investors' decision-making. In periods of pronounced volatility (such as during the last year), it has been very difficult to concur with the assertion that at all times markets have remained rational. Similarly, it is difficult to conclude that during the technology, media and telecommunications ('TMT') bubble at the turn of the century, the extreme pricing of technology stocks was sustainable or 'rational'.

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We believe there are nearly always mispricing opportunities in markets, particularly for investors who are prepared to investigate asset markets thoroughly, and who are equipped to use long-term perspective.

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In short, we believe there are nearly always mispricing opportunities in markets, particularly for investors who are prepared to investigate asset markets thoroughly, and who are equipped to use long-term perspective. Regardless of how certain an investor can be about the current information available about a particular investment proposition, there is inevitably uncertainty about its future prospects. The investment community as a whole appears to be increasingly skeptical that markets are efficient. In a recent survey of Chartered Financial Analyst Institute members,<sup>1</sup> two thirds of respondents said they no longer agreed that market prices reflected all information available to investors, and 77% of respondents disagreed 'strongly' or 'very strongly' with the suggestion that investors behaved 'rationally'.

We think that a good active manager can add significant value in the fulfillment of clients' investment objectives by selecting appropriate securities and by making favorable asset allocation decisions. Indeed, we believe that investment managers are best placed among a client's various advisers to add that value; quite simply, investment managers have the best understanding of financial markets, particularly where a multi-asset orientation means that they evaluate opportunities across the investment landscape as a whole (rather than in relation to only a limited part of that landscape). In keeping with this belief, Newton's equity and bond analysts and investment managers sit in one location and we believe that their collaboration, coupled with our global, thematic investment approach, is highly effective in affording us perspective on the investment landscape.

Paradoxically, the efficiency that passive proponents say exists in financial markets is surely attributable (to the extent that such efficiency is ever evident) to the actions of active investors. Without active investors, markets would lack any qualitative oversight and, in that respect, passive managers are dependent on the investment decisions of active managers (whose decisions will be based on that qualitative oversight). At the heart of the effective allocation of resources in a free market must be the participation of investors who are able to discriminate between 'good' and 'bad' prospects. A lack of such participation is symptomatic of a market in which capital is distributed ineffectively and in which prosperity is thereby reduced.

### **Taking advantage of mispricing opportunities**

Given our opposition to the efficient market hypothesis, it follows that we do not believe the hypothesis is an appropriate foundation for the development of solutions to meet clients' investment objectives. In fact, it is our belief that asset markets almost invariably present mispricing opportunities that underpins our confidence that an active investment approach is best suited to delivering attractive risk-adjusted returns to clients. Measures of economies and financial markets tend to take the form of averages, for example in relation to readings of gross domestic product, inflation, equity market indices and so on. In reality, all such measures are representative of many different component factors and at any point in time some will be performing better than others. An active investor may add value by looking at the detail of individual companies' fortunes and by taking perspective on long-term opportunities (above all at times when asset markets are driven by short-term factors that overlook those opportunities).

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<sup>1</sup> Chartered Financial Analyst Institute (UK), June 2009.

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Use of a passive investment strategy may entrench asset allocation to the detriment of the investor by encouraging a static approach.

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We believe that a skilled, active investment manager, particularly a multi-asset manager with a holistic understanding of opportunities across different asset classes, is well equipped to make risk and return judgments between the different classes of capital that are issued by individual companies. Such an investment manager should be well placed to construct a portfolio that will meet investors' objectives but, in order to be as effective as possible, an active manager must be active in relation to specific securities rather than simply between asset classes.

We believe that the use of a passive investment strategy may entrench asset allocation to the detriment of the investor by encouraging a static approach. Changes in asset allocation can occur, with some passive managers employing 'rebalancing' tools. For example, investors may switch between one passive fund and another should their asset allocation views change. However, these changes are more likely to be implemented most rapidly and effectively when they are carried out by an active fund manager whose day-to-day task is to evaluate the range of investment opportunities available across the investment landscape.

As well as considering the efficiency of particular markets, investors must also evaluate the 'liquidity' and accessibility of markets in appraising the investment opportunities that are available to them in practical terms. A passive approach may not be capable of replicating the illiquid or inaccessible parts of some indices.

## Concepts of risk

### **Benchmark risk**

It seems extraordinary to us that arguments about risk tend to focus almost exclusively on the security selection risk inherent in active management and very little upon the benchmark risk that is unavoidable in taking a passive approach. In our view to say risk is 'neutralized' for a passive investor is plainly wrong given the absolute volatility exhibited by financial markets. Even if the risk characteristics of passive strategies were to match those of underlying indices, investors would still be exposed to the significant risk that indices themselves would fall.

Neglecting the importance of benchmark risk can give rise to misplaced concepts about both the risk control intrinsic in passive strategies and the value of active management 'outperformance'. A passive investor who suffers a 40% decline in the value of their portfolio should take little comfort from the fact that they have avoided security selection risk, and an active investor who 'achieves' a return of -38% against that 40% decline in the market is unlikely to be mollified by the relative 'strength' of their investment return. Both scenarios equate to pyrrhic victories. Returns from financial markets in 2007 and 2008 should remind investors in stark terms that risk exists in relation both to active and passive investment approaches.

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Passive investors can be hostages to the fortunes of troubled companies, even if they foresee those companies' troubles.

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### Index concentration

Although there are 'equal-weight' or 'capitalization-weight' indices which seek to obviate the negative implications of mirroring an index without exception, most indices (and the passive funds that track them) are market-capitalization based. That is, the larger a stock's weighting in an index, the greater its impact on the movement of that index (and therefore the greater its contribution to the performance of a tracking fund). This may give rise to significant 'concentration risk' in a passive investor's portfolio.

With the performance of the larger sectors and larger stocks having a greater impact on overall performance (regardless of the merits of those sectors and stocks), the market-capitalization-based passive investor will be compelled to buy ever-greater holdings of securities that have already done well (and to hold ever-smaller amounts of those that have done less well). Decisions to buy and sell are brought about thus by changes in index composition, rather than on the basis of the merits of particular stocks. Using this approach, we believe that passive investors can be hostages to the fortunes of troubled companies, even if they foresee those companies' troubles. In relation to bond funds, the effect of a passive approach, paradoxically, is to shorten duration when interest rates are high and to lengthen duration when interest rates are low.

There are occasions when it is perfectly sensible to continue buying stocks that have performed well, not least if a company's prospects continue to improve in tandem with its share price. However, it may make sense to buy stocks following a period of underperformance (when their valuations have become more attractive); and there may, of course, be stocks and sectors that at particular times an investor would benefit from not holding at all (most obviously the financial sector over much of the last two years). A passive approach precludes the investor from making such qualitative judgments about the prospects of particular parts of a market.

Passive investment approaches are said by their advocates to offer investors 'diversified' exposure, but it is highly questionable whether an investor can achieve appropriate diversification simply by mirroring an index slavishly. In the U.K., the largest 10 stocks in the FTSE All Share Index<sup>2</sup> represent 43.4%<sup>3</sup> of the market value of the index as a whole and the top 50 stocks represent 76.9% of the total index value. Within the largest 10 stocks, there is a significant concentration of oil and gas and pharmaceutical stocks; the three biggest oil and gas stocks—BP, Royal Dutch Shell and AstraZeneca—account collectively for 18.7% of the Index, and the two largest pharmaceutical stocks—AstraZeneca and GlaxoSmithkline—account jointly for 7.2% of the Index.

Not all indices are so concentrated (the MSCI World Index,<sup>4</sup> for example, has a 'broader' spread of stocks), but passive equity investors would embrace some significant sectoral positions, irrespective of their conviction about the sectors concerned, by tracking the fortunes of most indices. To some extent, given the distortions inherent in all market-capitalization-based indices, the choice to take a passive approach and mirror an index is nonetheless therefore an investment 'decision.' An investor with a marked aversion to holding oil and gas stocks or pharmaceutical stocks (whether on fundamental grounds or for other reasons, such as ethical grounds), for example, would be ill advised to 'buy' the U.K. stock market.

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<sup>2</sup> See index disclosure on p.20.

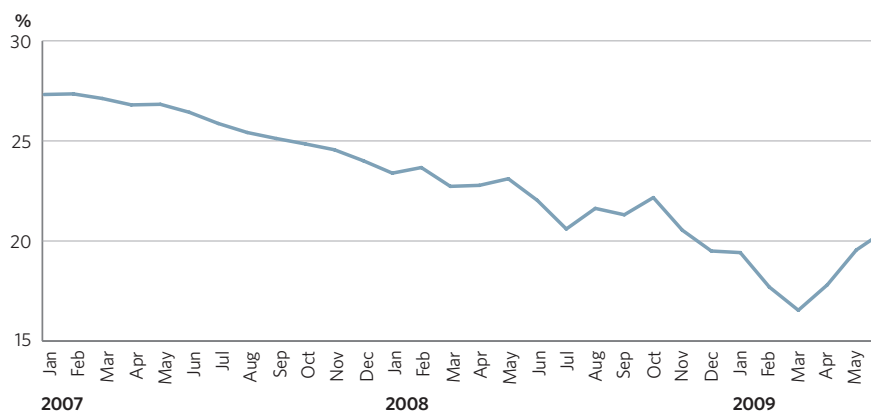
<sup>3</sup> All market share data is sourced from FactSet Research Systems, May 31, 2009.

<sup>4</sup> See index disclosure on p.20.

The concentration risk of taking a passive approach to investment may be significant, as witnessed in the financial sector during the global financial crisis.

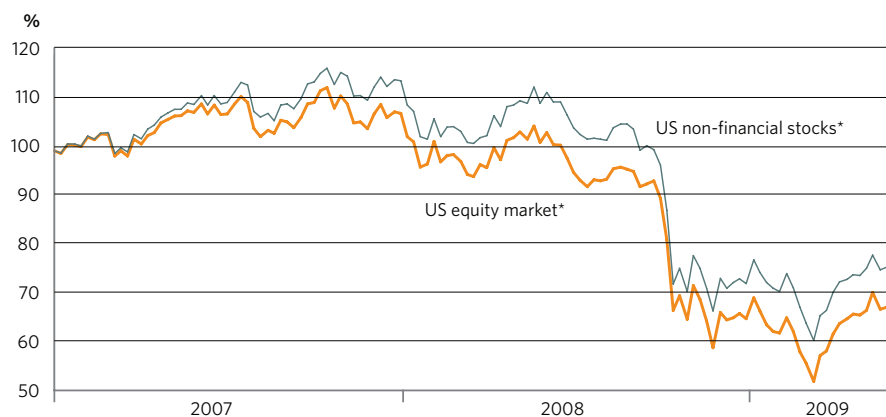
The concentration risk involved in taking a passive approach to investment may be significant, as witnessed in the financial sector during the recent global financial crisis. Financial stocks accounted for 27.3% of the FTSE World Index<sup>5</sup> (in dollar terms) at the beginning of 2007, but they comprised only 16.5% of that index by the end of February 2009. As illustrated by Exhibit 2 below, a passive approach would have 'dragged' the values of investors' portfolios down with the fate of the financial sector during the financial crisis (and such an approach would have made no distinction between strong and weak institutions, a distinction that we believe was critical to the fortunes of many investors throughout the crisis). In fact, ironically, only the worsening fortunes of a bank would have led a passive investor to hold less of its shares once the bank's market cap fell below the threshold required to stay in the index.

**EXHIBIT 1: FINANCIALS AS % OF MSCI WORLD INDEX (\$ TERMS)**



Sources: WM Performance Services & MSCI, June '09.

**EXHIBIT 2: FINANCIAL SECTOR DRAG ON PERFORMANCE**



\* Total return indices; Datastream series, rebased to 100 at 12/31/06. Source: Thomson Reuters Datastream as at 06/26/06.

<sup>5</sup> See index disclosure on p.20.

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At Newton, our active approach seeks to anticipate the forces of change and to identify the opportunities that derive from those forces.

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Similarly, during the inflation of the technology, media and telecommunications (TMT) bubble at the turn of the century there were comparable implications for the passive investor. The technology sector had grown to comprise 6.4% of the FTSE All Share Index at the end of March 2000 but, following the bursting of the TMT bubble over the next two years, it comprised only 0.7% of the Index at the beginning of October 2002 based on FTSE Index data. Even following a partial recovery in the technology sector in the years since then, the sector still now comprises only 1.4% of the Index.

Among spectacular performers when TMT companies' share prices soared during 1999 and at the beginning of 2000 was Vodafone, whose market capitalization rose to the equivalent of 12% of the U.K. stock market in March 2000, before falling to 4.4% at the beginning of July 2002 based on FTSE Index data. An index-tracking investor would have suffered therefore a 7.6% fall in the value of their portfolio merely from holding Vodafone between those two dates.

### **Risk management**

Investors may be prepared to forsake some of their potential return for a less volatile investment approach, but passive management may be inflexible in meeting risk-related requirements. Active investment management has the advantage of permitting, for example, an absolute-return approach to investment returns, whether that approach is explicitly stated via the adoption of a (perhaps cash-related) targeted return or implicitly sought in conjunction with the use of index or peer-group benchmarks. Such an approach, by means of its focus on absolute rather than relative returns, allows investors to pursue both risk and return characteristics that are appropriate to them.

Passive investment approaches reflect the 'here and now' (the prevailing make-up of the indices they mirror). At Newton, by contrast, our active approach seeks to anticipate the forces of change and to identify the opportunities that derive from those forces. Long-term changes in the world's economies, financial markets and companies may not yet be reflected in indices, but an active investment manager can seek to take advantage of them. By contrast, a passive approach would tend to favor stocks that have done well (and whose market capitalization has grown) and to overlook those that have done poorly (and whose market capitalization has fallen); in effect, we believe such an approach is akin to using a rear-view mirror rather than looking at the road ahead. Among those stocks whose market capitalization has fallen there may well be some very attractively valued opportunities.

Volatility in financial markets is not simply a threat; it can also be used to good effect in generating attractive investment returns. However, it must be managed in order to be beneficial to investors. Active approaches are adept at allowing such risk management, but passive approaches are much less so.

### Counterparty risk

During the financial crisis, investors suffered not simply from declines in asset prices, but graphically too in places from the frailty of their counterparties. In the aftermath of the credit crisis, there have been some suggestions that investors will favor passive management over active management given the counterparty risks that may arise in relation to active investment approaches. However, some forms of passive investing may in fact introduce counterparty risks

If swaps (instruments by which an investment manager may swap with a counterparty a portfolio return for the return from an index) are used to create a synthetic passive fund, counterparty risk occurs. Counterparty risk will also arise if an investment manager lends out stock (as many passive managers do).

The orderly unwinding of swap positions following Lehman Brothers' demise and the crisis entailed in AIG's ratings downgrade provide some reassurance in contemplating the scale of counterparty risk associated with the use of swaps. However, such risk may be a serious concern for ETF investors, and it is noteworthy that recent investment bank-backed entrants to the ETF market have launched only synthetic funds.

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If all active managers are trying to beat an index-based return, it clearly becomes harder for each of them to exceed that return; the best will do so, but it is unrealistic to expect them all to do so.

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### The nature of investment returns

#### Active investment management—a 'zero-sum game'?

Countless studies have been published which aim to 'prove' that active investment management produces higher returns than passive management and vice versa. In reality, the debate about which approach has been more successful is often argued along flawed lines given the symbiotic relationship between the two approaches. If it is accepted that a passive return equates to the return of an index (although, in practice, that is not always the case—see below), and if it is accepted that the aggregate return of active funds is necessarily linked to the return of an index (as both cause and effect of that index return), it must follow that inevitably there will be a strong relationship between passive and aggregated active returns.

If all active managers are trying to beat an index-based return, it clearly becomes harder for each of them to exceed that return; the best will do so, but it is unrealistic to expect them all to do so. In relation to 'peer group' benchmarks (where a median of a group of investors is taken as the benchmark return), it is a mathematical truism that one investor will generate the median return, half of the remaining investors will outperform the benchmark, and half will underperform. A majority of funds simply cannot exceed the median of themselves.

This argument might also be framed as a recognition of the 'zero-sum' nature of active investment management (in relative terms at least). While it may be possible for all active managers to generate an 'attractive' absolute return over a given period, it is not possible for them all to deliver an attractive return in relation to each other. Over time, therefore, there are significant structural difficulties in seeking to argue without qualification that active management as a whole has generated, or will generate, stronger returns than passive management.

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Passively managed funds generally offer no protection against declines in the indices they track and, for this reason, they may well underperform active funds during downturns.

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### Market background

Aside from the structural difficulties that we noted above in relation to evaluating the returns from active management, it should be recognized of course that in the recent past (2008 especially) many active investment managers failed to protect their clients adequately from the effects of the financial crisis (albeit that equity index-based passive funds, similarly, offered scant protection to investors).

The exceptional macroeconomic and financial-market events of 2008, as well as the drying up of liquidity in the global financial system, were detrimental to a significant majority of active investment managers over the course of the year. The extent and pace of 'deleveraging' (debt repayment) that occurred during 2008 led distressed sellers to dispose of assets that were saleable, meaning often that high-quality securities were not differentiated from low-quality ones; furthermore, supposedly heterogeneous asset classes became highly correlated with each other. Against this backdrop, returns from actively managed portfolios varied greatly. The difference between the top quartile and bottom quartile performance of global bond funds, for example, widened to 6% in 2008 from its historical average of about 0.5%.<sup>6</sup> More generally, we recognize that certain environments should tend to suit active and passive approaches respectively better. Passively managed funds generally offer no protection against declines in the indices they track and, for this reason, they may well underperform active funds during downturns. By contrast, active managers are able to use cash and other 'defensive' assets to shield investors from equity market declines. Regardless of market conditions, we contend that a multi-asset approach (by contrast with a multi-specialist approach) can be very useful in permitting an investment manager the leeway to switch between asset classes to the benefit of investors.

In broad terms, passive funds gained popularity in an era of very strong equity returns and it could be argued that those funds required such an era to establish their credentials. Metaphorically, it is intuitive that a rising tide may float a large number of (investment) boats, with passive funds destined to do reasonably well in absolute terms when the indices that they emulate do well.

Returns from passive funds are typically better at times when very large sector constituents dominate the performance of indices. Such funds performed well, for example, during the TMT boom, when many active managers tended to be underweight in technology given the rapid growth of the sector as a proportion of stock-market indices (and quite possibly owing to concerns about the extremity of TMT stock valuations).

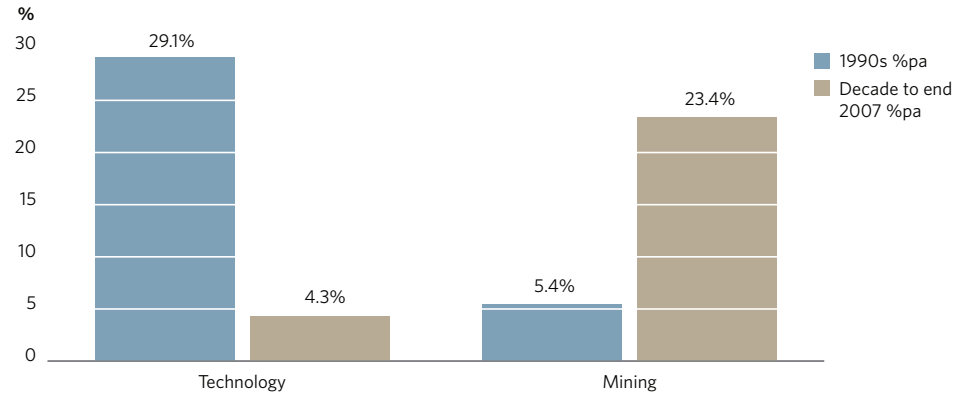
However, 'fashionable' sectors can fall out of favor quickly and passive investors are particularly vulnerable to changes in fashion. The chart below shows, for example, the respective returns of the global technology and mining sectors to which passive investors would have been exposed during the 1990s and in the period thereafter. A passive approach, or an active one that failed to recognize the change from the 'deflationary' boom of the 1990s (which favored technology stocks for example) to an 'inflationary' boom in the decade to the end of 2007 (which favored mining stocks for example), would have been detrimental to investment returns during those periods.

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<sup>6</sup> Mellon Transition Management, June 2009.

The challenge for active investment managers is not simply to generate outperformance over discrete periods but to do so consistently and sustainably.

**EXHIBIT 3: TECHNOLOGY SECTOR VERSUS MINING SECTOR PERFORMANCE COMPARISON**



Source: Thomson Reuters Datastream as at 03/31/08.

We believe that the environment we now face is more challenging than that in which passive funds have tended traditionally to do well. The identification of ‘winning’ sectoral and stock characteristics is likely to be essential in generating attractive investment returns against a challenging economic and financial-market backdrop. We assert that excellent opportunities exist for research-driven active managers to add value on behalf of their clients in the all change world and we cover this point in more detail below.

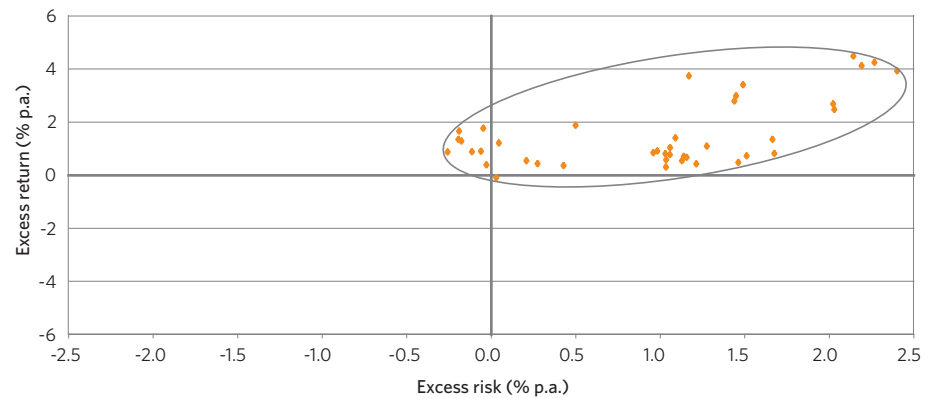
**Effective active management has produced strong returns**

The challenge for active investment managers is not simply to generate outperformance over discrete periods but to do so consistently and sustainably. The value of even modest outperformance can have a significant cumulative impact on invested capital. Using basic “time value of money” calculations a net-of-fees return of 7% over 25 years would turn an original investment of \$1 million into \$5.43 million, but an 8% return over 25 years would turn that investment into \$6.85 million (equivalent to an additional 142% return over the period).

We reiterate that it is not our intention in this paper to argue in favor of all forms of active investment management; indeed, some ‘active’ investment managers may not invest with sufficient conviction (‘away from’ a benchmark) to generate an attractive return. It is salient nonetheless to recognize that a number of good firms have delivered strong, consistent and sustained performance, and the fact that some investment managers have not done so should not obscure the fact that a number of investment firms have.

Exhibit 4 shows the median ‘excess’ returns and standard deviations of active global equities managers in the Mercer universe over rolling three-year periods in the 10 years ended March 31, 2009, against a global equity index. We have adjusted the chart to remove the impact of survivorship bias in the samples.

**EXHIBIT 4: MERCER GLOBAL EQUITY UNIVERSE—MEDIAN FUND RELATIVE TO FTSE WORLD -ROLLING 3 YEAR RISK VS. RETURN (P.A.)—Q1 1999 TO Q1 2009\***



Sources: Mercer MPA (underlying data), Newton.

\*See index disclosure on p.20.

Active investment management is capable not simply of generating outperformance ('alpha') versus a stipulated benchmark, but it allows the risks inherent in the adoption of a benchmark (the 'beta' of a portfolio's performance) to be managed as well.

## Trustees' duties

### General considerations

The burdens upon trustees have increased significantly over the last two decades. Ever-greater layers of legislation and regulation, for example, have required defined-benefit (DB) pension fund trustees in particular to institute a formal separation between themselves and their sponsoring companies and to appoint consultants to advise on their investment arrangements. Pension fund costs and the demands upon trustees' time have also been exacerbated by the necessity for trustees to be familiar with increasingly complex financial markets and investment vehicles. Meanwhile, DB trustees have had to address funding positions that have worsened in the context of both the increasing longevity of their plan members and disappointing investment returns this decade.

### In seeking to discharge their duties, DB trustees face a number of key risks, including:

- that life expectancy continues to rise and that trustees face the headwind of ever more challenging actuarial demands
- that markets generate insufficient returns to allow trustees to meet their objectives
- that the strategies and asset allocations they choose in seeking to meet their objectives prove to be ineffective

Trustees may be vulnerable to the first of these risks (although they may be able to take steps to hedge 'mortality risk'), but we contend that they are able to lower the impact of the second two areas of risk. Active investment management is capable not simply of generating outperformance ('alpha') versus a stipulated benchmark, but it allows the risks inherent in the adoption of a benchmark (the 'beta' of a portfolio's performance) to be managed as well. In particular, by harnessing a flexible, absolute-return approach to asset allocation (rather than a 'multi-specialist', benchmark-relative approach), investors should be best-placed to take advantage of the scope for effective investment management expertise to generate strong returns and to mitigate the risks inherent in asset markets.

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In seeking to ensure such fairness and transparency, we think active investors may benefit in particular from a performance-related arrangement.

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Good client service and solid investment performance should allow trustees to overcome some of the pressures that might otherwise arise in their oversight of active investment management; a transparent and intelligible investment approach should be beneficial in helping trustees to contend with periods in which investment performance is disappointing. The services of a consultant may also help clients to achieve their objectives (particularly if such services work in tandem with the relationship between investment managers and their clients, which we believe is critical to the effective fulfillment of clients' investment objectives).

### **Responsible investment and corporate governance**

Issues of socially or environmentally responsible investment and corporate governance may affect different investors' decisions in different ways; not all investors will be subject to formal requirements to consider such issues. However, we believe that proper scrutiny of companies' responsible investment and corporate governance characteristics should be intrinsic to all investment considerations. 'Irresponsible' or badly governed companies are less likely to make attractive investment prospects than companies that act responsibly and are well governed.

Importantly, active investors can engage with companies by voting, by calling meetings *and* by selling a security (which is the ultimate sanction they possess in expressing a view forcefully about an SRI or corporate governance matter), but passive managers are unable to sell a security, however vehement their opposition to a company's conduct. Furthermore, active managers can decide not to buy a security in the first place if they have concerns about a particular issue. Active managers' 'veto' over purchases and sales of securities strengthens their influence over companies' activities. Passive investors, by comparison, are locked into the universe of stocks in an index and thus do not interact with individual companies.

### **Costs**

Aside from the level of costs incurred by investors, we think it is essential that there is a fairness and transparency in the incurrence of those costs. In seeking to ensure such fairness and transparency, we think active investors may benefit in particular from a performance-related arrangement. The use of such an arrangement should align investors' interests with those of their investment manager, but should serve also to align the fee investors pay for investment management services with the ultimate effectiveness of those services. Performance-related fees typically take the form of an arrangement under which an investor pays a 'base' fee (which might be similar to the fee they would pay on a passive fund) and a performance-related fee linked to the outperformance of the fund in relation to a chosen benchmark or target.

Costs for investment management products and services (both active and passive) vary widely. In assessing the costs of different approaches, investors should be mindful to take account of all expenses they will incur. Passive investors who invest via an ETF may be subject, for example, to additional costs such as those inherent in the spread between a security's buying price and its selling price (the 'bid/offer' spread). There is also a bid/offer spread intrinsic in the pricing of ETFs themselves.

## The implications of an *all change* world

The *all change* world is likely to have significant implications for the asset management industry and for investors generally. We identified a number of these implications in our recent paper on the topic, and we reprise some of them below in the context of our conviction that they are broadly favorable to the case for active management.

### Disillusionment with investments

Events in financial markets during the global financial crisis have caused many investors to feel disillusioned with a number of asset classes and with equities in particular. The psychological appeal to investors of a 'passive' approach towards equity investment is understandable on the basis that active forms of management may be perceived by some to add another layer of uncertainty to investors' decision-making in an uncertain world. However, we contend that prevailing conditions are very positive for the long-term accumulation of equities and that active investment management is key to identifying opportunities in stock markets.

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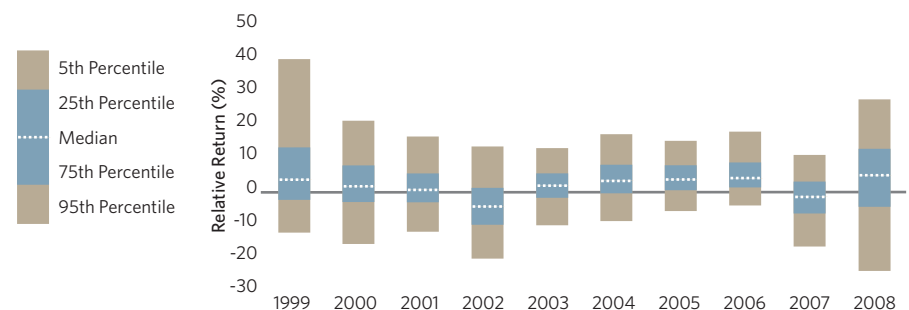
In more uncertain environments, greater volatility and the wider dispersion of valuations and returns increase the potential for good active investment managers to add value.

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We think that the *all change* world, in which heightened volatility and great uncertainty prevail, will afford significant opportunities to effective active managers to add value for their clients. The characteristics of the *all change* world are substantially different from those of the '*becalmed*' era of 2004-2006 in which investors embraced risk in the context of their perception that the economic 'cycle' was dead and in which asset markets exhibited remarkably low volatility. Exhibit 5 shows that the range of fund returns generated against the FTSE Index All Share (U.K. Equities) in 2008 was much greater than in previous years. In more uncertain environments, greater volatility and the wider dispersion of valuations and returns increase the potential for good active investment managers to add value.

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**EXHIBIT 5: CROSS SECTIONAL DISTRIBUTION OF STOCK RETURNS  
IN FTSE ALL-SHARE INDEX 1999-2008\***



Source: WM Performance Services & FTSE, June '09

\*See index disclosure on p.20.

Low volatility and gradually increasing asset prices worked in favor of passive investment strategies over periods during the last two decades when asset markets were strong (not least in relation to equity-based funds during the TMT boom at the turn of the century), but a 'trendless' and volatile world diminishes the effectiveness of

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When markets are driven by sentiment (rather than by fundamentals), and by greater inefficiency and irrationality, it is intuitive that opportunities become more abundant as valuations become detached from the fundamental, long-term attributes of investment candidates.

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a passive approach. Lower returns and higher volatility help to reduce the value added by the 'market' and demand greater differentiation and added value from investment managers in the form of active management. When markets are driven by sentiment (rather than by fundamentals), and by greater inefficiency and irrationality, we believe that it is intuitive that opportunities become more abundant as valuations become detached from the fundamental, long-term attributes of investment candidates.

Interestingly, one study has noted recently that, when viewed on a sectoral basis, valuation spreads in almost every industrial sector of the U.S. equity market are nearly as wide as they have ever been historically;<sup>7</sup> this clearly creates significant opportunities for the active investment manager to exploit more attractively priced equities. The challenge for investors and their advisers will, of course, continue to be to identify those managers who are positioned best to add that value.

In corporate bond markets, similarly, the wider dispersion of valuations than existed previously and the likelihood that default levels will rise from current levels create opportunities for active managers to harness higher quality companies and to avoid those that are likely to default; a passive investor may lack the benefit of such discrimination.

#### **Return solutions rather than products**

In the new, *all change* world, investors are likely to seek credible return solutions that are developed to meet their specific requirements. Additionally, we believe that they will be less eager than previously to embrace off-the-peg 'products'. Much of the disillusionment among investors and their advisers over the last two years was caused by the failure of a number of complex products either to meet their return objectives or to control risk. It follows that investors are likely to scrutinize investment management approaches more carefully in the years ahead and to be diffident towards products that they do not understand sufficiently. In particular, they will want to ensure that the approaches they adopt bring about appropriate solutions to their own investment objectives rather than the fulfillment of some other purpose (such as growth in an investment manager's assets).

Investors (and their advisers) are likely also to pay greater attention to the risk attributes of investment strategies than they did previously. In the 'becalmed' environment that preceded the crisis in global credit markets, risk was inadequately 'priced' and inadequately managed, largely owing to the extrapolation of crudely modelled returns and a misplaced sense of complacency about the perceived (absence of) risks in financial markets. In the years ahead, by comparison, investors are likely to be much more scrupulous about the management of their investment risks.

The events of the last two years have thrown into relief the inadequacies of narrowly defined investment solutions and rigid, benchmark-related portfolio structures. In response to the obvious deficiencies of a narrow, product-driven approach, we believe that diversification and flexibility will be privileged attributes in the years ahead. In pursuit of these attributes, we expect to see an increased emphasis upon active, service-orientated approaches and we are anticipating a shift towards real-return types of strategy in particular as investors seek to overcome the shortcomings of approaches that focus only on benchmark-orientated returns.

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<sup>7</sup> The Boston Company, 'Inflection point: the case for equities and active management', May 2009.

### **'Back to basics' and a shift towards simplicity and transparency**

Many investors have been frustrated over the last two years by the shortfall of investment returns against the promises made by some investment managers (and versus what, perhaps unrealistically, investors expected). In the less challenging conditions that prevailed in the period preceding the global financial crisis, product 'innovation' and 'proliferation' had become manifest. In some cases, investors embraced 'black-box' approaches in spite of their lack of understanding of them, and perhaps perversely in some cases because a lack of understanding was thought to be tantamount to the appeal or 'superiority' of the product; how else could a 'Ponzi' scheme that appeared to be capable of a trade-off between risk and return absent elsewhere on the investment landscape have had such large funds committed to it?

In the post-financial-crisis, *all change* world, our view is that the focus of investors and their advisers is likely to revert to the 'basics'. Simplicity is likely to be a more highly prized feature of investment approaches given that the complexity and opacity of some investment 'solutions' were in part the causes of their failure over the last two years.

A back-to-basics approach is not synonymous with a passive approach to investing. Instead, we believe that the basics of investment management are simple and transparent strategies that are understood by those who invest in them and that are adept at meeting clients' objectives in a consistent, risk-controlled fashion.

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## The characteristics of effective active management

It is not our contention that all forms of active management are at all times beneficial to investors, but we do think that proven active investment management is usually advantageous to investors in comparison with passive management. Demands for investment management services vary over time according to a range of different and evolving factors (for example, cultural changes in attitudes towards saving, population demographics, socioeconomic changes, and shifts in responsibility for the funding of long-term saving, for example between employers and employees). However, we believe that effective active management requires in all circumstances a number of key elements:

### **A simple, transparent and robust investment approach**

As we noted above, many investors have been let down in recent years by investments in products that they did not properly understand. In the future, they are likely to favor simple solutions, with opaque investment arrangements likely to fall out of favor to the benefit of simpler and more transparent and intelligible approaches.

At Newton, we believe it is incumbent on us to help clients to understand the way in which their investments are managed and to reduce the complexity of their investment arrangements without imposing an unnecessary burden upon them. Passive investment approaches may appear superficially to be simple, but they are not universally transparent. Synthetic tracking funds, for example, can be opaque both in relation to the way in which they are managed and in relation to the counterparty risks they entail.

The robustness of our investment approach is grounded in our global, thematic philosophy and process (which afford us the perspective necessary to identify investment opportunities) and in proprietary research which is carried out by our career industry analysts on a global basis.

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The themes which we harness at Newton are generally long-term in nature and are not intended to ‘forecast’ or take advantage of every short-term fluctuation in asset markets.

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### Rigorous investment selection

While we believe strongly that effective active managers can add value through favorable asset allocation, we believe that good stock selection is also critical in meeting clients’ objectives. At Newton, we do not simply buy ‘equities’ or ‘bonds,’ but rather we make judgements about specific investment opportunities (based on their thematic attractiveness, fundamentals and valuation). The ideal company has strength in each of those three areas.

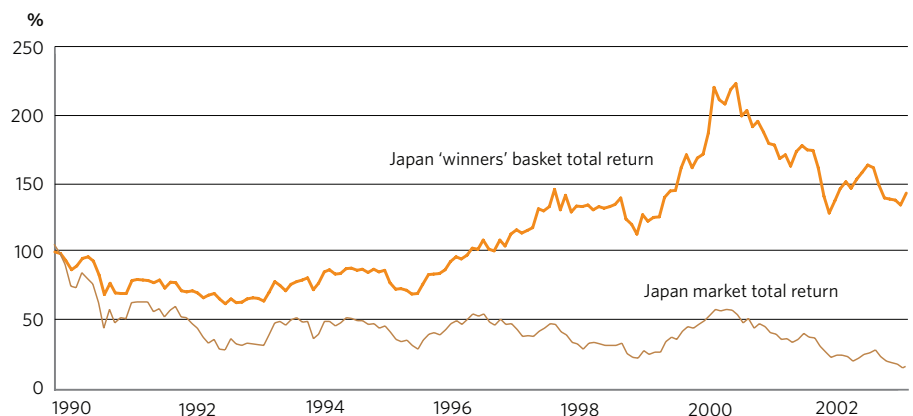
Strong security selection may generate attractive investment returns, even amid the overall weakness of an asset class. The decline of the Japanese equity market between 1989 (when it represented 40% of the MSCI World Index<sup>8</sup>) and 2009 (when it represented just 11%), for example, was clearly a headwind to equity investors’ fortunes in that market, but it would be erroneous to conclude that investors in Japanese shares have been bereft of opportunities over the last two decades. Exhibit 6 shows the aggregate total return of the 40 best-performing stocks in the Nikkei 225 Index against the performance of the Japanese stock market as a whole between the beginning of 1990 and the end of 2002 (which captures the main phase of Japanese equity market weakness).<sup>9</sup>

### Strong performance and appropriate management of risk

Investment managers should deliver strong and consistent investment performance. Notwithstanding that imperative, investors should be realistic that no investment approach can be expected to generate outperformance every quarter (not least if an investment approach is focused upon the long-term generation of wealth). The themes which we harness at Newton are generally long-term in nature and are not intended to ‘forecast’ or take advantage of every short-term fluctuation in asset markets. The heightened volatility that is likely to characterize financial markets in the *all change* world may well extend the period over which investors need to hold assets to achieve their objectives. As a consequence, investors should resist the inclination to become excessively preoccupied with short-term performance.

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**EXHIBIT 6. JAPAN AS EVIDENCE OF THE BENEFITS OF STOCK SELECTION**



Sources: Thomson Reuters Datastream, Newton as at 12/31/02.

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<sup>8</sup> Source: FactSet as at May 31, 2009.

<sup>9</sup> Topix index total return shown because Nikkei 225 Index total return data is not produced.

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By harnessing a simple, transparent and robust investment approach and an effective service from an active manager with a strong and consistent performance record, investors should be ideally placed to pursue their investment objectives in a highly challenging world.

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In terms of managing risk, investors should ensure that their investment manager has in place a robust risk measurement approach and an effective risk management process. In this respect, the finding of a recent survey<sup>10</sup> that many asset managers are failing to put risk at the heart of their product development is cautionary. The adoption of a passive approach that aligns investors' risks with those of a (potentially volatile) index is no substitute for the proper active management of risk in the context of investors' specific requirements.

## Conclusion

It is certainly appropriate for investors to review their investment arrangements in light of the damage inflicted on them by the weakness of financial markets over the last two years. However, we are resolute in our conviction that recourse to a passive investment approach (other than in relation to precise liability matching requirements and, perhaps, as a provisional home for assets moving between one active manager and another) is generally inappropriate.

We observe that there are nearly always mispricing opportunities in financial markets (however large and 'developed' those markets are) and we contend that a good active manager can add significant value in meeting clients' investment objectives. This is particularly true during periods of uncertainty when asset valuations are widely dispersed (as currently they are).

Investors encounter risk in relation to all investments and, as highlighted by the considerable volatility exhibited by financial markets over the last two years, it is erroneous to think that passive management eliminates such risk. We believe that while passive management makes investors hostages to the risks inherent in indices, active management allows investors to seek to control risk according to their own specific requirements.

Not all forms of active management will at all times be beneficial to investors, but by harnessing a simple, transparent and robust investment approach and an effective service from an active manager with a strong and consistent performance record, investors should be ideally placed to pursue their investment objectives in a highly challenging world.

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### Index Disclosure

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 Thomson/Reuters/Datastream Total Return series reflects aggregate performance of U.S. equity issues, U.S. non-financial stocks, U.S. technology stocks and U.S. mining stocks. The Topix 100 Index and Nikkei 225 Index track major issues on the Tokyo Stock Exchange and are widely used proxies for the performance of Japanese equities. The FTSE All-Share Index tracks major issues on the London Stock Exchange and is a widely used proxy for performance of U.K. equities. The indexes are trademarks of the foregoing licensors and are used herein solely for comparative purposes. The foregoing index licensors do not sponsor, endorse, sell or promote the investment strategies or products mentioned in this paper, and they make no representation regarding the advisability of investing in the products or strategies described herein.

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<sup>10</sup> Ernst & Young, June 2009.

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