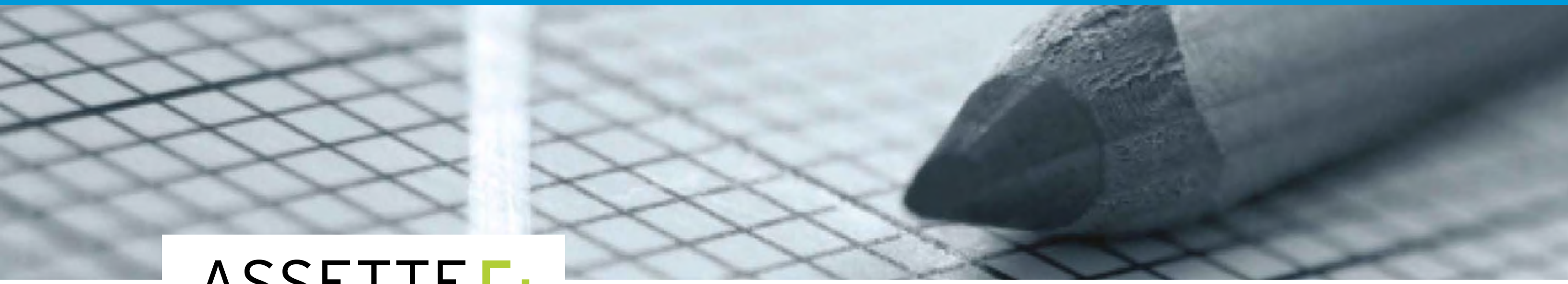

ASSETTE

How Investment Managers Use Active Share to Win New Business, Retain Clients and Justify Fees

Including graphics that illustrate eight different ways active share can help managers make the case for their investment approach

2/4/14

Active share has become an important tool for investment managers who want to provide statistical evidence of their active contribution to returns over the benchmark. This paper will give a brief review of the concept behind active share, discuss the internal and external benefits it offers active managers, and provide real-life illustrations of how managers can easily integrate active share into their client and sales communications processes.

What is active share?

Active share is the sum of the absolute value of the differences in the weight of each holding in a portfolio versus the weight of each holding in the benchmark index, divided by two. To put it in more simple terms, think of it as 100% minus the sum of overlapping weights of securities between the portfolio and index. The overlap is the minimum of the security's weight in the portfolio and the index. Here is the formula:

Active Share = 100% -∑|Overlapping Weights [portfolio, i and index, i]|[1]

The higher the active share, the greater the difference, which means that the manager is taking more active bets against the benchmark. A high active share is considered good. Conversely, the lower the score, the more overlap with the index and the more index-like the portfolio is.

Originally, an 80% and above active share was the rule of thumb for identifying a high-active-share manager. Today, the metric is more nuanced and varies by a manager's investment style. A recent Wall Street Journal article reports that Dr. Martijn Cremers, the co-founder of the concept, now says that an active share of at least 60% is good. Large-cap managers should be in the 70%-plus range; midcap managers in the 85%-plus range; and small-cap managers should have an active share in excess of 90%.[2]

What makes active share unique is that it is calculated based on the actual holdings in the manager's portfolio compared to the actual holdings in the benchmark index. In the past, the gold standard for measuring active management has been tracking error. But tracking error is based on a pattern of returns—a pattern that infers, but does not demonstrate, the level of active management. Active share, on the other hand, is based on observed holdings compared to benchmark holdings at the same point in time. It quantifies the active contribution in a way that gives investors a clear picture of where and how a manager is deriving alpha.

While active share does not replace tracking error, it does provide a different window into a manager's active skill. Most experts advocate using both when assessing fund performance and/or contributions to active returns.

How it is used

When active share was introduced by Martijn Cremers and Antti Petajisto in 2009, it was hailed as a predictive tool for identifying managers who would be likely to outperform their benchmark.[3] Since then, active share has been the subject of further research by Cremers, Petajisto and others. While some question the efficacy of active share as the be-all-and-end-all predictor of manager outperformance, there is one thing everyone seems to agree on: Active share is an excellent way to identify whether a manager is a closet indexer. As such, it has become a valuable piece of evidence for managers who want to demonstrate that they are taking active bets in their portfolio and to quantify the contribution their active approach is making to client's funds.

Industrywide acceptance

Acceptance of active share is growing. An increasing number of consultants are using active share in their analysis of individual managers and total client portfolios. And some forward-thinking managers are using their own active share numbers to illustrate their active contributions to existing and prospective clients. Says Terry Dennison, US director of consulting for Mercer Investment Consulting, “Managers are now coming forward with their active-share statistics. They’re not waiting for us to come to them.”[4]

Benefits to active managers

Active share can play a powerful role in an active manager’s toolkit in three important ways:

1. Supporting client retention

Institutional investment clients today are under constant pressure to justify their decision to hire active managers — and pay active management fees. Not only is it part of their fiduciary responsibility, but they are also faced with a barrage of new business solicitations from other active and passive managers.

Active share gives an active manager a metric that can provide ongoing evidence that their process is adding active value — evidence that validates the client’s decision to engage the manager in the first place and reinforces their decision to retain them. Providing those figures on a monthly and/or quarterly basis paints a clear picture that, over time, the manager’s process is based on active skill, not luck.

> Active share can provide ongoing evidence that a manager’s process is adding active value — evidence that validates the client’s decision to hire them and reinforces their decision to retain them.

Active share can also strengthen the client-manager relationship. Introducing a new attribution metric provides a ready-made opportunity for managers to engage with their clients on a variety of levels. First, it is a clear demonstration that a manager understands their client’s fiduciary duties and strives to give them tools that help them fulfill those duties. It is also an excellent way to review their investment process from a different angle and provide a bit of education in the process. Just using active share is, in itself, an indication that an investment manager is dedicated to industry best practices and open to innovative research ideas.

2. Enhancing competitive standing

Enhanced competitive standing is the name of the game in institutional investment management marketing. In a world of style boxes and performance rankings, managers who can demonstrate high active share have a leg up on those who can’t. A manager who incorporates active share in their marketing material and performance reporting raises the bar for their clients’ other managers and enhances their own competitive standing in the eyes of the client and their consultant.

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In new business presentations, a high active share percentage separates an active manager from a closet indexer. It extends a manager’s claim of active skill beyond reliance on past performance by focusing on real-time holdings comparisons against the benchmark. For managers who can provide a snapshot of their active share over different market cycles and economic environments, it lends credence to claims of persistence.

Active share has been a game-changer for consultants, too. Portland, Ore.-based Sellwood Consulting LLC explains how active share has changed the way they evaluate managers:

> "Every investment manager's portfolio is, and has always been, a combination of two portfolios — the index, and their active portfolio — in different proportions that depend on how 'active' the manager is. Active share brings transparency to the evaluation of active manager portfolios, allowing us to quantify the proportions of each inside an otherwise opaque investment manager portfolio. With active share, no longer do we need to resort to shorthand 'active' or 'passive' labels; instead we can appropriately situate managers on a spectrum between passive and active."[5]

Including active share in manager performance attribution reports sends a powerful signal to fund consultants. Managers who do so provide evidence that validates their active management story and distinguishes them from the rest of the pack. In the highly competitive institutional investment marketplace, even the smallest differentiator can make the difference between winning a coveted appointment or going home empty-handed.

3. Providing internal governance

Some institutional managers have found that active share has utility beyond performance attribution. Wellington Management, for example, uses active share to improve their portfolio monitoring and management process. The concept is employed as an internal metric during equity group peer reviews, as a tool to monitor portfolio risk, and as an effective means of evaluating multimanager portfolios to avoid an aggregate closet index fund. They find active share a "very useful tool" for predicting alpha in some investment categories and favor it in internal reviews because "it is consistent over time as measure of relative risk."[6]

Academic researchers Adams, Mansi and Nishikawa considered active share when evaluating the link between board structure, fund sponsor ownership and operational performance. In their 2010 paper "Internal Governance Mechanisms and Operational Performance: Evidence from Index Mutual Funds," they noted, "The performance measures we employ represent the sum of several operational policy decisions. For robustness and to further examine the relation between boards and individual fund operational policies we consider front load fees, 12B-1 fees, cash holdings, tracking error and active share measure."[7]

The bottom line is that active share is becoming a "must have" statistic for active managers who want to stay on the leading edge of performance attribution.

Integrating active share in marketing and client communications

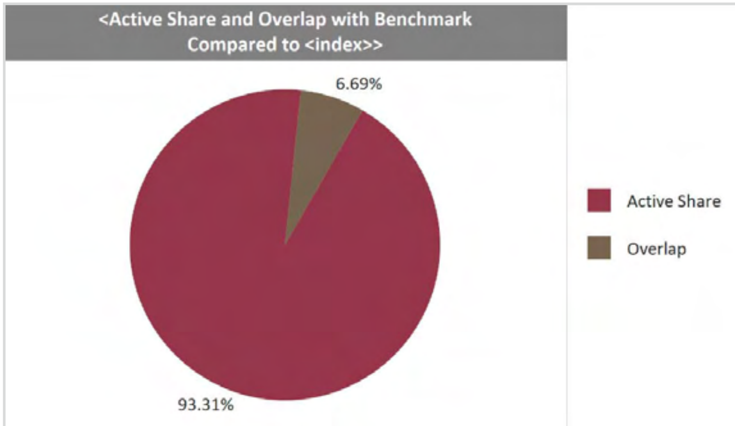
Investment managers are finding active share to be a versatile addition to their performance toolkit. In addition to illustrating simple point-in-time comparisons to an appropriate benchmark, active share can help managers demonstrate the persistence of their portfolios' approach over a variety of time series and market conditions. A manager's active share can be deconstructed to help clients and consultants understand what types of active judgments the manager is making versus the benchmark. And, when run against multiple indices, active share can shed a spotlight on sector and style biases over time — confirming the consistency of a manager's stated approach, highlighting drift or even indicating the need for a more appropriate portfolio benchmark.

The bottom line is that active share is becoming a "must have" statistic for active managers who want to stay on the leading edge of performance attribution. It provides a new perspective on how and where managers differ from their benchmark, and can offer powerful confirmation of a manager's active contribution to returns.

Examples of active share graphics

We offer eight illustrations of how investment managers can use active share to tell their investment story.

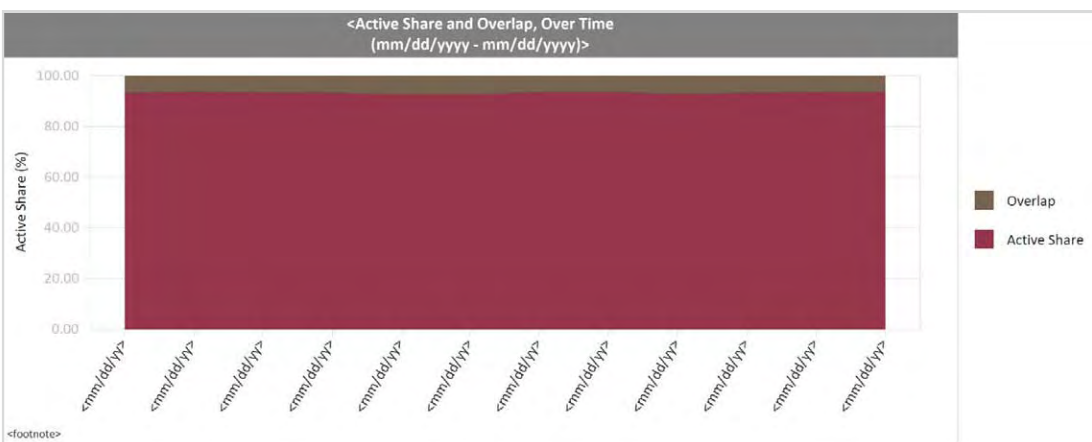
1. ACTIVE SHARE AND OVERLAP WITH BENCHMARK: POINT IN TIME



This chart illustrates the active share of the portfolio (93.31%), as well as the portion that overlaps the benchmark index (6.69%). In this example, the portfolio has a high active share as of the holdings date, which indicates active judgments are being made.

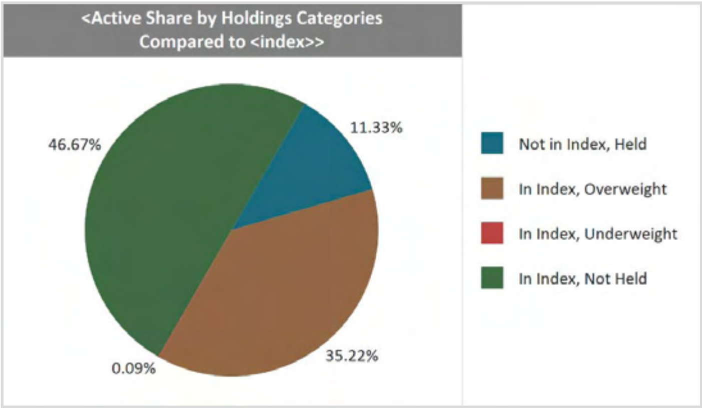
Active share is always measured against the benchmark index for the portfolio. It is, therefore, important that you select a benchmark that is appropriate for the portfolio strategy under consideration.

2. ACTIVE SHARE AND OVERLAP WITH BENCHMARK: TIME SERIES



Consistency in active management, as indicated by a high active share, is a reminder to clients that you're doing what they pay you to do—taking positions above and beyond the benchmark. By showing active share percentages over time, you can illustrate the persistence of your active approach.

3. ACTIVE SHARE BY HOLDINGS TYPE VS. BENCHMARK: POINT IN TIME

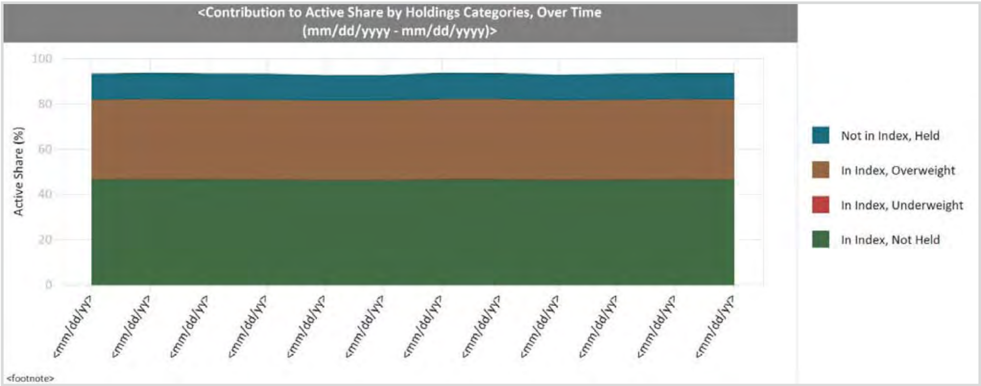


This chart shows your clients what type of active investment decisions are contributing to active share. There are four ways to be different from the index:

1. Hold securities that are not in the index.
2. Hold securities in the index, but overweight the position.
3. Hold securities in the index, but underweight the position.
4. Don't hold securities that are in the index.

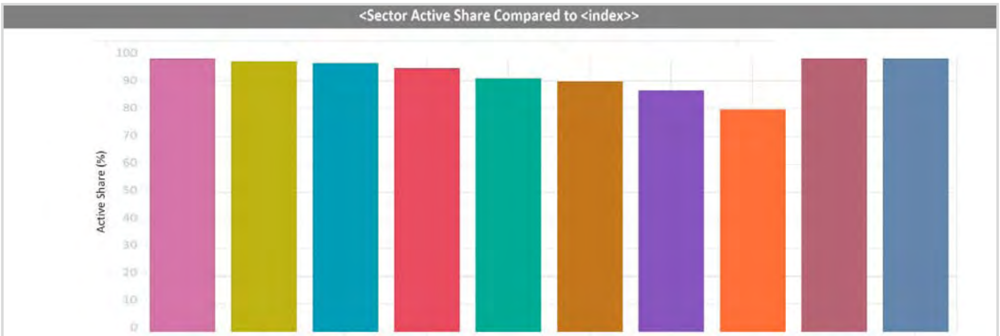
By deconstructing the active share by holdings category, you can illustrate how your investment approach manifests in portfolio holdings vs. the benchmark. In the above example, we see a portfolio where the largest active share is coming from avoiding certain securities held in the index and virtually no active share is derived from underweighted positions in index securities.

4. ACTIVE SHARE BY HOLDINGS TYPE VS. BENCHMARK: TIME SERIES



This chart allows you to show how you achieve active share over a period of time, based on the four holdings categories described above. The more consistent the pattern of active share by holdings types is over time, the more likely it is that your investment philosophy is being applied consistently.

5. ACTIVE SHARE BY SECTOR VS. BENCHMARK



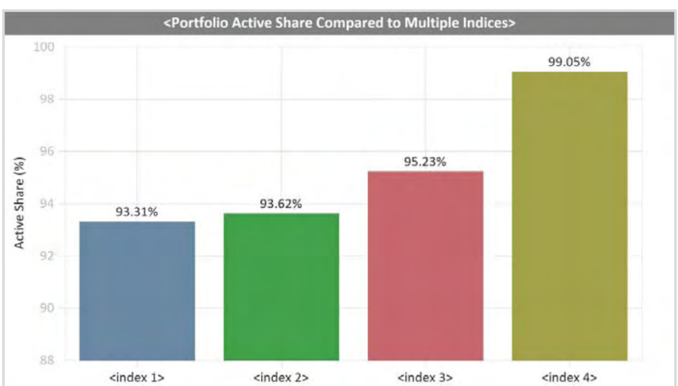
	Sector 1	Sector 2	Sector 3	Sector 4	Sector 5	Sector 6	Sector 7	Sector 8	Sector 9	Sector 10
Active Share	<nn.nn%>	<nn.nn%>	<nn.nn%>	<nn.nn%>	<nn.nn%>	<nn.nn%>	<nn.nn%>	<nn.nn%>	<nn.nn%>	<nn.nn%>
Portfolio Weight	<nn.n%>	<nn.n%>	<nn.n%>	<nn.n%>	<nn.n%>	<nn.n%>	<nn.n%>	<nn.n%>	<nn.n%>	<nn.n%>
Index Weight	<nn.n%>	<nn.n%>	<nn.n%>	<nn.n%>	<nn.n%>	<nn.n%>	<nn.n%>	<nn.n%>	<nn.n%>	<nn.n%>
Relative Weight	+/-<n.n%>	+/-<n.n%>	+/-<n.n%>	+/-<n.n%>	+/-<n.n%>	+/-<n.n%>	+/-<n.n%>	+/-<n.n%>	+/-<n.n%>	+/-<n.n%>

<footnote>

This chart illustrates the active share of each sector in the portfolio—demonstrating the extent to which each sector's holdings vary from those in the index. It is a simple way to isolate the "activeness" of each sector. The weights of each sector in the portfolio and the index, as well as the relative weight, are also displayed to provide context.

This type of sector-level active share analysis is based on treating each sector as its own portfolio and does not take into account the weight of the sector in the portfolio. Any sector not held in the portfolio, like Sectors 9 and 10, above, has an active share of 100%, since that sector is completely (i.e., 100%) different from the index sector.

6. PORTFOLIO ACTIVE SHARE VS. MULTIPLE INDICES: POINT IN TIME



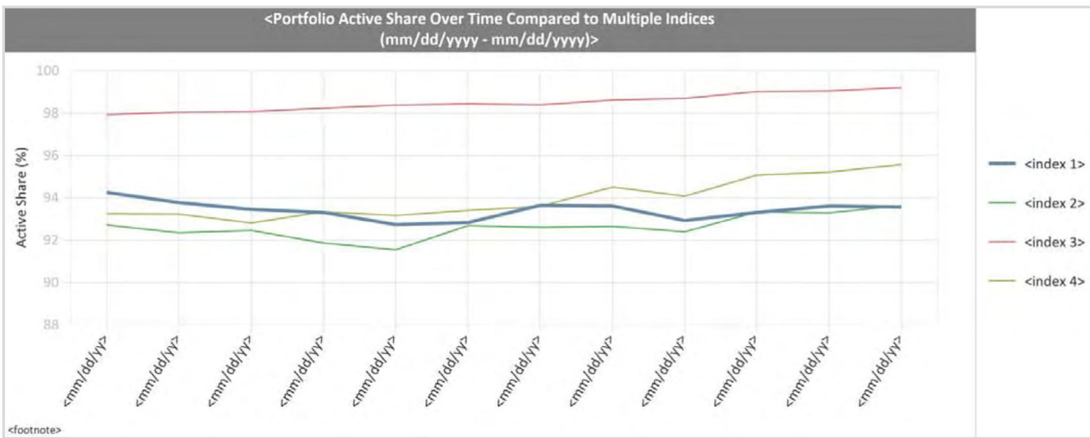
<footnote>

This chart is a useful way to demonstrate that your portfolio conforms to the style of its chosen benchmark. By showing the active share of the portfolio compared to its benchmark and other indices, you can illustrate the consistency of your style.

If you are true to your investment style, your portfolio's chosen benchmark, "index 1" in chart 6, should be the index that results in the lowest active share for your portfolio among the displayed indices. That makes sense, since the portfolio should have more overlap with that index than any other. Conversely, the higher the active share of other indices, the less like them your portfolio is. In other words, you have both positive and negative proof that you are staying true to your style.

For example, let's assume you manage an active small-cap growth portfolio and your primary benchmark is the Russell 2000 Growth Index. You decide to include the Russell 2000 Growth, Russell 2000, Russell Mid-Cap and Russell 2000 Value indices in the analysis above. If another index results in a lower active share than your primary benchmark, it is an indication that the portfolio has drifted into the style represented by that index. If not, you have point-in-time evidence that a) your portfolio reflects a small-cap growth bias and b) your portfolio has not drifted into small-cap, mid-cap or value territory.

7. PORTFOLIO ACTIVE SHARE VS. MULTIPLE INDICES: TIME SERIES



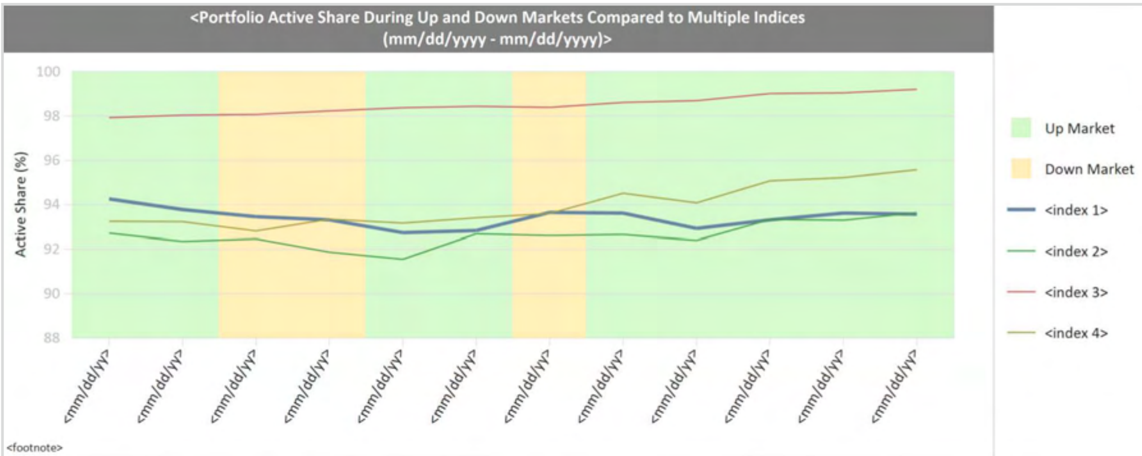
This graph shows how the portfolio conforms to the style indicated by its primary benchmark and other indices over time. Portfolios that consistently demonstrate the lowest active share versus their primary benchmark are likely managed through a disciplined investment philosophy and process, something that clients and consultants look for when evaluating managers.

This portfolio's primary benchmark index, <index 1>, is denoted by the thick blue line. As you can see, this hasn't been the one with the lowest active share in the past, but the portfolio is beginning to align with its primary benchmark as of the latest period. Is this due to style drift or are there other reasons why the portfolio didn't align with its primary benchmark in the past?

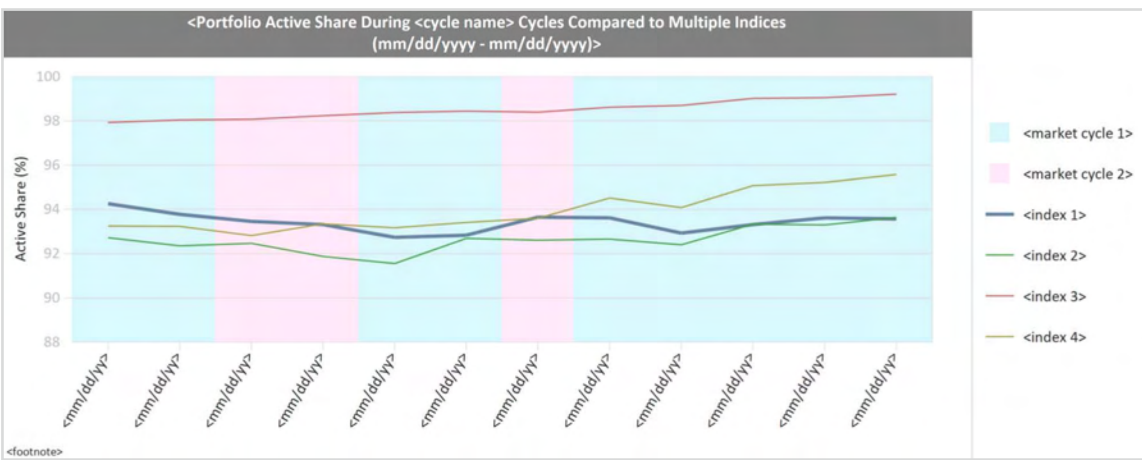
Perhaps the portfolio's strategic mandate changed during the period covered by the chart, or reallocations of cash into or out of the portfolio temporarily disrupted the manager's investment discipline. Both could explain the early periods of misalignment with the primary benchmark in the above chart. Structural changes to the composition of the benchmark index can also create misalignments, although these tend to be shorter-term anomalies and smooth out over time.

Of course, perhaps the portfolio simply has a history of style drift. No matter what the rationale in the example above, having access to this type of historical active share information allows managers to engage in meaningful discussions with clients and consultants about how exogenous factors affect their portfolio, the discipline of their investment process and their commitment to style consistency.

7a. ACTIVE SHARE VS. MULTIPLE INDICES: UP AND DOWN MARKETS

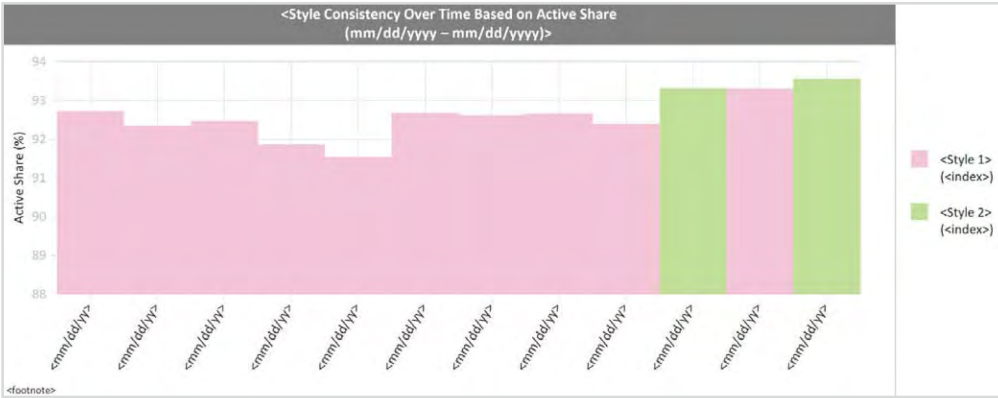


7b. ACTIVE SHARE VS. MULTIPLE INDICES: BY MARKET CYCLE



Managers have great flexibility when showing style patterns over time. Graphs 7a and 7b, above, illustrate how your active share compares with multiple indices in up-and-down markets and over various market cycles. Each gives you the opportunity to show your style conviction no matter what economic or market conditions prevail.

8. ACTIVE SHARE VS. STYLE INDICES: CONSISTENCY OVER TIME



This chart uses active share/multiple indices analysis in a different way, one suggested in the original research—that active share could be used to track the style of a fund over time.[8]

Based on a specified set of color-coded indices, the chart identifies the index with the lowest active share at the end of each time interval. The portfolio is determined to “belong” to the style represented by the index with the lowest active share. If the color remains the same across all intervals, it indicates the portfolio has been consistent in its style and/or investment approach.

As an example, let’s say you are a small-cap growth manager and your primary benchmark is the Russell 2000 Growth index. For the purposes of this chart, you specify the following indices and colors:

R2000 Growth	Small-Cap Growth	Pink
R2000	Small Cap	Green
R2000 Value	Small-Cap Value	Gray
Russell Mid-Cap	Mid-Cap	Blue

Your portfolio has had the lowest active share to the Russell 2000 Growth index in all but two periods displayed in the chart. Those intervals may be anomalies, or due to index reconstitution, or perhaps they signal a change in your investment approach. Either way, this chart can be a powerful tool to validate your consistency and generate meaningful discussions with clients, consultants and new business prospects.

[1] This formula is an alternative to the original formula presented in the 2009 paper cited below. In email correspondence between Dr. Martijn Cremers and Thusith Mahanama, CEO of Assette, on 1.8.2014, Dr. Cremers stated that he now prefers this alternative formula for active share.

[2] Light, Joe. 1.18.14. “And the Next Star Fund Manager is...” The Wall Street Journal. Retrieved from: http://stream.wsj.com/story/latest-headlines/SS-2-63399/SS-2-429840/

[3] Cremers, Martijn, and Petajisto, Antti. 2009. “How active is your fund manager? A new measure that predicts performance.”

[4] Max, Sarah. 1.14.13. “Is your fund manager active enough?” www.online.barrons.com/article.

[5] Sellwood Consulting LLC. 9.24.13. “How We Use Active Share to Recommend Better Equity Portfolios.” www.sellwoodconsulting.com.

[6] Stahl, Kent; Gregg, Thomas; Simon, Tom. April 2011. “Active Share: Predicting Alpha and Risk.” Wellington Management. www.wellington.com

[7] Adams, John C.; Mansi, Sattar A.; Nishikawa, Takeshi. March 2010. The Review of Financial Studies, Vol. 23, Issue 3. “Internal Governance Mechanisms and Operational Performance: Evidence from Index Mutual Funds.”

[8] Ibid. Cremers and Petajisto. 2009.