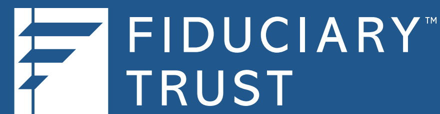
Identifying Managers with the Potential to Outperform



Investment Strategy Insights

Investors can gain exposures to asset classes primarily through passive or actively-managed strategies. We believe that either strategy is valid, depending upon market conditions. Our evaluation of passive vehicles is relatively straightforward: we seek funds with low costs (both explicit management fees and implicit trading costs), that are likely to deliver returns that closely approximate their underlying benchmarks.

Manager Due Diligence

Committing capital to an active manager, on the other hand, is a time intensive process requiring significant manager specific due diligence. Investment due diligence entails having a clear understanding for how a particular manager expects to deliver outperformance, what competitive advantage or analytical edge they can bring to bear, and in what types of market environments their strategy should fare best. Numerous in-person meetings with key decision-makers at these firms are needed to adequately understand a strategy. We also expect firms with which we partner to have well-defined environmental, social, and governance (ESG) policies that align with our standards, both for potential investments and their broader organizations.

In addition, we perform a significant level of research to supplement these conversations. This includes analysis of past returns and current holdings in order to obtain a sense for how a strategy generated historical returns and what underlying factors will drive future returns. When our data matches the narrative a manager puts forward, we feel comfortable that we have a solid understanding of the underlying strategy. We also ask managers that pass initial muster to respond to detailed requests for proposals that contain operational due diligence questions in addition to investment requests. Essentially, we are looking for firms

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that have strong compliance and operational controls in place to prevent "surprises." We also want to ensure that any manager with which we invest is fully aligned with our interests. That is, we want to see teams with significant personal investments in their strategies and ownership in their firms, along with compensation arrangements that are tied to long-term investment performance as opposed to asset growth. In short, we want managers to share in our view of success.

As mentioned previously, it is extremely time intensive to perform qualitative investment due diligence. Given the large number of active strategies that are available across different asset classes, it is important to filter that number down to a more manageable level. We are cautious about performing screens that are based on past returns, as these filtering methods will invariably favor recent winners and penalize excellent managers whose investment styles might be out of favor. Indeed, there is little value in performing these types of screens in our opinion. Instead, within traditional asset classes, and particularly within equities, we have identified two factors that are highly predictive of future manager results: fees and level of activity.

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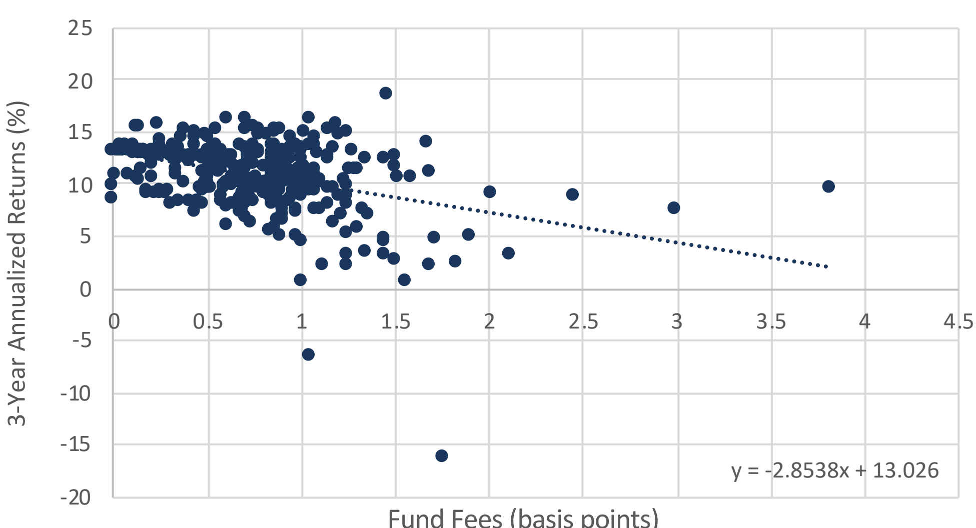
The Importance of Low Fee Funds

Significant research has shown a strong negative correlation between a manager's ability to outperform its benchmark and the fees it charges investors. This relationship is intuitive, and is persistent across time periods, regions, and asset classes.

Exhibits A, B and C illustrate the correlation between fees and investment performance. They show the three year annualized total returns (Y-axis) versus the expense ratio (X-axis) of funds belonging to three equity investment categories; U.S. Large Blend, Foreign Large Blend, and Emerging Markets. In each case, fund returns generally decline as fees increase. Expense ratios have greatest explanatory power in the U.S., and fund returns fall in a relatively predictable manner as fees increase (returns cluster closely around the dashed line). That explanatory power diminishes as we move from an efficient market like the U.S., to less efficient markets like international equities.

Exhibit A: Returns vs. Fees: U.S. Large Blend Equity Funds

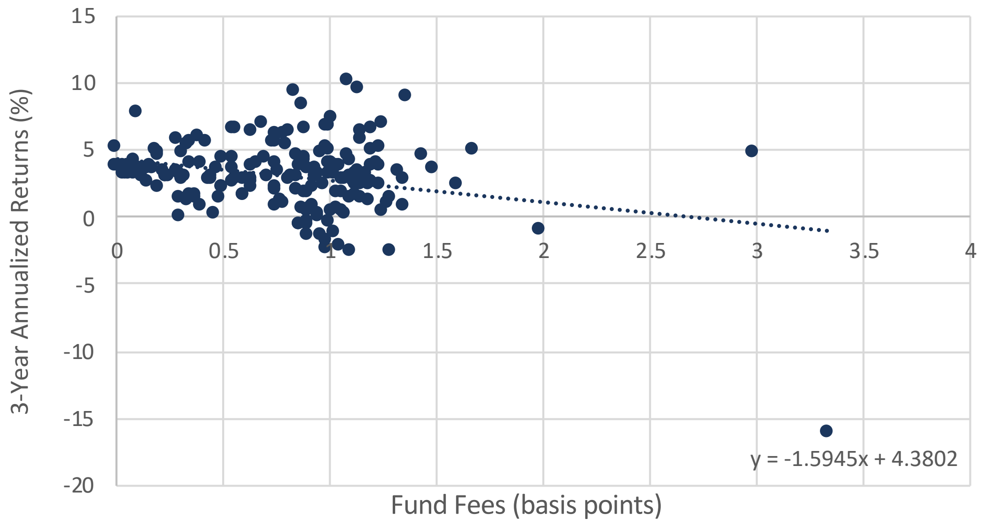


Source: Fiduciary Trust Company, Morningstar. Data is as of 11/30/2020, and represents returns and fees for the Morningstar U.S. Large Blend category.

The Roles for Active and Passive Investments:

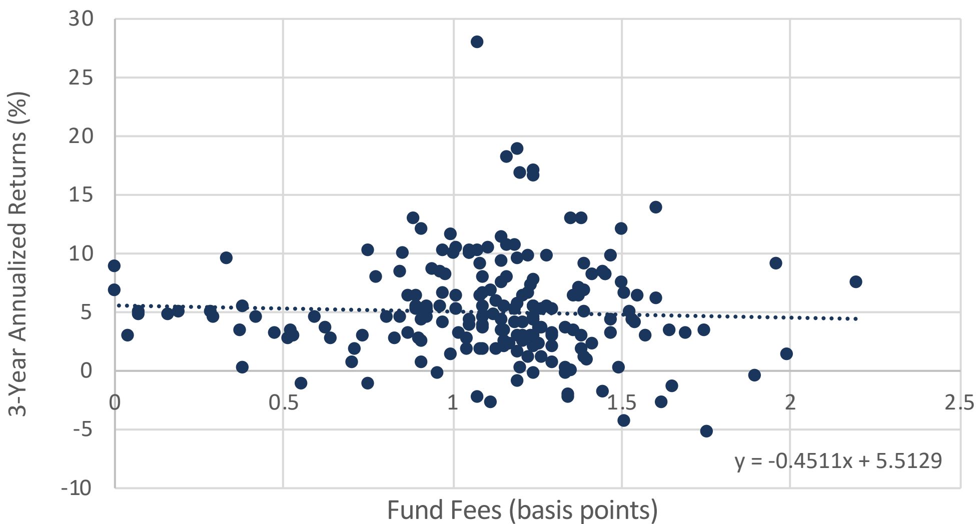
fidtrustco.com/active-vs-passive

Exhibit B: Returns vs. Fees: Foreign Large Blend Equity Funds



Source: Fiduciary Trust Company, Morningstar. Data is as of 11/30/2020, and represents returns and fees for the Morningstar Foreign Large Blend category.

Exhibit C: Returns vs. Fees: Emerging Market Equity Funds



Source: Fiduciary Trust Company, Morningstar. Data is as of 11/30/2020, and represents returns and fees for the Morningstar Diversified Emerging Markets category.

At Fiduciary Trust, we are willing to pay higher fees for active management where there is a greater potential for active to outperform passive management, and international markets appear to be better positioned for active funds to succeed than U.S. funds. We have displayed the best fit line (dashed blue line) in each picture, and the equation for each best fit line in the bottom right hand portion of each chart. In all three segments, the slope (the coefficient of the X variable, which in this case is expense ratio) of the line is negative implying the intuitive inverse relationship we expected between fees and returns. It is also interesting to note that the absolute value of that slope coefficient is largest in the U.S., followed by

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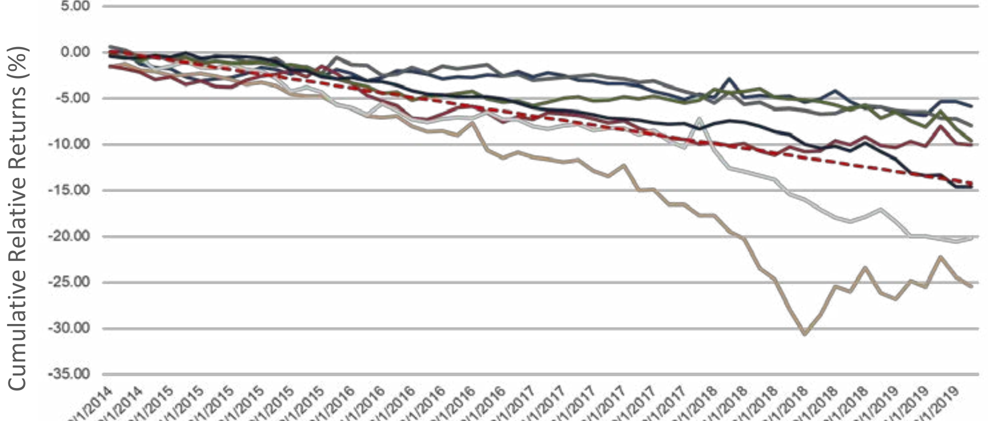
the Foreign Large Blend category and then Emerging Markets. Therefore, not only do fund returns cluster more closely around the best fit line in the U.S., that line is steeper than elsewhere. In short, fees are highly consequential to fund returns across the board, but are most consequential in more efficient markets.

Avoiding "Closet Index" Actively-Managed Funds

A fund that is not very "active" is unlikely to outperform its benchmark by a wide margin

It also makes sense that a fund that is not very "active" (i.e. one that looks and behaves like its benchmark) is unlikely to outperform its benchmark by a wide margin (by that reasoning it is true that such a fund is unlikely to underperform its benchmark by a wide margin, either). This seems especially true when taking fees and transaction costs into account. It is our contention that it is the intersection of these two variables, high fees and lower levels of activity, that will almost surely produce poor prospective returns. While being highly active and having low fees will not guarantee success, we feel confident that high fees combined with a "closet benchmarking" strategy will produce unsatisfactory outcomes. Exhibit D illustrates this point, depicting the cumulative negative excess returns of portfolios of high cost, less active funds for major Morningstar categories over time.

Exhibit D: Cumulative Returns of High Fee, Less Active Funds vs. Benchmarks



Source: Fiduciary Trust Company, Morningstar, and Bloomberg. Legend definitions: EM is Emerging Markets, EAFE is Europe and Far East, US SB is U.S. Small Cap Blend, US MB is U.S. Mid Cap Blend, US LG is U.S. Large Cap Growth, US LV is U.S. Large Cap Value, and U.S. LB is U.S. Large Cap Blend. Funds selected based on Morningstar category with benchmark correlations above 90% and expense ratios above 1%. U.S. categories are benchmarked to relevant Russell indices, while EAFE and EM are benchmarked to the MSCI EAFE and MSCI EM indices respectively. Data is from 9/30/2014 – 7/31/2019.

It is remarkable how consistent the relative decline is within each category, implying this cohort of funds should be avoided. Utilizing these simple criteria to screen out high fee and/or less active funds helps dramatically reduce the number of strategies on which it is sensible to conduct due diligence. We also look to measures such as assets under management, recent asset growth, and manager tenure to help further narrow the universe of sound investment opportunities. Again, none of these measures incorporate past returns into the evaluation process.

The Role of Portfolio Construction in Fund Selection

Once we have filtered down the potential universe of active managers to a group we like and on which we have done the necessary investment and operation due diligence, portfolio construction becomes a critical step in active portfolio management. We want to ensure that when using multiple funds to gain exposure to an asset class, those funds complement each other well. Holding everything else equal, we prefer to utilize funds that generate returns in differentiated ways. For example, it might be sensible to combine a systematic, quantitative investment team with one that performs bottom-up analysis on company fundamentals. Knowing nothing else about the strategies, they should have little in the way of overlap, and clearly construct portfolios in different manners. While each manager on their own may produce volatile relative returns, a portfolio comprised of both would likely produce a smoother ride for investors. We perform a significant level of quantitative research on past returns and current holdings to attempt to produce portfolios that can capitalize on these types of diversification benefits. Exhibit E shows the monthly relative returns of two emerging market funds we currently recommend in portfolios, along with the relative return of a 50/50 split of the two.

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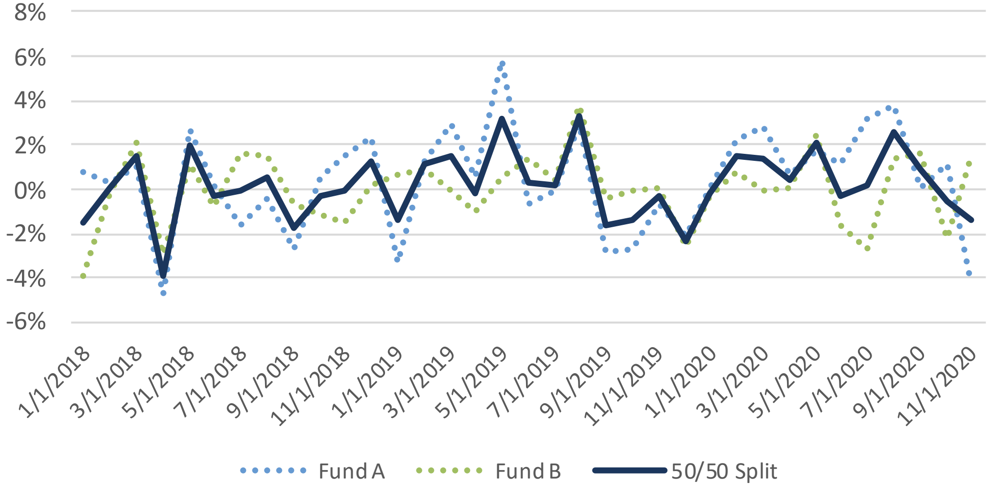
Exhibit E: Monthly Total Relative Returns of Selected Funds



Source: Fiduciary Trust Company, Bloomberg. Data is from 12/31/2017 – 11/30/2020. Fund A and Fund B are two actively-managed Emerging Markets Equity mutual funds in FTC's Moderate Beacon portfolio as of 11/30/2020.

Note the portfolio (50/50 Split) has more modest up and downturns than either of the funds that comprise it. Additionally, there are moments when the funds move in tandem, and other times when they oppose one another. Over the full sample though, the alpha of the two funds show little correlation, and combining them into the portfolio produces a smoother ride for investors. While we seek managers who construct portfolios in different ways, we are also mindful not to pair managers together with offsetting positions. The likely result of pairing up two managers with offsetting positions would be a portfolio that looks similar to a benchmark index but comes at a higher cost (which we demonstrated is not a useful investment strategy earlier with our analysis of high cost "closet indexers"). This risk becomes

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Manager Research and
Due Diligence

increasingly likely as more managers are added together. Therefore, we typically ensure our strategies only contain our highest conviction active strategies at any given point in time. Simply put, we are trying to identify sets of management teams and strategies that are excellent in their own rights, but when paired together can consistently deliver outperformance. We feel this approach provides our active portfolios and clients with their best chances to outperform.

In summary, when evaluating passive investment options, quantitative measures around explicit and implicit costs drives the majority of our decision-making process. Active manager evaluation is considerably more research intensive, but we have found certain quantitative metrics such as fees and measures of activeness useful for screening the universe of active investment options down to a more manageable list. For funds that pass these initial filters, our due diligence efforts focus on identifying underlying drivers of a manager's past returns, along with reviewing current portfolio holdings to see how these metrics align with the investment strategy. We also focus considerable efforts on manager interviews to fully understand the investment merits of a strategy, and pay attention to soft metrics such as manager experience, compensation arrangements, and compliance and operations controls firms have in place. In addition, we examine what ESG policies a firm has in place and its alignment with our ESG standards. Finally, we are careful to combine our highest conviction managers together, and seek complementary investment strategies that can deliver diversification benefits to our portfolios. ■

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