The Value of Active Management for a Total Portfolio

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Investors should adopt a holistic view of investing in order to construct a successful portfolio. While there are conflicting views on which investment approach provides superior results, active and passive investments can complement each other to help investors accomplish their financial goals. In this paper, we will illustrate why we believe active portfolio management should play an integral role in a thoughtful investment plan.

Active vs. Passive Management

The major difference between the active and passive investment style is their take on the market. Active managers believe that market prices of common stocks and securities are not always priced accurately, which creates opportunities to outperform the overall index. Passive managers, on the other hand, seek to replicate the return of a given market index. Passive investing is often seen as a way for investors to gain exposure to capital markets and generate returns over the long term. It works under the assumption that market prices are accurate and that money managers cannot beat the overall index.

Active managers take advantage of market inefficiencies

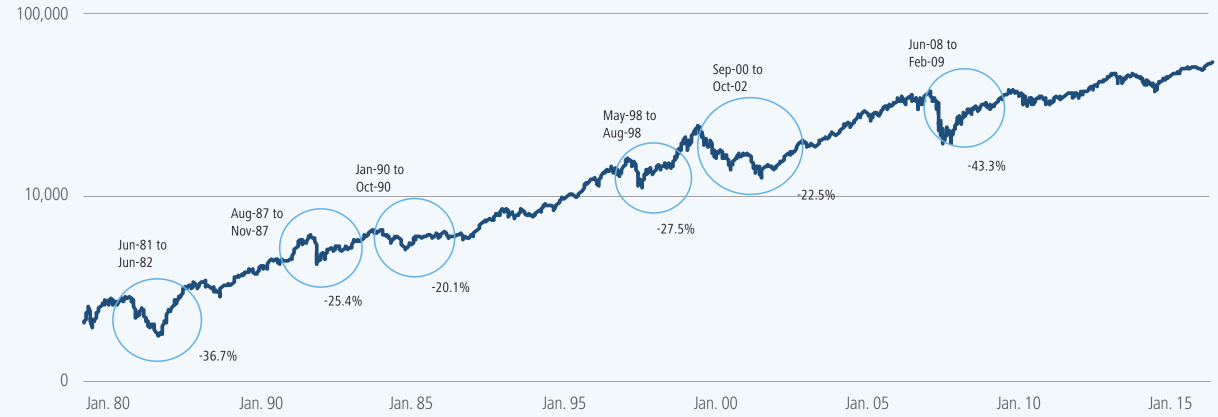
In practice, capital market efficiency resides somewhere in between these two extremes. Evidence supports the notion that active management can add value to portfolio returns over a broad range of different asset classes.

Lesser degrees of market efficiency exist in certain asset classes. This happens because of a variety of factors, including poor understanding of the true value of a stock or security and biases that influence investors to act irrationally or prematurely. Active managers have demonstrated that they can add value in many asset classes across geographies and capitalization sizes including global fixed income, Canadian large-cap equity, global large-cap equity, small- and mid-cap equity, and emerging markets, where fundamental research and portfolio manager skills pay off, presumably because they are less efficient.

Active managers have also demonstrated they have the ability to outperform the index and their portfolios can be less volatile than the index during bear markets. By using active portfolio construction processes, these managers are able to avoid unintended systematic risks that would negatively impact their investors, especially in down markets and provide greater exposure to companies with superior valuations or growth potential. Equities are inherently risky. Active strategies can diversify that risk and protect investors' capital by investing in stocks with lower correlations and by underweighting sectors and stocks that are overly concentrated in the index.

The following S&P/TSX Composite Index chart shows the bear markets during 1980 to 2017.

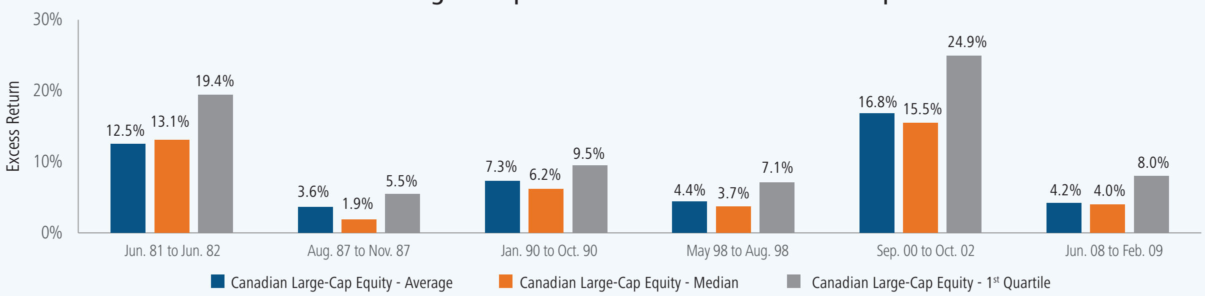
S&P/TSX Composite TR Index – Bear Markets During 1980 – 2017



Source: eVestments, gross-of-fees returns

During each bear market since 1980, the benefits of active management have been quite evident as the average gross-of-fees return of the Canadian Large-Cap Equity eVestment universe** exceeded that of the passive index, as can be seen in the following chart.

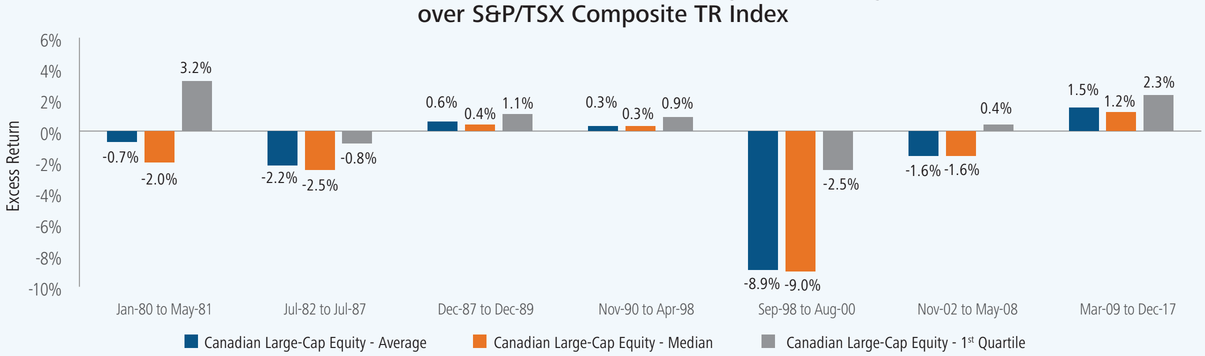
Bear Market Active Manager Outperformance versus S&P/TSX Composite TR Index



Source: eVestment, gross-of-fees returns

The chart below shows active returns of average, median, and 1st quartile Canadian Large-cap managers** over S&P/TSX Composite Total Return Index during the bull markets since 1980.

Bull Market Active Return of Canadian Large-Cap Managers**
over S&P/TSX Composite TR Index



Source: eVestments, gross-of-fees returns

** Canadian Equity products that primarily invest in large capitalization stocks regardless of the style (growth, value, or core) focus.

Active managers add alpha by investing "off benchmark" and in IPOs

The active return of a fund in relation to the return of a benchmark index is sometimes referred to as alpha. Active managers can add alpha by taking advantage of mispriced securities and investing off-benchmark where they may find attractive opportunities. Active managers can add greater value by expanding their investment outlook in terms of credit, geography and structural reach.

Another way to add alpha is by participating in Initial Public Offerings (IPOs). IPO securities are typically sold at a discount compared to those sold in the secondary market, where shares trade on an exchange. Active managers can buy new shares in an IPO at an affordable price and then sell some of them in the secondary market at a higher price. The difference between the IPO price an active manager paid compared to what they sold it for on the secondary market can go towards the investor.

Active managers can enhance portfolio diversification through asset allocation strategies

Diversification is crucial to constructing portfolios with attractive expected returns at acceptable levels of risk. One popular passive approach is to create a diversified portfolio of traditional assets, consisting of 60% equity and 40% fixed income, which seems to offer a reasonable combination of the higher expected return of equity with lower volatility of fixed income. This idea might make sense for the hypothetical average investor, but generally a younger investor, who is far more from retirement, can afford to take more risk for higher expected returns, while an older investor who is close to, or in retirement, might be better invested in a less volatile portfolio. To balance risk and return for investors, active managers employ a variety of asset allocation strategies. Some of these include balanced funds, portfolio solutions and target date strategies, which help investors stay invested throughout their investment time-horizon.

Conclusion

Investors should view investing from a total portfolio perspective and utilize active asset-allocation strategies to add value. Active managers have shown that they can add value where market inefficiency exists. Alpha can be added by investing off-benchmark.

It is difficult to time the markets or know when passive or active investments will outperform. Contact your financial advisor to develop the best plan that will address your needs.

* eVestment is a global investment manager database. eVestment collects information directly from investment management firms and other sources believed to be reliable. eVestment does not guarantee or warrant the accuracy, timeliness, or completeness of the information provided and are not responsible for any errors or omissions. Performance results may be provided with additional disclosures available on our systems and other important considerations such as fees may be applicable. Not for general distribution. All categories not necessarily included; Totals may not equal 100%.

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