

Is Your Portfolio's Active Share *Really* High?

ACTIVE SHARE (AS): MEASURES HOW MUCH A PORTFOLIO'S CONSTRUCTION DIFFERS FROM ITS INDEX

DECEMBER 2015

High



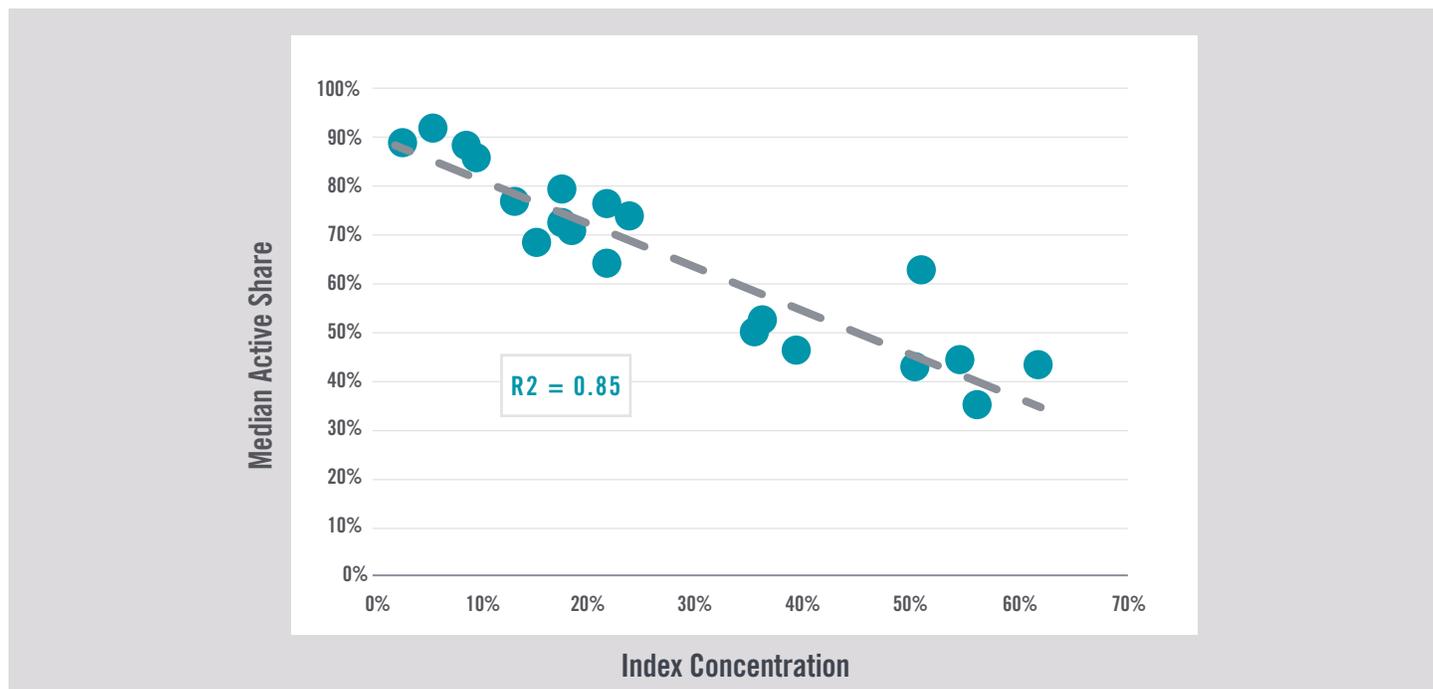
Low



Some investors seek high Active Share, assuming >90% is the right definition of “high.” But our researchⁱ shows that “high AS” is not an absolute; it depends on the benchmark index’s concentration, defined here as the percentage of the index represented by the largest 10 stocks.

As Index Concentration Increases, Active Share Among Fundsⁱⁱ Tends to Fall (as of 6/30/15)

Observed relationship between median AS and index concentration for 22 different indices



Source: SEB Investment Management, Brandes Institute, June 2015

So What?

Original AS research found outperformance net of fees for those U.S. funds in the top quintile for both AS (over 90%) and tracking error (over 8%). And funds with AS under 60% were labeled “closet indexers.”¹ But...



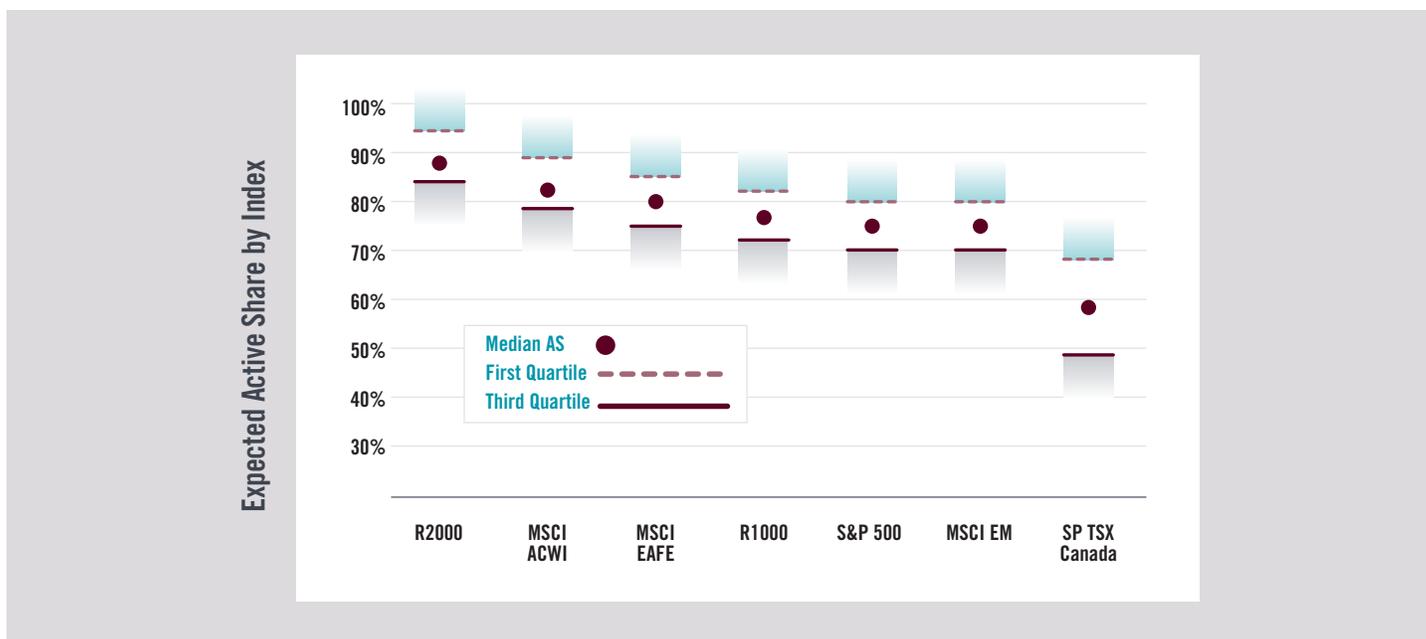
¹Cremers, Martijn and Petajisto, Antii. “How Active is Your Fund Manager? A New Measure That Predicts Performance.” March 31, 2009. Available at SSRN.com: <http://ssrn.com/abstract=891719> or <http://dx.doi.org/10.2139/ssrn.891719>

But is that right? And what does it mean?

Based on the concentration of any index, we can calculate its Expected Active Share or EAS: the projected median AS for a peer group of portfolios managed against that index. We also can estimate the first and third quartile AS levels for that peer group.



Expected Active Share Varies by Index, (as of 6/30/15)



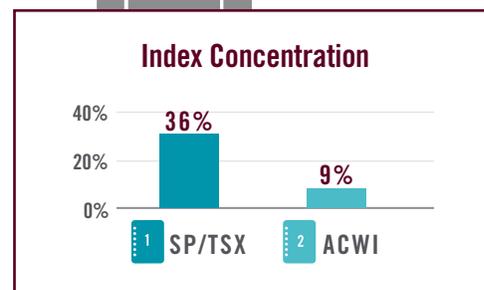
Source: SEB Investment Management, Brandes Institute, June 2015



Why does index concentration matter so much?

Assume a manager with the same approach runs two portfolios, each benchmarked to a different index:

- The concentrated Canada S&P/TSX Index (with only 100 institutional-sized² stocks) and the much broader MSCI ACWI Index (with more than 2,000 institutional-sized stocks)
- In each portfolio, the manager owns 50 equally weighted positions spread across the indices' cap ranges



Source: SEB Investment Management, Brandes Institute, June 2015

²"Institutional-sized" stock defined here as over \$2.89bn in market cap using 6/30/15 data.

ACTIVE SHARE COMES FROM TWO SOURCES:

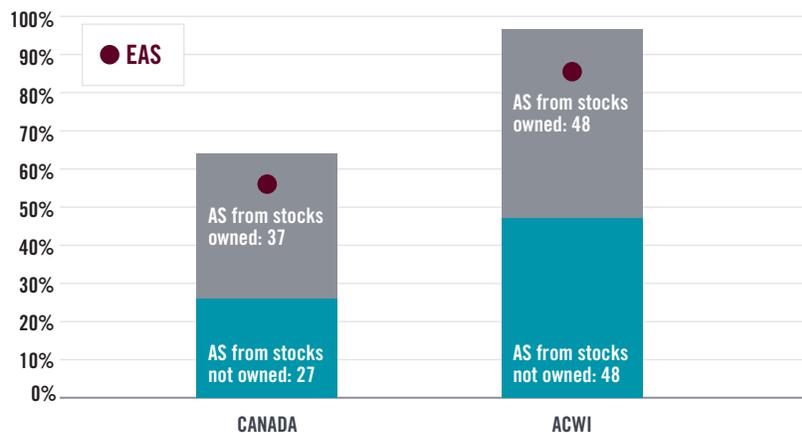
1 the relative weights of stocks **owned**

2 the index weight of all the stocks **NOT** owned

With more than 20 times as many institutional-sized stocks in the ACWI universe, the “not-owned” stocks make a more significant contribution vs. the concentrated Canadian index.

Sources of Active Share: Stocks Owned and Stocks Not Owned

Active Share Comparison, assuming same portfolio of 50 equal 2% positions:
Concentrated Index (Canada) and diversified index (ACWI)



Hypothetical Illustration. Does not represent any specific index or investment. Actual results will vary.

Calculating Expected Active Share? EASY as 1-2-3

- 1 Start with the index concentration (for example, Canada S&P/TSX is 36%)
- 2 Subtract it from 100%
- 3 Multiply by 0.91 (derived from our regression analysis)



$$\text{EAS} = 0.91(100\% - \text{Index Concentration})$$

Canadian Index Example: $100\% - 36\% = 64\%$;
 $64\% \times 0.91 = \text{EAS of } 58\%$

Use Expected Active Share to gauge whether AS for a portfolio really is high. Read the full Brandes Institute [white paper](#) for more details.



The complete report, "Is Your Portfolio's 'High Active Share' Really High? A Simple Approach to Evaluating a Portfolio's Active Share in the Context of its Benchmark," reflects a collaborative effort between SEB Investment Management (SEBIM) and the Brandes Institute. SEBIM, based in Stockholm, is one of the largest asset managers in Scandinavia and a subsidiary of SEB, a leading Nordic financial services group.

The data needs for this research required information on the constituent stocks and weights in each index used, and the availability of a peer group of portfolios managed against each index for which each portfolio's Active Share was available or could be calculated. The portfolios for which we had this data were mutual funds, with the underlying data sourced from Morningstar. In total the data includes 15 mutual fund peer groups with at least 20 funds, measured against 14 different indices (there were two peer groups for the S&P 500, one with 2013 data and one with 2014). There were two sets of mutual fund data used. The SEB data set consisted of 866 European-registered mutual funds, with data recorded for 835 of them as of yearend 2014 (Weights for the Australian index, the S&P ASX 200 were only available as of November 25, 2014, so this data was used instead of yearend 2014), and the others at yearend 2013.

The Brandes Institute data set consisted of 206 North American registered mutual funds. These were primarily US registered funds, plus 13 Canadian registered. The Canadian registered funds and 18 US small cap funds had data as of yearend 2014, and the other funds all were measured as of yearend 2013. The 2013 peer group data was made available for this research courtesy of Lazard Asset Management and the authors of the 2014 paper "The Predictive Power of Portfolio Characteristics," Gillman, Khusainova and Mier, who had sourced this data from Morningstar.

Additional Disclosures

R-squared: R² (pronounced "R-squared") is the square of the correlation coefficient and measures the proportion of return variability in a security or portfolio explained by movements in the benchmark index. In the context of this study, R-squared measures the relationship between the median AS of each portfolio universe (measured using the peer group of funds benchmarked to each specific index), and the top ten concentration of that index. R-squared values range from 0 to 1; the closer to 1, the better the "goodness of fit" between the variables.

Tracking error: A measure of how closely a portfolio's returns match those of its benchmark index. Tracking error is calculated by taking the standard deviation of the difference between the portfolio returns and the index returns

Past performance is not a guarantee of future results.

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Index Disclosures

MSCI ACWI Index: The MSCI All Country World Index is a free float-adjusted market capitalization index that measures the equity market performance of developed and emerging markets.

MSCI EAFE Index: The MSCI EAFE (Europe, Australasia, Far East) Index is a free float-adjusted market capitalization index that measures the equity market performance of developed markets in Europe, Australasia, and the Far East.

Russell 1000 Index: The Russell 1000 Index with gross dividends measures performance of the large-cap segment of the U.S. equity universe.

Russell 2000 Index: The Russell 2000 Index with gross dividends measures the performance of the small-capitalization segment of the U.S. equity universe. The Russell 2000 Index is a subset of the Russell 3000 Index.

S&P 500 Index: The S&P 500 Index is a market capitalization index that measures the equity performance of 500 leading companies in industries of the U.S. economy.

MSCI Emerging Markets Index: The MSCI Emerging Markets Index is a free float-adjusted market capitalization index that measures the equity market performance of emerging markets.

S&P/TSX Composite Index: The S&P/TSX Composite Index measures the equity performance of the largest companies on the Toronto Stock Exchange (TSX) as measured by market capitalization. Index constituents account for about 70% of market capitalization for all Canadian-based companies listed on the TSX.

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