

THE LORD ABBETT
INVESTMENT OPINIONS AND COMMENTARIES

Review

THE CRAFT OF ACTIVE MANAGEMENT

Why the Market Needs Active Management

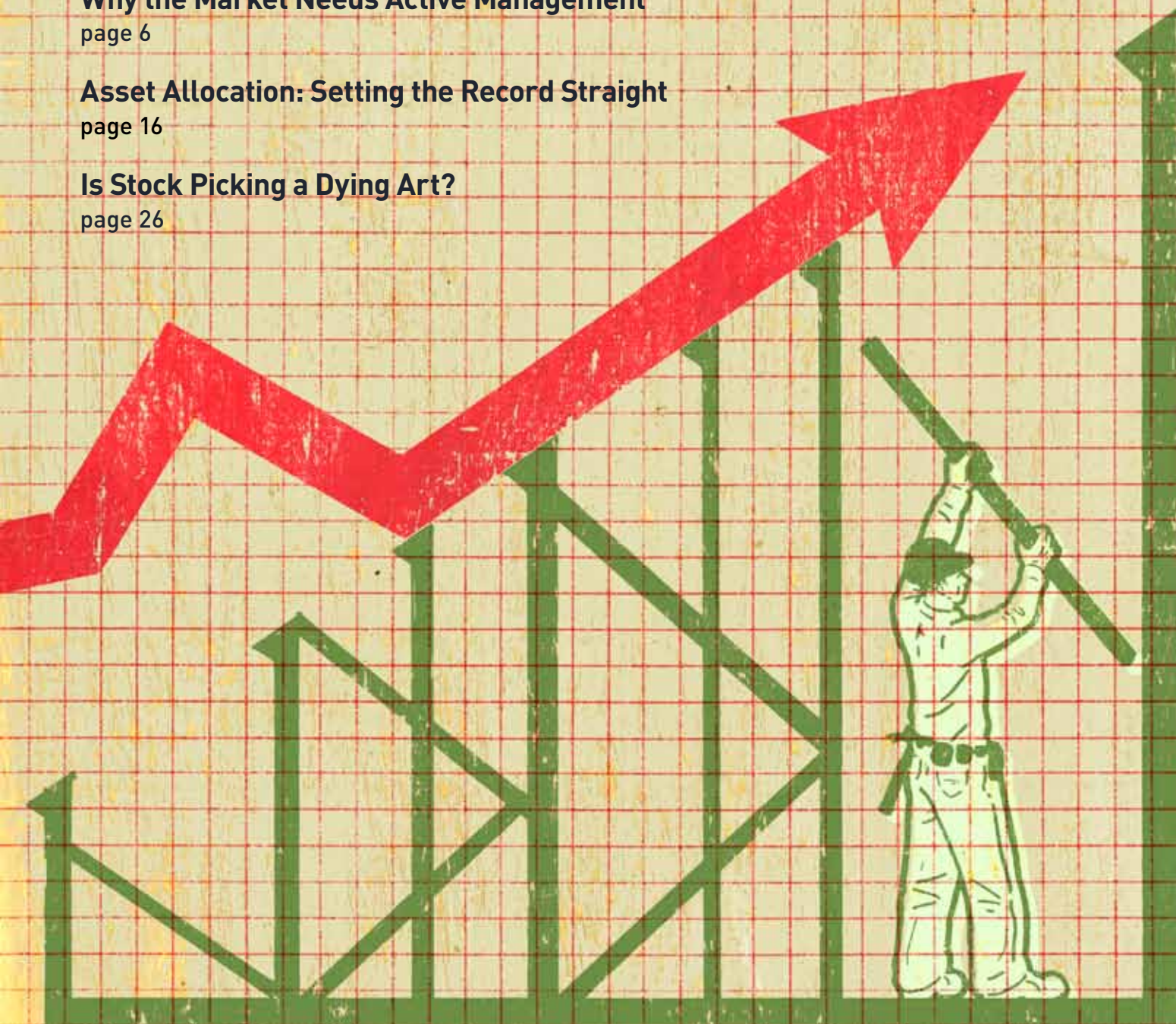
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Review



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The Great Debate: Active versus Passive



THE RISE OF passive investing over the past decade has been impressive. Assets in one type of passive vehicle, exchange-traded funds (ETFs), now total almost \$1 trillion, up from just \$66 billion in 2000, according to the Investment Company Institute. The appeal of these vehicles is likely to continue because it stems largely from their lower cost. But investors who shun actively managed strategies may not realize what they are giving up. New research shows that a particular type of active management is more likely than others to contribute alpha, or added performance.

The growth of passive investing has been supported by two pillars: 1) a belief that markets are efficient and 2) conventional wisdom that a portfolio's asset allocation accounts for 90% of its long-run return. The first idea implied that active management was unlikely to add significant alpha. The second idea led financial advisors to focus on assembling ETF portfolios with carefully calibrated asset-class exposures.

The first pillar—that the stock market is efficient—means that prices are generally rational, reflecting all information that is relevant to a stock's value—earnings, growth, competitive advantage,

management experience, etc. The collapse of the tech bubble in the late 1990s and the subprime crisis in 2008 gave some investors second thoughts about the market's efficiency, but an argument can be made that even during these periods investors were acting rationally. Many investors, therefore, continue to believe in the market's efficiency. Does this mean that active management makes no sense for them?

As we argue in "Why the Market Needs Active Management," faith in market efficiency and a belief in the value of active management are completely compatible. Essentially, no matter how efficient a market becomes, some inefficiency will always remain, and this leaves open the possibility of outperformance by an active investor.

This is because, as two economists noticed more than 30 years ago, the market's efficiency rests on a paradox: *If all investors believed the market was efficient, the market would not be efficient.*

If the market were perfectly efficient, prices would completely reflect all relevant information. But if prices reflected all relevant information, investors would not have enough incentive to obtain and act on the information on which prices are based.

To put it another way, the level of efficiency in the market depends on the activities of active investors, that is, those who believe there are inefficiencies or mispricings in the market that they can exploit.

If active investors relaxed their efforts, stocks would increasingly become mispriced, once again attracting the attention of astute (active) investors. Market efficiency, therefore, is always in flux.

So, even if some investors still embrace the pillar of market efficiency (and many do), they shouldn't turn their backs on active management. Market efficiency will never be perfect, and that leaves opportunities for active management to exploit.

The second pillar supporting passive investing—that 90% of a portfolio's long-run return derives from its asset allocation—has suffered a more definitive blow. In our story, "Asset Allocation: Setting the Record Straight," we lay out how in 2010 the 90% figure was thoroughly debunked by Roger

NEW RESEARCH shows that a particular type of active management is more likely than others to contribute alpha, or added performance.

Ibbotson, an authority on asset allocation, and his colleagues at Ibbotson Associates.

What they found was that asset allocation generates not 90% of a portfolio's return but just 15–20%. Of more import to passive investors is their other finding: active management also contributes 15–20%.

To say that active management contributes to performance is not to say that it always adds alpha, however. So, finding a way to discern among active managers who contribute positively and those who contribute negatively is critical. To do this, it is helpful to consider the

concept of Active Share.* Developed by professors Martijn Cremers and Antti Petajisto, Active Share provides an intuitive measure of just how active an actively managed fund is.

In "Is Stock Picking a Dying Art?" we review the professors' research, which shows that equity mutual funds that score high on Active Share—classified by the authors as "stock pickers"—are more likely to outperform their benchmarks. Important too is that they show that this outperformance has held up even when stocks are highly correlated, as they were during the subprime crisis. Even during such periods, this outperformance historically has amounted to nearly an extra 1% per year, *after fees and expenses*. Of course, there is no guarantee that this will be the case in future periods.

Some have rightly pointed out certain flaws in Active Share and that funds scoring comparatively low can also add alpha. Those that make conscious top-down decisions to overweight sectors, styles, and other factors, or that choose to combine top-down techniques with bottom-up stock selection, can also add value. But Active Share research provides one new tool for finding active managers who are most likely to add alpha.

So, while the relatively low cost of passive investing may continue to hold some appeal, those who opt strictly for such approaches would do well to consider the full cost. By forgoing active management, in portfolio performance, passive investors are closing themselves off from a potential source of alpha.

* Active Share is a form of methodology used to evaluate a fund's actual performance and volatility against a benchmark. The methodology is not an indicator of how a specific investor's investment will perform.

Asset allocation does not guarantee a profit or protect against loss in declining markets.

A Note about Risk: The value of investments in equity securities will fluctuate in response to general economic conditions and to changes in the prospects of particular companies and/or sectors in the economy. The value of an investment in fixed-income securities will change as interest rates fluctuate and in response to market movements. As interest rates fall, the prices of debt securities tend to rise. As rates rise, prices tend to fall. Bonds are also subject to other types of risk such as call, credit, liquidity, interest rate, and general market risks.

Why the Market Needs Active Management

LORD ABBETT PARTNERS ROBERT FETCH, DIRECTOR OF DOMESTIC EQUITY PORTFOLIO MANAGEMENT, AND WALTER PRAHL, DIRECTOR OF QUANTITATIVE RESEARCH, OFFER THEIR INSIGHTS.

PASSIVE investing continues to gain favor in both retail and institutional markets. While they still lag actively managed alternatives, index mutual funds and exchange-traded funds have posted significant gains in investor market share. The

market collapse in 2008 has only sharpened the debate over the merits of passive versus active management.

Passive management assumes markets are so efficient that average investors cannot hope to consistently outperform. But while markets are largely efficient, mis-

pricing and unjustified swings in investor sentiment occur frequently. In fact, they will never be eliminated completely, and this provides fund managers—at least those who are disciplined, experienced, and willing to venture away from their benchmarks—with opportunities to outperform.

ILLUSTRATION BY DAN PAGE



Are the Markets Efficient?

STRONG FUND MANAGERS ARE NON-CONSENSUS THINKERS, AND I BELIEVE THEY ALSO HAVE A GREATER ABILITY TO RECOGNIZE PATTERNS. THEY CAN SEE AHEAD OF THE CROWD THAT SOMETHING HAS CHANGED THAT MAKES THIS INDUSTRY OR THAT COMPANY BETTER THAN ANOTHER. THESE MANAGERS TEND TO ANTICIPATE WELL WHAT IS GOING TO HAPPEN NEXT.

—RICK RUVKUN, Lord Abbett Partner & Director of Domestic Equity Research

Indexing and the passive approach to investing have their roots in the observations of French mathematician Louis Bachelier, who noticed in 1900 that stock prices moved unpredictably. Economists in the 1950s and 1960s picked up on this, and developed it further, proposing that markets were random and unpredictable because they were efficient. The idea that markets were random and unpredictable was popularized by Princeton professor Burton Malkiel, in his 1973 book, *A Random Walk Down Wall Street*.

According to the “random walk” theory, changes in stock prices show no discernible pattern: plotted on a graph, they look more like the steps of an inebriated sailor trying to find his way back to the ship. This happens because stock prices reflect all *publicly known* relevant information (i.e., they are efficient), and instantaneously change as new information appears.

Of course, if the flow of information is unimpeded and information is immediately reflected in stock prices, “then tomorrow’s price change will reflect only tomorrow’s news and will be independent of the price changes today,” according to Malkiel. By definition, news is “unpredictable and, thus, resulting price changes must be unpredictable and random.”¹ In short, markets are unpredictable because they are efficient.

The idea that markets reflect all relevant information and quickly incorporate any new information came to be known as the Efficient Market Hypothesis (EMH), and was accepted wisdom in the 1960s and 1970s.

Proponents of EMH assume investors are reasonably intelligent. And when the actions of intelligent investors are aggregated in the market, it is very difficult to find stocks that are mispriced. Investors, therefore, will be unable to *consistently* earn above-market returns, unless they take on greater risk. In other words, there are no easy pickings. From this line of thought it then follows that paying somebody to outperform the market makes little sense. Why not buy a low-cost index fund instead?

The rise of passive investing has, understandably, put many active managers on the defensive. But early proponents of EMH did not fault active managers. “It’s important to keep in mind that what the efficient markets discussion was about for so long



was not whether there is sufficient return to active management, because everybody saw that there was a social rationale—the rational allocation of capital—and a private rationale. Nobody seriously disputed that,” said Walter Prah, Lord Abbett Partner & Director of Quantitative Research.

Rather, the original target of the EMH proponents was so-called technical analysis, which assumes that it’s possible to make investment decisions on the basis of past prices and trading volumes alone—a tiny fraction of all the information available about a security. Active management based on analysis of company fundamentals—such as sales, income, cash flow, and the like—was never the target of the original EMH analysis.

A secondary consideration, at least for most investors, is the critical role that active management plays in the primary function of capital markets: capital allocation. The decisions of hundreds of active managers to buy a stock, even in the secondary market, combine in the aggregate to reward companies who are believed to be the most efficient users of capital and, therefore, are more likely to earn the best return. The need to allocate capital rationally, and the need for active management to accomplish this, ensures that active management will always be necessary.

“You can’t have a successful allocation of capital if everybody in the market is investing passively,” Prah said. “In some sense, those who would question the role of active management are denying the capital allocation aspect of the market.”

Or Are They Irrational?

In the late 1970s, some researchers took issue with the assumption that investors are always rational and began looking at the role that psychological factors—such as fear, overconfidence, or pessimism,

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SKILL IN ASSESSING MANAGEMENT IS CRITICAL.

TO A LARGE EXTENT, YOU HAVE TO EVALUATE THE QUALITY OF THE BUSINESS, BUT YOU ALSO HAVE TO EVALUATE THE “JOCKEYS” [I.E., MANAGEMENT] AND THEIR ABILITY TO EXECUTE THEIR PLANS. WITH EXPERIENCE, YOU GET ALMOST A SIXTH SENSE OF WHETHER THEY WILL BE ABLE TO DO A GOOD JOB AND CREATE SHAREHOLDER VALUE.

—MICHAEL SMITH, Lord Abbett Partner & Director of Small Cap Core

for example—play in the movements of the market. This new approach, known as behavioral finance or behavioral economics, received validation in 2002, when economist Daniel Kahneman was awarded a Nobel Prize for his work in this field.

Behavioralists believe that investors, as human beings, are subject to emotions and other influences and that, as a result, they have certain biases. One of these is a tendency to find stories more persuasive than facts and figures. Another is a tendency called “herding,” in which investors are influenced by the behavior of crowds. Another bias is a reluctance to admit mistakes, which leads investors to hold losing stocks too long. And because these tendencies are widespread, they result in the mispricing of stocks.

For some observers, recent events also have helped undermine the view of markets as efficient. In the tech bubble of the late 1990s, for example, investors continued to buy stocks even though valuations had risen to all-time highs, with price-to-earnings ratios reaching triple digits on some. And during the housing bubble of 2006–08, homebuyers (and lenders) in some markets apparently believed prices would continue to rise at double-digit rates indefinitely.²

Some fund managers have grabbed onto behavioral finance as a way of justifying active management, according to Prahl. They’ve become defensive and have exaggerated the market’s inefficiencies.

But because of the “paradox of market efficiency,” that isn’t really necessary.

The Paradox of Market Efficiency

EMH doesn’t mean that markets are *perfectly* efficient. It also doesn’t mean investors are merely calculating machines. Those who originally espoused market efficiency knew investors weren’t completely rational, but as in other academic disciplines, they chose to make simplifying assumptions that enabled them to create mathematical models and make predictions.³ And among some practitioners the belief that markets were mostly efficient gradually morphed into a belief that markets were perfect, according to Justin Fox, author of *The Myth of the Rational Market*. As a result, the conviction that markets are



efficient became associated with a belief in passive management.

But nearly 30 years ago, two economists demonstrated definitively that while markets may be fairly efficient, perfect efficiency is not possible.

In 1980, Sanford Grossman and Nobel laureate Joseph Stiglitz showed that if markets were perfectly efficient—that is, if all prices completely reflected all relevant information—there would be no incentive for investors to obtain the information that the market prices are believed to perfectly reflect. But if there were no incentive, then market prices would not reflect that information—that is, they would not be efficient.

This notion—known as the Grossman–Stiglitz Paradox—means that active management is *needed* to make the markets efficient. If active management disappeared, so would the market’s efficiency.

So, if markets can’t be perfectly efficient, how efficient can they be? Simply put, markets reach the limit of efficiency when the reward for making an investment no longer covers the cost of the information needed to make the investment. Investors in emerging markets, for example, may travel to Asia, Latin America, and Africa as part of their research process because they are likely to be compensated with a large return. As those activities are rewarded less and less with outsized returns, the market is becoming more efficient. [*The risks associated with emerging markets, which stem from their less stable political and economic systems, can include geopolitical and economic events as well as greater price fluctuations and higher transaction costs.*]

This explanation of market efficiency makes clear that not only is perfect efficiency not possible but that it is not a matter of either/or. Contrary to how EMH is often portrayed, said Prah, “there was always a kind of understanding that efficiency is a spectrum, and the paper by Grossman and Stiglitz just made that more explicit.”

The Job of the Active Manager

So, if markets are largely, but not perfectly, efficient, how much inefficiency remains? Again, it’s at least enough to provide an incentive for at least some degree of active management. But that may

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A FIRM THAT IS STEEPED
IN A CULTURE OF
FUNDAMENTAL ANALYSIS.

—RICK RUVKUN

YOU REMEMBER WHAT THE FEAR WAS LIKE [IN THE 2008–09 MARKET SELL-OFF]?

AND YOU KNOW HOW GREAT IT FELT A FEW YEARS AGO WHEN THE MARKET KEPT ON GRINDING UPWARD MONTH AFTER MONTH? WELL, YOU HAVE TO LIVE THROUGH PERIODS LIKE THAT SO THAT YOU DON'T LET YOUR EMOTIONS DICTATE YOUR ACTIONS, AND IT'S DURING THOSE TIMES THAT IT'S IMPERATIVE THAT YOU STICK WITH YOUR INVESTMENT DISCIPLINE.

—ROBERT FETCH, Lord Abbett Partner & Director of Domestic Equity Portfolio Management

be considerable. As Robert Fetch, Lord Abbett Partner & Director of Domestic Equity Portfolio Management, observed, “When you start with the assumption that the market is efficient and try to apply that, you find that there are all kinds of things going on that make no sense—things that don’t correspond to the idea that information is quickly disseminated and reflected in market prices.”

What often drives prices from day to day is not pure rationality. “In the short run,” said Fetch, “it’s that sentiment pendulum that sets prices at the margin. It’s not all based on objective information that has been perfectly disseminated and digested.”

The market is subject to cycles that can extend for longer periods as well. In addition to bull markets and bear markets, there are cycles of investor sentiment. In the late 1990s, for example, many investors poured money into the stock market despite the sky-high multiples, often into dot-com companies that had never turned a profit. On the other hand, more recently, when many blue-chip stocks were available at bargain multiples, investors, in a flight to quality, hurried to bonds or cash instead.

“In March 2009, the S&P 500® Index⁺ was breaking through 700 and headed for 600. If you thought that growth would return to the economy and things would get back to normal in three, five, seven, or even 10 years, then it was the ideal time to buy,” Fetch said. “The upside potential on a return to normal—say, the S&P 500 at 1,300—was probably near 100%. The downside potential was so much less, probably 10–15%. And with a negative return on the index over the previous 10 years, you had to think that was not going to go on much longer. So, you only had one choice to make—to get in. But it was hard to find anybody who wanted to buy a stock.”

In other words, a dispassionate analysis of the situation would have led investors back into the market, but their fears kept them on the sidelines.

Those who remained on the sidelines, however, were not necessarily irrational. If the financial system appears to be collapsing, then moving to a safer haven such as Treasuries makes perfect sense. So, what may appear to be irrationality and inefficiency may be just a difference of opinion.

In any case, it is the job of the active manager to take advantage of opportunities or inefficiencies like these in order to earn higher returns. Inefficiencies may result from swings in investor sentiment or may lurk in certain corners of the market—in small caps, among stocks that are beaten down, or among those whose growth prospects are underappreciated.



How Good Managers Enhance Market Efficiency—and Potentially Earn Higher Returns

If successful, the active manager's search for such inefficiencies can bring a reward in the form of a higher risk-adjusted return. Proponents of the EMH assert that active managers cannot add incremental return without taking on extra risk. But the Grossman–Stiglitz Paradox demonstrates that no market can be perfectly efficient. So, the job of the active manager is not to add return by taking on more risk but to do so without the extra risk, according to Prahl.

“If all we were doing as active managers was generating return by adding on risk, then obviously we wouldn't really be adding any value. The case for active investing has to be not that you seek higher returns by adding risk but that you seek higher returns without adding extra risk.”

Taking Advantage of Inefficiencies Through Discipline and Experience

If market inefficiency stems in part from investor sentiment, exploiting that inefficiency should also involve finding ways to limit this influence. Good managers use a framework or a set of tools that help them to be more objective. That framework helps the manager avoid getting swept up in the swings in investor sentiment. “If you have a discipline, you can take advantage of those

HUMAN NATURE IMPLIES THAT YOU HAVE CERTAIN BIASES, WHICH IN TURN AFFECT THE WAY YOU LOOK AT A STOCK.

BUT I'VE FOUND THAT THE BEST MANAGERS ARE THOSE WHO CAN REDUCE THEIR BIASES. THEY LOOK AT THINGS AS OBJECTIVELY AS THEY CAN. CONTROLLING YOUR BIASES AND HAVING AN OPEN MIND ARE CRITICAL.

—JUSTIN MAURER, Lord Abbett Partner,
Portfolio Manager of Smid Cap Value

I THINK OF IT THIS WAY: PEOPLE WHO GO TO THE MOVIES ALL THE TIME BECOME FAMILIAR WITH PATTERNS IN PLOT LINES. AND OFTEN THEY KNOW HALFWAY THROUGH A MURDER MYSTERY WHO THE VILLAIN WILL TURN OUT TO BE. LIKEWISE, GOOD MONEY MANAGERS HAVE “SEEN ENOUGH MOVIES” TO KNOW HOW THE STORY ENDS.

—RICK RUVKUN

sentiment swings where the inefficiencies are created,” said Fetch.

A good discipline includes knowing when to sell. “You can’t ‘fall in love’ [with a stock]. You have to be unemotional. The tools should help you do that. As a value investor, for example, I should have in mind both a purchase price and a selling price.”

Experience also is critical. “You have to live through those boom and bust periods so that you learn not to let emotions dictate your actions. This is where experience comes to bear.”

Fetch exhorts his younger colleagues to be thankful for the 2008–09 market rout: “I tell them, ‘You’ve had the good fortune to live through this period at the front end of your careers. You’re going to know that ugly recessions can occur, and there can be ugly bear markets, just like certain generations were affected by the Depression.’ So, they should have an awareness that should stay with them their whole lives, and they won’t throw caution to the wind.”

Enhancing Market Efficiency Through “Active Share”

But proponents of EMH hold that there is no free lunch. Beating the market takes effort. And, in fact, research from two professors at the School of Management at Yale University shows that portfolio managers who are more active—that is, who spurn “index hugging”—are most likely to outperform. The authors propose a

¹Burton Malkiel, “The Efficient Market Hypothesis and Its Critics,” Princeton University/CEPS Working Paper No. 91, April 2003.

²Robert Shiller, “How Animal Spirits Drive the Economy,” <http://fora.tv>, 2009.

³Justin Fox, *The Myth of the Rational Market* (HarperCollins Publishers, 2009).

⁴The S&P 500® Index is widely regarded as the standard for measuring large cap U.S. stock market performance and includes a representative sample of leading companies in leading industries. The index is unmanaged, does not reflect the deduction of fees or expenses, and is not available for direct investment.

⁵K.J. Martijn Cremers and Antti Petajisto, “How Active Is Your Fund Manager?” *The Review of Financial Studies* (September 2009).

A NOTE ABOUT RISK: Investing involves risk, including the possible loss of principal. The value of investments in equity securities will fluctuate in response to general economic conditions and to changes in the prospects of particular companies and/or sectors in the economy. Investments in small companies involve greater risks not associated with investing in more established companies, such as business risk, significant stock price fluctuations, and illiquidity. Investing in international securities generally poses greater risk than investing in domestic securities, including greater price fluctuations



metric called “Active Share,” which measures the degree to which a manager ventures away from the fund benchmark.⁵

In a recent article in the peer-reviewed *The Review of Financial Studies*, K.J. Martijn Cremers and Antti Petajisto note that, “Active management, as measured by Active Share, significantly predicts fund performance relative to the benchmark.” Moreover, “Funds with the highest Active Share outperform their benchmarks both before and after expenses, while funds with the lowest Active Share underperform after expenses.” [*This predictor is based on research and is intended to demonstrate the relative performance of an investment versus its benchmark. This is not intended to predict an individual investor’s actual investment outcome or experience.*] (For more information on Active Share, see “Is Stock Picking a Dying Art?” on page 26.)

Conclusion

Active management will always be critical to capital markets. The need for the rational allocation of capital ensures that it will always play a role. Likewise, passive management, which assumes that the market is efficient, relies on active management to make the market efficient. So, some portion of invested funds will always be actively managed. From an investor’s standpoint, then, the question is, which active managers add most to market efficiency and, therefore, are more likely to earn higher returns? Most likely are those who through experience and a tested analytical framework are able to eliminate sentiment from their decision-making and those who are most willing to venture away from their benchmarks.

—Reported by Ron Vlieger

SOMETIMES SMART PEOPLE ARE UNWILLING TO CHANGE THEIR VIEW

BECAUSE THEY DON'T BELIEVE THEY CAN BE WRONG. SO, THERE MUST BE A WILLINGNESS TO LEARN FROM EXPERIENCE. ANOTHER WAY TO THINK OF IT: SKILL IN INVESTING IS ANALOGOUS TO GOOD JUDGMENT. IT CAN BE ACQUIRED, BUT IT CAN'T BE TAUGHT.

—TOM O'HALLORAN, Lord Abbett Partner
& Director of Multi and Small Cap Growth

and higher transaction costs. Special risks are inherent to international investing including those related to currency fluctuations, foreign, political, and economic events. These risks can be greater in the case of emerging country securities. The value of fixed-income securities will change as interest rates fluctuate. As interest rates fall, the prices of debt securities tend to rise. As rates rise, prices tend to fall. No investing strategy can overcome all market volatility or guarantee future results.

Treasuries are debt securities issued by the U.S. government and secured by its full faith and credit. Income from Treasury securities is exempt from state and local taxes.

Lord Abbett does not offer exchange-traded funds (ETFs) or index funds. ETF products, like all investments, are subject to market risk, which may result in loss of principal. Bond ETF products are subject to interest rate, credit, and inflation risk. Index funds are constructed to match, or track, the components of specific market indexes, which can be volatile and can decline significantly in response to adverse issuer, political, regulatory, market, or economic developments.

PLEASE NOTE: The market may not perform in a similar manner under similar conditions in the future.

Asset Allocation:

SETTING THE RECORD STRAIGHT

REASSESSING
THE LANDMARK 1986
BRINSON STUDY

Twenty-five years ago, A STUDY WAS PUBLISHED THAT TODAY SHAPES THE WAY MANY FINANCIAL ADVISORS PERFORM THEIR JOBS. PURPORTED TO SHOW THAT MORE THAN 90% OF A PORTFOLIO'S LONG-RUN RETURN COMES FROM ITS ASSET ALLOCATION, THE STUDY EVENTUALLY BECAME PART OF A RATIONALE FOR A BROAD MOVE AWAY FROM TRADITIONAL ADVISOR PRACTICE. INSTEAD OF RECOMMENDING MUTUAL FUNDS, ADVISORS BEGAN TO FOCUS ON ASSEMBLING PORTFOLIOS FROM PASSIVE VEHICLES SUCH AS INDEX FUNDS AND EXCHANGE-TRADED FUNDS (ETF). THE BELIEF THAT ASSET ALLOCATION IS THE PREDOMINANT DRIVER OF RETURNS BECAME COMMON AMONG INSTITUTIONAL AND RETAIL INVESTORS AS WELL.



“INVESTORS BEGAN TO
FOCUS ON THEIR ASSET
MIXES RATHER THAN ON
BUYING HOT FUNDS....
SOON EVERY MAGAZINE
WAS PRINTING MODEL
ASSET ALLOCATIONS.”

— MORNINGSTAR

OVER THE YEARS, MANY HAVE EXPRESSED MISGIVINGS ABOUT THE STUDY, AUTHORED BY GARY P. BRINSON, L. RANDOLPH HOOD, AND GILBERT BEEBOWER. BUT THE QUESTION OF THE PRECISE ROLE OF ASSET ALLOCATION HAS REMAINED UNANSWERED. IN 2010, HOWEVER, IBBOTSON ASSOCIATES, A FIRM THAT SPECIALIZES IN ASSET ALLOCATION, PUBLISHED A STUDY THAT BRINGS NEW CLARITY TO THE DEBATE. IF CORRECT, THESE FINDINGS PRESENT ENORMOUS IMPLICATIONS FOR THOSE WHO FORGO ACTIVELY MANAGED STRATEGIES IN FAVOR OF ETF-BASED PORTFOLIOS. WALTER PRAHL, LORD ABBETT PARTNER & DIRECTOR OF QUANTITATIVE RESEARCH, **EXAMINES THE CONTROVERSY.**

The 90% Solution

Published in 1986, “Determinants of Portfolio Performance” was intended to help pension plans choose between active and passive managers. The Brinson study (or “BHB study,” as it came to be known), examined the quarterly returns of 91 pension plans over the 10-year period from 1974 to 1983.

The authors found that a pension plan’s long-term, or static, asset allocation accounted for 93.6% of the volatility of returns from quarter to quarter. That is, quarterly variations resulted largely from how the plan allotted its assets among stocks, bonds, cash, and other alternatives. (A 1991 update reduced the 93.6% figure to 91.5%. On the basis of the two studies, the authors concluded that “more than 90%” of return variability comes from asset allocation.)

That such an abstruse finding would have any effect on investment practices, let alone one so lasting, is hard to believe. Yet years after the BHB study, as index funds and ETFs became more available, many in the investment world latched onto the 90% figure. But instead of interpreting it in relation to quarterly volatility, many believed it referred to long-run outcomes. It therefore became received wisdom for advisors, institutions, and others that static allocation was practically all-important for achieving desired long-term returns.

Right from the start, however, some had qualms with the study. Some noted, for example, confusion about return variation versus return outcomes.¹ Others pointed out that, on average, static allocation accounts for fully 100% (not 91.5%) of return outcomes.²



But once the misinterpretation became conventional wisdom, the implication became clear: If performance comes largely from the static allocation, then why bother with actively managed funds, which seek to add value through stock picking or sector rotation? Why not focus instead on assembling portfolios with risk-appropriate asset mixes? If performance is driven by the selection of asset classes and not from the selection of securities or from other forms of active management, then why not opt for low-cost ETFs?

Asset allocation, therefore, became “the secret to successful investing,” according to Morningstar. “Investors began to focus on their asset mixes rather than on buying hot funds.... Soon every magazine was printing model asset allocations.”³

This new focus on asset allocation did bring at least one benefit. Because it entailed taking a long-term, strategic approach, it also produced a welcome sense of discipline. Instead of chasing after performance, advisors increasingly worked with clients to set objectives and make plans, with the intention of sticking to them.

Asset Allocation: Static or Tactical?

That some confusion would result from the BHB findings was perhaps inevitable. The original study, in particular, could have better distinguished volatility from performance. And, as we’ll see, the BHB study credits asset allocation with the large amount of variation that is attributable to the market itself. But, as if this weren’t enough, marketers also added to the confusion by capitalizing on some misunderstanding about two types of asset allocation.

The BHB study’s findings addressed *static allocation*. Also referred to as policy, or strategic, allocation, a plan’s static allocation is set by an investor or policy committee after considering the desired return and risk tolerance. When the share of one or more asset classes drifts too far, the investor may “rebalance” periodically. This may occur annually, but the goal is to return the asset classes to their original apportionment, not to capitalize on current market conditions.

Tactical allocation, on the other hand, involves shifting assets more frequently, based on current market trends. The BHB study’s 90% figure did not apply to these short-term moves. In fact, the study classified this as a form of active management, along with security selection, and found that it contributed little to quarterly returns.

Some blurring of the lines continues today. One marketing flier, for example, offered strategic model portfolios based on seven- to 10-year investment

“IN OTHER WORDS,
THE RESULTS OF
THE BRINSON STUDY...
ARE A CASE OF
A RISING TIDE
LIFTING ALL BOATS.”

— ROGER IBBOTSON AND
PAUL KAPLAN

THE BHB STUDY TOOK THE THREE PARTS OF A RETURN—MARKET MOVEMENT, STATIC ALLOCATION, AND ACTIVE MANAGEMENT—AND COMBINED THE FIRST TWO IN ORDER TO COMPARE THEM TO THE THIRD.

outlooks while touting that an investment committee of analysts and strategists meets regularly to “identify investment opportunities.” Allocations come from the committee’s “analysis of various economic, political, regulatory, and global issues.”

“Tactical asset allocation is not what Brinson was talking about at all,” said Walter Prah, Lord Abbett Partner & Director of Quantitative Research. “[Brinson] was clearly talking about static policy targets toward which a portfolio is periodically rebalanced. The claim of the Brinson study is that static allocation, not tactical allocation, accounts for over 90% of the variation in returns. Tactical allocation is explicitly part of the remainder that [Brinson et al.] say explains very little of the variation in portfolio returns.”

If Not 90%, How Much? Inching Toward the Answer

Not long after the BHB study was published, analysts began to express misgivings. One pointed out, for example, that by focusing on quarterly returns, the study overlooked the importance of compounding.⁴ Over a long period, even small degrees of outperformance by an active manager can add significantly to returns. But these objections lacked a rigorous methodology.

What was needed was a means for correctly dissecting returns, that is, for isolating the effects of various investment decisions—everything from the static allocation to the selection of securities. In 1991, researchers Chris Hensel, Don Ezra, and John Ilkiw proposed that to isolate the impact of any investment decision, it would be necessary to find a proper basis for comparison.⁵ This basis can be another portfolio that represents an alternative decision or one that represents no decision at all.

The choice of this alternative portfolio, however, is critical. In practice, it is usually the average of what other plans or funds are holding. Another option is to compare the effect of the overall movements of capital markets.

Using major benchmarks to represent the capital markets as a whole, Ibbotson and colleague Paul Kaplan, director of the Morningstar Center for Quantitative Research, tested this idea in 2000.⁶ They found that, indeed, the quarterly variation of the S&P 500® Index⁷ explained 75% of funds’ monthly movements. Using an average of the other major benchmarks, they found that it explained 79% of the monthly variation.

In effect, because the BHB study neglected to factor out market movement, what it actually showed was that the variability of returns was due merely to



the choice to invest, to hold securities instead of cash.

The result was that the role of the static allocation was overstated. The BHB study attributed quarterly variation almost entirely to static allocation, when in reality it was due largely to market movements. In effect, it conflated the effects of asset allocation with those of general market movements. “In other words,” said Ibbotson and Kaplan, “the results of the Brinson [study]...are a case of a rising tide lifting all boats.”⁸

Drug A versus Drug B

The work by Hensel et al. and by Ibbotson and Kaplan showed that the methodology of the BHB study was faulty, or at least unsuitable. That is, it was not appropriate for the question it claimed to answer.

“There’s a sort of methodological ambiguity here,” said Prah. “What the BHB study is doing is essentially performance attribution, and this is inherently hierarchical in the sense that whatever you attribute performance to first will account for most of the performance.”

To understand this, it is helpful to think of the BHB study as analogous to one that tests the effectiveness of two drugs, Prah explained. The disease in question is one like pneumonia, from which most patients, say 85%, would eventually recover, whether treated or not. The researchers administer Drug A to one group of patients and then administer both Drug A and Drug B to a similar group of patients. In the first group, 90% recover, or 5% more than would have without treatment. In the second group 95% recover, or 5% more than would have recovered if treated only with Drug A. Nevertheless, the researchers mistakenly conclude that Drug A is more effective.

This conclusion is clearly wrong, but this is basically what the BHB study did. In the drug study, there were three factors behind the 95% recovery rate: untreated recovery, recovery resulting from Drug A, and recovery resulting from Drug B.

What the BHB study did was to take the three parts of a return—market movement, static allocation, and active management—and combine the first two in order to compare them to the third. “The BHB study essentially credits static allocation with almost the entire return, including the market return,” said Prah, “and then credits active management with only an incremental return.”

That’s not to say that the BHB study’s methodology is completely invalid. It depends on the question being asked. “If you’re asking how many people survive when they’re given Drug A, 90% is the correct answer,” Prah said. “Where the mistake occurs is in comparing the incremental survival rate, 5% from Drug B, to the overall survival rate, 90%. But if you’re asking about the relative contribution of these two medicines, this is not the correct methodology.”

In the drug example, it’s obvious that the conclusion is incorrect. Confusion

“ASSET ALLOCATION
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EQUAL LEVEL OF
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FOR AROUND 20%.”

— XIONG, IBBOTSON, ET AL.

“THE CLAIM OF IBBOTSON IS VERY SIMPLE, THAT THE CONTRIBUTIONS OF STRATEGIC ALLOCATION AND ACTIVE MANAGEMENT ARE OF APPROXIMATELY EQUAL MAGNITUDE.”

— WALTER PRAHL
LORD ABBETT PARTNER & DIRECTOR
OF QUANTITATIVE RESEARCH

surrounding the BHB study, however, arose in part because, in contrast to this hypothetical drug study, attributing performance first to asset allocation and then to active management seems to make intuitive sense since that’s the order of the investment process, said Prahl. It’s natural to think of static allocation as taking place prior to any active management that occurs.

Asset Allocation and Active Management: Equally Important?

It was this methodological confusion and the lack of an analytical framework for quantifying these effects that had long left the primary question unanswered: Which is more important to portfolio returns: asset allocation or active management?

But this question was finally answered in 2010.⁹ Sampling three peer groups—U.S. equity funds, balanced funds,¹⁰ and international equity funds—over a 10-year period (1999–2009), Ibbotson and his colleagues at Ibbotson Associates found two results.

First, they confirmed that market movement is the primary reason for the variability of short-term performance. “[T]he market movement component accounts for about 80% of the total return variations,” the authors wrote.

Second, once market movement is netted out, active management and static allocation are *roughly equal in their contribution to return variability*, though this fluctuates somewhat from peer group to peer group. Adjusting for the interaction effect, “asset allocation policy return and active portfolio management have an equal level of explanatory power,” said the authors, “with each accounting for around 20%”¹¹ (see Chart 1).

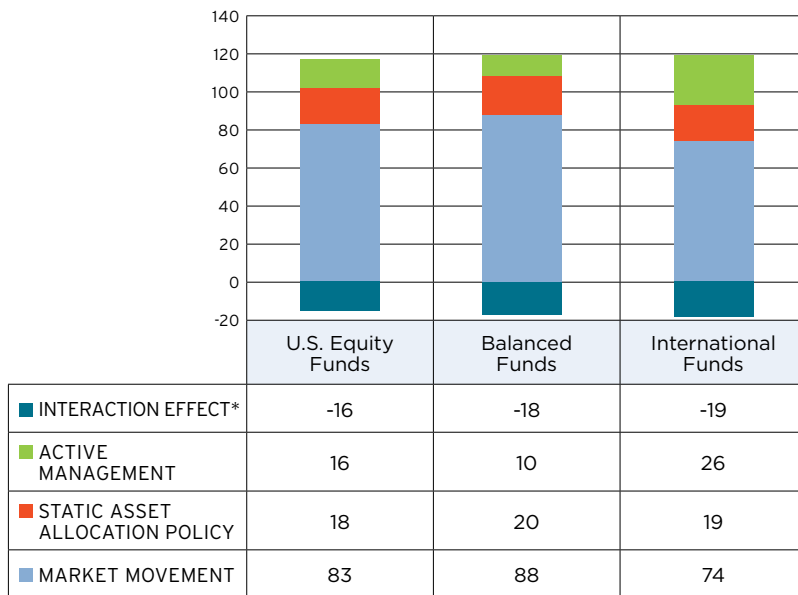
Ibbotson and his colleagues confirmed this using a cross-section approach. That is, instead of explaining fund performance through time, they looked at the variation of performance across funds at one point in time. By examining the variation across portfolios, which naturally removes the effect of market movements through time, they found that the remaining *variation was explained equally by static allocation and by active management*.¹²

“Nobody is saying that strategic allocation is unimportant,” said Prahl. “The claim of Ibbotson is very simple, that the contributions of strategic allocation and active management are of approximately equal magnitude.”

With these findings, it appears that the confusion surrounding the issue of asset allocation has been cleared away. Ibbotson and his colleagues have shown that the debate pitting asset allocation against active management is now moot. It is not a matter of either/or but both/and.



CHART 1. The Roles of Static Allocation and Active Management Are Roughly Equal
Decomposition of Total Return Variation (%), 1999-2009



Source: James X. Xiong, Robert Ibbotson, Thomas M. Idzerek, and Peng Chen.

*Interaction effect refers to the effect independent variables have when that effect is different from their main effects. The interaction effect is a balancing term that makes the percentages add to 100. For the purposes of this discussion, it does not alter the primary findings.

Stock Picking, Factor Timing, and Asset Allocation

If static allocation is not all-important but is instead only equally important with active management, what is the implication for investors? For those who choose to rely on portfolios of passive vehicles, and thereby close off any possibility of capturing alpha¹³ from active management, the answer is clear: this choice is not nearly as inconsequential as they have been led to believe.

While these investors may think they will at least benefit from the “equal importance” of asset allocation, even that may be diluted. What many marketers

MODEL PORTFOLIOS ARE IN MANY CASES ENGAGING IN A FORM OF ACTIVE MANAGEMENT KNOWN AS TACTICAL ASSET ALLOCATION, ADJUSTING ASSET CLASS WEIGHTS IN RESPONSE TO MARKET CONDITIONS.

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of model portfolios describe as “asset allocation” is not what the BHB and Ibbotson studies referred to at all. As noted above, these model portfolios are in many cases engaging in a form of active management known as tactical asset allocation, adjusting asset class weights in response to market conditions.

A natural question, then, is: what performance might an investor expect from this form of active management versus other alternatives? Broadly speaking, there are two types of active management: bottom-up and top-down. In the first category is stock-picking, or more generally, security selection. In the second is factor-timing. Factor timing includes over- and underweighting industry sectors, capitalization sizes, or other such factors. Tactical asset allocation applies factor timing to a portfolio’s asset mix.

So, how does the performance of these two approaches compare? Here the concept of Active Share proves useful. Developed by Yale professor Martijn Cremers and New York University professor Antti Petajisto, Active Share measures the degree to which an actively managed equity portfolio that takes the first approach—picking stocks—is truly active.

Importantly, the professors found that portfolios scoring high on Active Share are also more likely to outperform their benchmarks. The Active Share literature has demonstrated that although both types of active management can add value, portfolio managers who are highly active stock pickers are able, on average, to do so more consistently. (See “Is Stock Picking a Dying Art?” on page 26.)

For those invested in model portfolios, this is critical. If these portfolios

¹Unpublished study by Jennifer and John Nuttall, cited by Roger Ibbotson in “The Importance of Asset Allocation,” *Financial Analysts Journal* (March/April 2010).

²Roger G. Ibbotson, “The Importance of Asset Allocation,” *Financial Analysts Journal* (March-April 2010).

³Morningstar, Interactive Classroom, Course 504, “Asset Allocation Is ‘It,’” www.morningstar.com, 2006.

⁴Compounding refers to the ability of an asset to generate earnings, which are then reinvested in order to generate their own earnings. In other words, compounding refers to generating earnings from previous earnings. Compounding does not account for the effect of taxes, investment fees, or expenses, which would lower performance.

⁵Chris R. Hensel, D. Don Ezra, and John H. Ilkiw, “The Importance of Asset Allocation,” *Financial Analysts Journal* (July/August 1991).

⁶Roger G. Ibbotson and Paul D. Kaplan, “Does Asset Allocation Policy Explain 40, 90, or 100 Percent of Performance?” *Financial Analysts Journal* (January/February 2000).

⁷The S&P 500[®] Index is widely regarded as the standard for measuring large cap U.S. stock market performance and includes a representative sample of leading companies in leading industries. The index is unmanaged, does not reflect the deduction of fees or expenses and is not available for direct investment.

⁸Ibbotson and Kaplan, *op. cit.*

⁹James X. Xiong, Roger G. Ibbotson, Thomas M. Idzorek, and Peng Chen (Ibbotson Associates), “The Equal Importance of Asset Allocation and Active Management,” *Financial Analysts Journal* (March-April 2010).

¹⁰A balanced fund is a mutual fund that invests in both stocks and bonds. Balanced funds often attempt to provide income and capture price appreciation while maintaining a relatively conservative orientation.

¹¹Xiong et al., *op. cit.*



engage in tactical allocation, investors are buying into a form of active management, said Prahl. So, these practices can't be defended by referring to the merits of static allocation. Moreover, not even the original erroneous interpretation of the BHB study would suggest that this approach offers any fundamental advantage over other forms of active management.

"What the Active Share research has revealed is that managers relying on market timing are less likely, on average, to add value than managers who engage in stock picking," Prahl said. For those opting for passive portfolios, "stock picking is a lot to give up. That's what the Active Share literature shows," he added.

So providers of model portfolios really have three problems to address, Prahl said. "First, it was never actually appropriate to cite the BHB study as a justification for their particular form of active management, even before the devastating Ibbotson critique. Second, that critique has made the use of this study even more problematic. And third, the... Active Share research that is actually relevant to the question at hand leads to exactly the opposite conclusion as has been alleged."

After 25 years of misunderstanding, the need to correct the record is long overdue. As Ibbotson has written: "The time has come for folklore to be replaced with reality. Asset allocation is very important, but nowhere near 90% of the variation in returns is caused by the specific asset allocation mix. Instead, most...variation comes from general market movement, and...active management has about the same impact on performance as a fund's specific asset-allocation policy."¹⁴

—Reported by Ron Vlieger

**“FOR THOSE OPTING FOR
PASSIVE PORTFOLIOS,
STOCK PICKING IS A LOT
TO GIVE UP. THAT’S WHAT
THE ACTIVE SHARE
LITERATURE SHOWS.”**

— WALTER PRAHL

¹² Xiong et al., *op. cit.*

¹³ Alpha refers to the return of a portfolio that is attributable to the efforts of an active manager. In many cases, alpha may be negative.

¹⁴ Ibbotson, *op. cit.*

IMPORTANT INFORMATION

Asset allocation does not guarantee a profit or protect against loss in declining markets. The process of rebalancing may carry tax consequences.

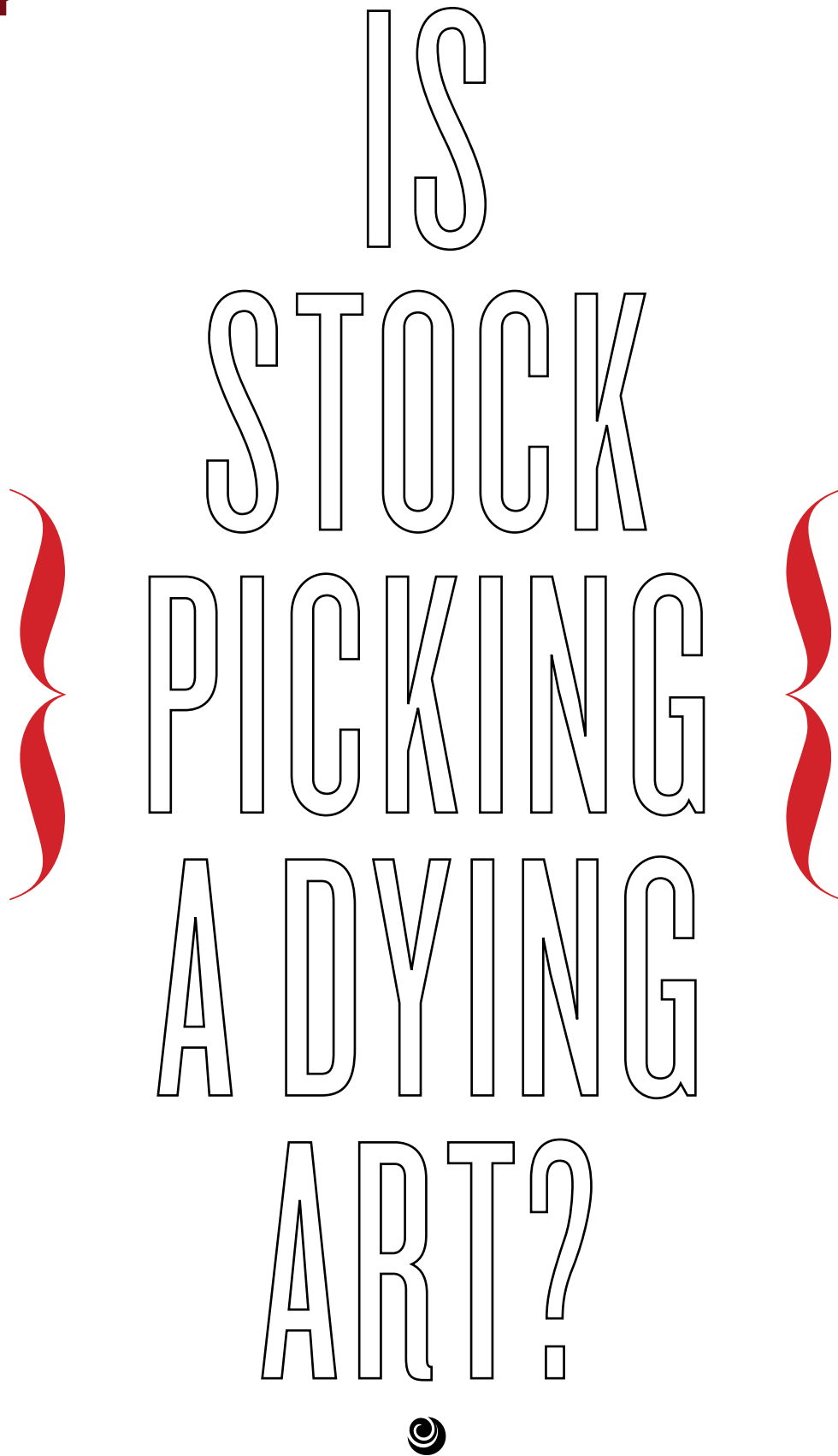
The value of investments in equity securities will fluctuate in response to general economic conditions and to changes in the prospects of particular companies and/or sectors in the economy. Investing in international securities generally poses greater risk than investing in domestic securities, including greater price fluctuations and higher transaction costs. Special risks are inherent to international investing, including those related to currency fluctuations and foreign, political, and economic events. The value of an investment in fixed-income securities will change as interest rates fluctuate and in response to market movements. As interest rates fall, the prices of debt securities tend to rise. As rates rise, prices tend to fall. No investing strategy can overcome all market volatility or guarantee future results.

Lord Abbett does not offer index funds or exchange traded funds (ETFs). An ETF is a security that tracks an index, a commodity, or a basket of assets like an index fund, but trades like a stock on an exchange. ETFs experience price changes throughout the day as they are bought and sold. ETF products, like all investments, are subject to market risk, which may result in loss of principal. Bond ETF products are subject to interest rate, credit, and inflation risk. Index funds are constructed to match, or track, the components of specific market indexes, which can be volatile and can decline significantly in response to adverse issuer, political, regulatory, market, or economic developments.

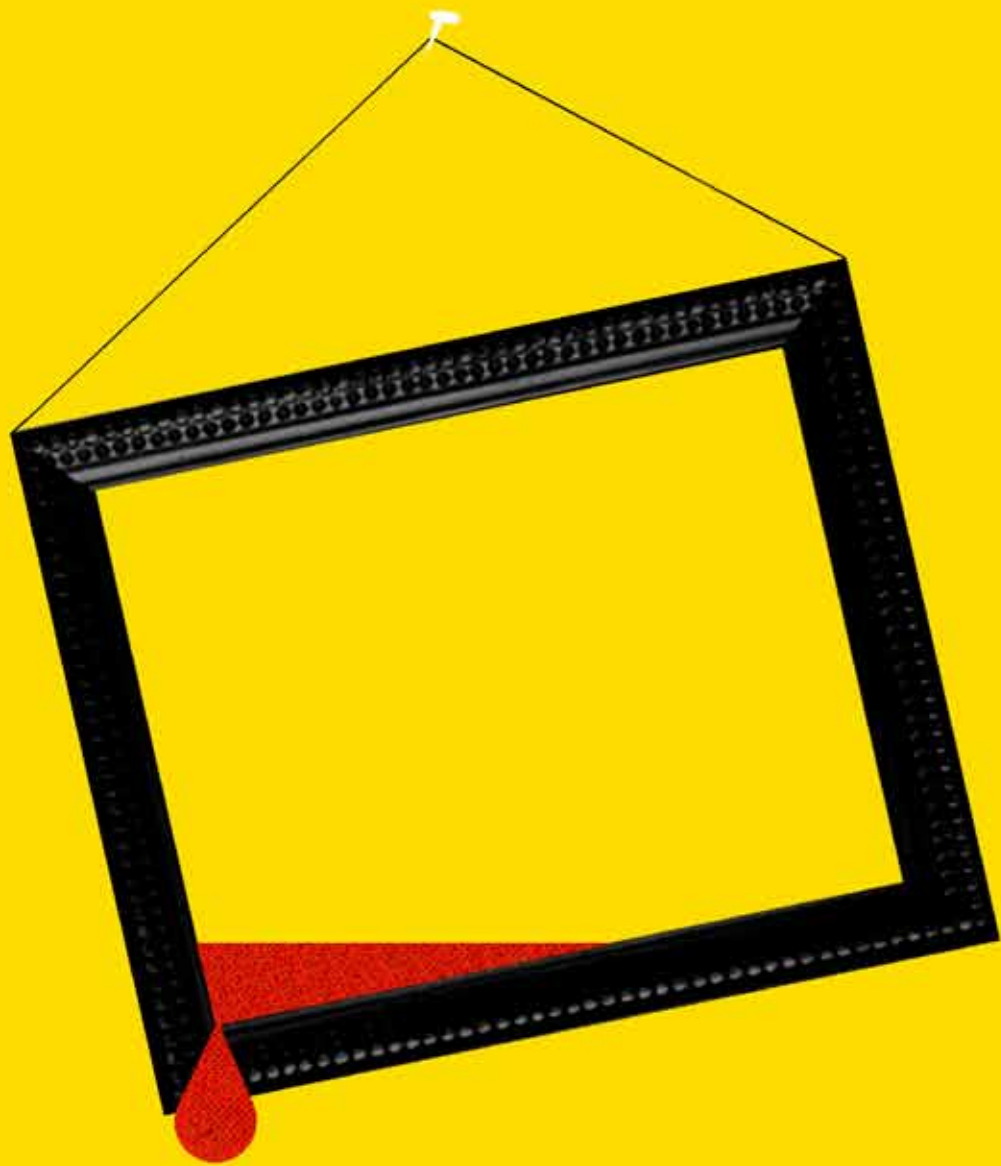
Active share is a methodology used to evaluate a fund's actual performance and volatility against a benchmark. The methodology is not an indicator of how a specific investor's investment will perform.

This should not be used as a tool or evaluation in making any investment decision. We strongly recommend that you consult with your financial advisor before making an investment decision.

IS
STOCK
PICKING
A DYING
ART?



Stock picking is an exercise in futility, say some analysts, but recent research, as well as the paradoxical nature of securities markets, suggests otherwise.



It's no secret that since the subprime crisis, the stock market has experienced some dramatic ups and downs. During these roller-coaster rides, correlations among stocks have risen sharply, approaching levels not seen since the crash of 1987.

While such a rise during a period of distress is not unexpected, high correlations have, at times, persisted, even as the crisis has eased. This has caused concern among some analysts.¹ When stock prices move in concert, it can mean that fundamentals such as earnings and growth rates are being overshadowed by other factors. If stock prices are being moved by something other than fundamentals, then selecting equities on the basis of fundamentals may appear to be futile. This frustration led one analyst to complain in *The Wall Street Journal* that, "Stock picking is a dead art form."²

Lord Abbett Partners **Walter Prah**, Director of Quantitative Research; **Dan Frascarelli**, Director of Large Cap Core and Large Cap Value; **Robert Fetch**, Director of Domestic Equity Portfolio Management; and **Tom O'Halloran**, Director of Multi and Small Cap Growth, examine the merits of the "stock picking is dead" argument.

Stock Pickers versus "Macro" and Other Forces

Intra-market correlations have risen primarily as a result of "macro" forces, according to *The Wall Street Journal*. These include not only macroeconomic factors but also political events and increased regulation. Forces such as these have resulted in "risk on/risk off" behavior, with investors shifting into stocks on positive news and shifting out when news is negative.

While macro forces move stocks by changing the outlook for fundamentals such as sales and earnings, many observers believe the growing prominence of exchange-traded funds (ETFs) and index

funds is also making stock picking more difficult. With index-related trading now accounting for 30% of daily volume, investors selecting stocks on the basis of company fundamentals can get swamped, say some analysts. If investors suddenly decide to shift out of the technology sector, for example, a technology index fund will need to sell in large volumes, potentially pushing

example, have been employing it in some of their analyses, and in November 2010, the company hosted an online seminar with Petajisto on his latest research.

Professor Petajisto updated his earlier effort with Professor Cremers to see whether the previous results still held and to see how stock pickers performed through the credit crisis. Examining data through

Petajisto found that stock pickers also outperformed during the financial crisis, countering the "stock picking is dead" thesis.

down the price of all companies in the index, whether they are profitable or not.

Although the idea that stock picking no longer works may seem reasonable, it is directly countered by some widely respected research, according to Walter Prah. In particular, work on a concept called "Active Share" shows that stock pickers have historically outperformed not only passive investing but other forms of active management as well. (For a more in-depth discussion of Active Share, see "How Active Is Your Fund Manager?" *The Lord Abbett Review*, Winter 2010.)

Developed by professors K.J. Martijn Cremers of Yale University and Antti Petajisto of New York University, the concept of Active Share³ has been around for a few years, but only recently has it begun to gain broader acceptance. Analysts at the mutual fund rating company Morningstar, for

2009, he confirmed the earlier finding that funds that are most active in picking stocks repeatedly beat their benchmarks.

He concludes: "I find that the most active stock pickers have been able to add value to their investors, beating their benchmark indexes by about 1.26% per year after all fees and expenses...Economically, this means that there are some inefficiencies in the market that can be exploited by active stock selection."⁴

But more significantly, Petajisto found that stock pickers also outperformed during the financial crisis, countering the "stock picking is dead" thesis. "In spite of unprecedented turmoil, many of the categories performed similarly to their historical averages," he wrote. "The average active (non-index) mutual fund lost to its benchmark by -0.51% per year net of expenses... Stock pickers continued to outperform by 0.97% per year."



Stock Picking Tends to Beat Other Forms of Active Management

Active Share is a simple concept that entails comparing the holdings and weightings of a fund in order to provide a numerical measure of the degree to which the fund diverges from its benchmark. That is, it provides one measure of just how active an active manager is.

The score can range from zero for a fund that matches its benchmark perfectly to 100 for one with no overlap whatsoever. Active Share can, therefore, be interpreted as the portion of a portfolio that differs from the benchmark.

In the earlier Cremers and Petajisto paper, the professors contrast Active Share with tracking error,⁵ which is a more conventional measure of active management, and argue that the two measures are complementary, with one measuring stock picking and the other measuring more macro-oriented approaches. Macro-oriented approaches may include, for example, overweighting particular sectors at different points in the business cycle. Others may overweight large caps or small caps.

Using these two dimensions, Petajisto

classifies actively managed funds into five groups. (See Chart 1.) “Stock Pickers” rely strictly on stock selection and don’t attempt to overweight macro factors such as industry sectors. “Concentrated” managers combine the two dimensions (stock selection and factor weighting), scoring high on both Active Share and tracking error.

“Factor Betting” funds rely little on stock picking, but score high on tracking error as a result of overweighting macro factors. The fourth group, “Moderately Active,” falls into the middle quintiles on both Active Share and tracking error. The fifth group, “Closet Indexers,” do little of either stock picking or factor weighting.

While Active Share has been used to defend the value of all types of active management, it is really defending one particular form, said Prah. “Many commentators are frankly missing the main conclusion of the research, which is that investment managers doing stock picking outperform on average, while those doing macro and sector rotation do not. This conclusion is based on the fact that ‘Active Share’ is correlated with manager performance, while tracking error is not.”

That’s not to say that value can’t be added through macro and sector rotation, Prah said. “Our own portfolio managers practice these approaches to different degrees, and have often added significant value this way.” But among managers as a whole, according to Cremers and Petajisto, stock picking has been more reliably associated with outperformance.

How Do Stock Pickers Outperform When Correlations Are High?

When stock prices are driven by macro forces, how is it possible that a pure stock-picking approach is able to withstand these surges? Individual stock returns can be thought of as consisting of two components, one systematic and the other nonsystematic. The former reflects macro shocks, sector developments, regulatory changes, and the like, while the latter reflects changes in the prospects of an individual company or its valuation relative to the market as a whole.

“When the volatility of the first component increases, so that movements of that component are larger in magnitude, we will see an increase in correlation among stocks,”

CHART 1. Mutual Funds Can Be Classified by Type and Degree of Active Management

Active Share Quintile	Tracking Error Quintile					Group Label
	Low	2	3	4	High	
High						Stock pickers
4						Concentrated
3						Factor bets
2						Moderately active
Low						Closet indexers

Source: Antti Petajisto, “How Active Is Your Fund Manager? Active Share and Mutual Fund Performance,” Morningstar Webinar, November 11, 2010.

said Prah. “But that doesn’t mean that the nonsystematic component has gone away or even become smaller. It just means that the systematic component will be contributing a larger share to overall stock price movement than the nonsystematic component.”

So, when the market becomes volatile, the contribution of the idiosyncratic component becomes relatively smaller. This contribution won’t change in the absolute sense, but the ability of stock pickers to outperform will be smaller relative to overall market volatility, according to Prah.

“This is exactly what Petajisto found: the performance difference between high Active Share managers and low Active Share managers remained in the same range as its previous historical averages,” Prah explained, “despite the fact that overall market returns were much more volatile.” Moreover, the Petajisto results suggest that the risk management practices of stock pickers have been adequate, on average, to prevent high systematic risk from swamping relative performance, Prah added.

Seeing the Trees and the Forest

The supposed demise of stock picking has led some investors to opt for macro-oriented mutual funds, according to *The Wall Street Journal*, and similarly oriented hedge funds have also been springing up.

But if Cremers and Petajisto are right, these investors may be disappointed. Top-down approaches are difficult to implement, said Robert Fetch, who applies his 36 years of experience to heading up Lord Abbett’s domestic equity team. Expected trends in macro factors—interest rates, economic growth, and the like—are often reflected in market prices too quickly for investors to take advantage. And, on the other hand, forecasts of macro factors can often be wrong.

Even political developments and their ramifications can be hard to foresee. So, portfolio managers who have recently begun

developing networks in Washington to get a jump on regulatory shifts may run into difficulties, said Fetch. One obvious example, the Affordable Care Act, signed into law in March 2010, contains many unknowns, and its likely impact is not fully understood. So, “being consistently right on the macro factors is difficult,” especially for those that lack experience, said Fetch.

If relying strictly on macro calls is risky, combining this dimension of active management with Cremers and Petajisto’s other dimension, stock picking, has been fruitful for some. That is, approaches that combine a top-down view with bottom-up fundamental research also have the potential to

outperform. Dan Frascarelli, who manages the Lord Abbett Classic Stock Fund, explicitly takes macro factors into account. He and his team look for catalysts that they believe will produce earnings growth greater than that of their universe, the Russell 1000® Index.⁶ These searches focus on three categories: company-specific, industry-specific, and economic. Ideally, the team’s picks will have catalysts in at least two categories, but “if they’re present in all three, that puts us in a position that is potentially stronger,” Frascarelli said.

If relying strictly on macro calls is risky, combining this dimension of active management with stock picking has been fruitful for some.

fect earnings—and for long periods. The earnings of a value company, for example, probably won’t grow by 30% a year over the long term, but they can do so when conditions are right, such as during an economic recovery. Often such value companies employ extensive operating leverage, which makes earnings decline sharply when times are tough, but can cause them to rebound sharply when recovery occurs.

In contrast, growth companies become more attractive when the economy slows down. “These cycles in which growth outperforms or value outperforms can last as long as six or seven years,” said Frascarelli, who also manages Lord Abbett’s Affiliated

outperform. Dan Frascarelli, who manages the Lord Abbett Classic Stock Fund, explicitly takes macro factors into account. He and his team look for catalysts that they believe will produce earnings growth greater than that of their universe, the Russell 1000® Index.⁶ These searches focus on three categories: company-specific, industry-specific, and economic. Ideally, the team’s picks will have catalysts in at least two categories, but “if they’re present in all three, that puts us in a position that is potentially stronger,” Frascarelli said.

The business cycle is an example of an economic catalyst that can dramatically af-

Fund and Large Cap Value strategy.

Taking industry and economic catalysts into account, however, doesn’t relieve the analyst of the need to do solid company-level research. “With our approach, a bottom-up analysis is primary,” Frascarelli said. “The fundamentals have to be there.”

While some portfolio managers explicitly combine the two dimensions of active management, even a more pure stock-picking approach cannot ignore the big picture. The credit crisis has brought this point home even for some celebrated veteran investors. (*continued on page 32*)



Lord Abbett's Equity Funds and Active Share

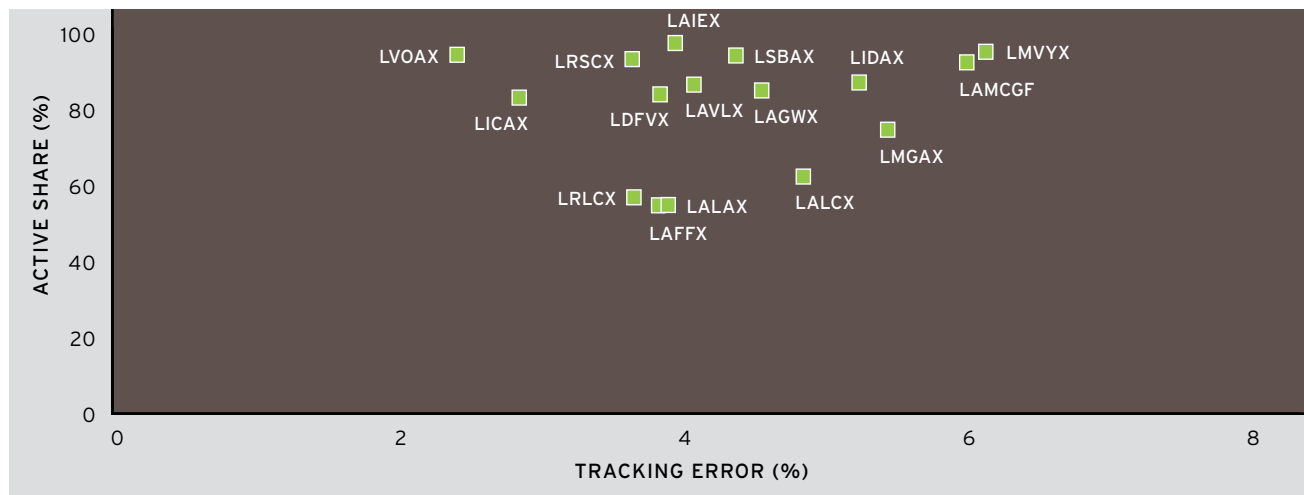
Media coverage of Cremers and Petajisto's research has tended to reduce the concept of active management to Active Share, ignoring the professors' other dimension, "factor betting." Factor betting involves decisions to over- or underweight sectors, company size, style (e.g., growth versus value), and other factors that are believed to influence performance. These weighting decisions result in tracking error, which the professors use as a proxy for this dimension of active management.

At Lord Abbett, portfolio managers are encouraged to add value by taking advantage of investment opportunities not reflected in the benchmarks. Managers are not expected to match the sector weightings of their benchmarks unless client guidelines mandate that they do so. Nevertheless, some funds have scored comparatively low on the Active

Share measure. (Cremers and Petajisto consider 60% the lower bound for truly active stock pickers.)

Some researchers have argued, however, that large cap funds have greater difficulty scoring high on Active Share while simultaneously calibrating systematic risk exposures such as sector allocation, market beta, or market capitalization. Large cap indexes are typically much more concentrated than small cap indexes, with the result that a small number of mega-cap stocks play a dominant role in determining the risk characteristics of the overall index. As a result, large cap managers may find it difficult to simultaneously achieve both the systematic exposures that they intend and a high Active Share. One study, for example, suggests that large cap funds must keep their Active Share 10-20% lower to avoid introducing unintended systematic biases.

CHART 2. Lord Abbett Funds Score High on Active Management



Source: Lord Abbett.

Fund (Ticker)	Tracking Error (%)	Active Share (%)	Fund (Ticker)	Tracking Error (%)	Active Share (%)
Fundamental Equity (LDFVX)*	3.83	82.7	Small Cap Value (LRSCX)	3.64	91.7
Affiliated (LAFFX)	3.82	54.0	Small Cap Blend (LSBAX)	4.36	92.6
Classic Stock (LRLCX)	3.65	56.0	Developing Growth (LAGWX)	4.54	83.6
Stock Appreciation (LALCX)	4.83	61.3	Value Opportunities (LVOAX)	2.42	92.8
Mid Cap Value (LAVLX)	4.07	85.2	Large Cap Value (LALAX)	3.89	54.2
Micro Cap Growth (LAMCGF)*	5.97	90.9	International Opportunities (LAIEX)	3.94	95.9
Micro Cap Value (LMVYX)*	6.10	93.7	International Core (LICAX)	2.85	81.7
Growth Opportunities (LMGAX)	5.42	73.5	International Dividend Income (LIDAX)	5.22	85.7

Source: FactSet, and Zephyr StyleADVISOR. Active Share data are as of September 30, 2011. Tracking error data cover the 12 months ended September 30, 2011, and are based on monthly gross returns.

*All fund returns are Class A shares, except Fundamental Equity - Class C shares and Micro Cap Growth and Micro Cap Value - Class I shares.

David Einhorn, for example, whose hedge fund Greenlight Capital took a high-profile short position on Lehman Brothers before the firm's collapse, told the Value Investing Conference a year after the crisis peaked late in 2008 that, "I have learned...that it isn't reasonable to be agnostic about the big picture. For years I had believed that I didn't need to take a view on the market or the economy because I considered myself to be a 'bottom-up' investor."

Einhorn continued: "Having my eyes open to the big picture doesn't mean abandoning stock picking, but it does mean . . . worrying about what may be brewing in certain industries, and when appropriate, buying some 'just-in-case' insurance for foreseeable macro risks even if they are hard to time."

Tom O'Halloran, whose Developing Growth Fund has an Active Share score of 83.6%, follows an approach to stock picking that recognizes that businesses do not operate in a vacuum. "We have a bottom-up stock selection process based on fundamental research, but the businesses we invest in are affected in no small part by their environment. So, there is a micro as well as a macro dimension to company analysis."

As for the swamping effect of index-re-

lated trading, O'Halloran notes that those waves can be ridden as well. "Often times, all of the stocks in a given sector will make a big move (up or down) together, even though fundamental analysis would lead one to believe there should be significant differences in performance. Here again, we try to exploit this development by increasing exposure to positions when we think money is going to pour into an ETF within a given sector, or by decreasing exposure when we think the opposite will occur."

Technical analysis, which focuses on price patterns and trading volumes, can be used to confirm or question the conclusions reached through fundamental analysis. On March 9, 2009, the S&P 500® Index reached a low of 676.5. At that point, the team's fundamental view was that an economic recovery would soon begin and that stocks had become very inexpensive. However, it was unclear whether the market would overshoot even more to the downside because fear had taken hold. In this context, technical evidence that the market had bottomed was critical. When the market moved up on higher volume, it appeared likely that a bottom had taken place. O'Halloran and his team then shifted 20% of the Develop-

ing Growth Fund's portfolio out of defensive sectors, such as health care, and into consumer and technology positions that reflected their upbeat view. While all sectors recovered from that point, that shift contributed to the subsequent rebound in the portfolio, O'Halloran said. [*The Fund's portfolio is actively managed and may change significantly over time. It is important to note that the Fund may not perform in a similar manner in the future.*]

The Market's Paradox Shows Opportunity Knocks

It should be no surprise that Petajisto's analysis of stock picking shows it to be superior to other approaches, given the paradox at the center of securities markets. This apparent self-contradiction ensures that just when it appears to many that stock picking is a futile exercise, that may be when the payoff will be greatest.

Those who argue that stock picking no longer works are really making a claim about the market's efficiency, says Prah. An efficient market is one that makes price distinctions among different stocks on the basis of differing prospects for fundamental performance. "If the argument is that

¹ Tom Lauricella and Gregory Zuckerman, "'Macro' Forces in Market Confound Stock Pickers," *The Wall Street Journal*, September 24, 2010.

² Ibid.

³ Active Share = $1/2 \sum_{i=1}^N \text{Absolute Value (weight of stock } i \text{ in portfolio - weight of stock } i \text{ in index)}$.

⁴ Antti Petajisto, "Active Share and Mutual Fund Performance," September 30, 2010.

⁵ Tracking error (or more formally, tracking error volatility) is commonly defined as the time-series standard deviation of the divergence between a fund return and its benchmark index return. A typical active manager aims for an expected return higher than the benchmark index, but at the same time he wants to have low tracking error (volatility) to minimize the risk of significantly underperforming the index.

⁶ The Russell 1000® Index measures the performance of the 1,000 largest companies in the Russell 3000 Index, which represents approximately 92% of the total market capitalization of the Russell 3000 Index.

⁷ The S&P 500® Index is widely regarded as the standard for measuring large cap U.S. stock market performance and includes a representative sample of leading companies in leading industries.

⁸ Beta is a measure of volatility relative to the market. A stock or portfolio that fluctuates more than the market has a beta above 1.0. A stock or portfolio that fluctuates less than the market has a beta less than 1.0.

Indexes are unmanaged, do not reflect the deduction of fees or expenses, and are not available for direct investment.



If stock picking were dead, that would mean no amount of mispricing would ever be enough to entice astute investors.

the stock market is losing the ability to do that,” said Prah, “then this is really an argument that efficiency is declining.”

Such a decline is not out of the question, Prah added. As economists Sanford Grossman and Joseph Stiglitz demonstrated 30 years ago, the efficiency of the market is not static but dynamic. (For a more in-depth discussion of market efficiency and the Grossman-Stiglitz Paradox, see “Why the Market Needs Active Management” on page 6.) If markets were always perfectly efficient—that is, if market prices reflected all relevant information—then there would, paradoxically, be no incentive for an investor to acquire the

information on which the prices are based.

In other words, if markets are efficient and stock pickers leave the market because they believe their efforts no longer pay off, prices will no longer reflect the information about company fundamentals that stock pickers analyze, and markets will become less and less efficient.

But this rising inefficiency in turn results in mispricings that attract stock pickers who seek to profit from this inefficiency. So, any decline in efficiency will be corrected by the powerful force of investor self-interest.

If stock picking were dead, that would mean no amount of mispricing would ever be enough to entice astute investors. It

would mean that the disparity between a stock’s price and its fair value could go on diverging indefinitely. “I don’t believe that,” said Prah, “and the reason I don’t goes back to Grossman-Stiglitz, who framed market efficiency as a dynamic process.”

“If that dynamic process moves too far in one direction,” added Prah, “the self-interested actions of investors will push it back—never to perfect efficiency, but to a degree of efficiency. Efficiency arises spontaneously out of the collective behavior of investors individually acting in their self interest.”

So, while macro forces, risk-on/risk off trading, and index-related funds have boosted intra-market correlations in recent years, stock picking is far from dead. Not only does research on Active Share demonstrate convincingly that stock pickers have outperformed their benchmarks even when intra-market correlations are high but the Grossman-Stiglitz paradox also establishes that securities markets will always rely on—and reward—those whose desire for higher returns leads them to invest based on company fundamentals. In other words, said Fetch, “the market will ultimately recognize the fundamentals.”

—Reported by Ron Vlieger

This article presents a form of methodology used to evaluate a fund’s actual performance and volatility against a benchmark. The methodology is not an indicator of how a specific investor’s investment will perform.

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THE
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Review

FOR FINANCIAL PROFESSIONALS

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