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Is Active Share the Whole Story?

BILL KETTERER, CFA

Since there has been so much discussion lately claiming high Active Share is *the* prerequisite for benchmark-beating performance, we reckon it's only a matter of time before an active manager is issued an Investment Policy Statement that includes a constraint on Active Share. In an attempt to head off this "Maginot Line" mentality, we thought we would briefly explore the possible consequences of such a requirement.

The concept of Active Share first hit our collective consciousness in 2009 following the publication of a paper entitled, *How Active is Your Fund Manger? A New Measure That Predicts Performance* (Cremers et al. 2009). Active Share was defined as the percentage of stock holdings in a portfolio that *differ* from the benchmark and is calculated by taking the sum of the absolute value of the differences of the weight of each holding in the portfolio versus the weight of each holding in the benchmark and dividing by two. The original research concluded, "funds with the highest Active Share significantly outperform their benchmarks, both before and after expenses, and they exhibit strong performance persistence."

In a follow-up article by one of the authors, *Active Share and Mutual Fund Performance* (Petajisto, 2013), the Active Share cut off for "closet indexing" was set at 60%. At this level, 40% of a portfolio would have the same weight as the benchmark while the remaining 60% would have weights different than the benchmark. The author suggests the cumulative weight of the portfolio that matches the benchmark weight "exists only because he wants to reduce his risk relative to the index." We believe this is a myopic interpretation of why a manger would devote so much capital to simply mirror his benchmark.

There are periods when fundamental reasons make owning mega-cap stocks very attractive. Such as; a rising interest rate environment when large companies have a cost-of-capital advantage, or when growth is stronger overseas and broader geographic diversification is desirable. In these instances, a manager may want to express a positive opinion of these companies, but to do so they have to overweight the company relative to the benchmark. Consequently, the manager has to buy a benchmark weight first, which Petajisto would classify as inactive share or risk reducing, before he can express his preference, which is active share. Paradoxically, some inactive share is necessary to express active share. If the fundamental environment favors large cap companies, a manager has to allocate a larger portion of the portfolio to inactive share. Strangely, if they have been given a mandate with a maximum inactive allocation, the rule could leave the manager with less flexibility to make active decisions.

So, how much "inactive" capital is needed before an over-weight position can be built in the largest, multi-national companies in the Russell 1000 Growth?

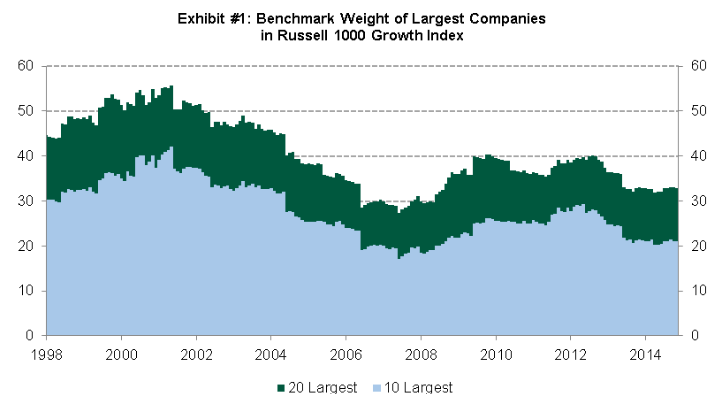

Exhibit #1 shows the combined weight of the top 10 and top 20 names in the Russell 1000 Growth index when sorted by weight in the index. Towards the beginning of 2000 when the R1000G contained approximately 500 stocks, the combined weight of the top 20 names was 55% of the index. To spin this slightly differently, in the last couple years of the tech bubble 55% of the *return* of the index was determined by the top 20 names and the best performing managers owned full or over-weight positions in those names because they were the best performers. Although we now know that over-weighting these mega-cap names would have led to poor performance following the tech bubble, a manager that only owned these 20 names would have an Active Share of only 45% even though he was making a very active decision to over-weight the largest names in his benchmark. A 60% active

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Active Share

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share limitation on the hiring decision in 1999 would have ensured under-performance in those years.

Overall, we find useful information in the 2013 Petajisto paper, but think investors need to be more selective in how they interpret and use Active Share. We suggest differentiating between manager's inactive weights which are held solely to reduce benchmark risk as suggested by Petajisto from those required to make active bets.

Another interesting part of the 2013 Petajisto paper was the discussion regarding the interplay between Active Share and Tracking Error. Understanding how a high Tracking Error can be an indication of hidden market factor bets is important because active bets may or may not be concentrated in unintended exposures. A manager may have "inactive" capital in his or her portfolio for a variety of reasons and understanding those reasons is more important than simply quantifying the amount.