The upside of active share

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IN 1999, the equity return expectations of major corporate and public defined benefit pension plans reflected the tendency of investors to extrapolate a prevailing trend. Double-digit returns in perpetuity could seem reasonable in the heady era of 'Dow 36,000'.

More realistic assumptions prevail today. Recent research by the State of Illinois showed that the percentage of US State and Public retirement investment plans assuming total annual returns in excess of 8% fell from 83% in 2001, to 35% in 2014.[1]

Each unit of excess return is more valuable in a lower return environment, so how should investors adjust what they demand from managers hired to help meet their financial goals? A first step is to assess whether 'active' managers are living up to their name.

One measure of the extent of a manager's active bets is 'active share', popularised by a 2009 academic paper by Cremers and Petajisto.[2] Calculated as the sum of the over- and under-weight bets taken in a portfolio relative to its benchmark index, divided by two (giving a maximum 'score' of 100%), active share has been widely adopted because it:

- is an intuitive measure that is simple to calculate;
- provides a useful complement to traditional measures of risk such as tracking error; and
- helps identify managers or firms who may be managing their career risk, rather than their portfolio, by 'closet indexing'.

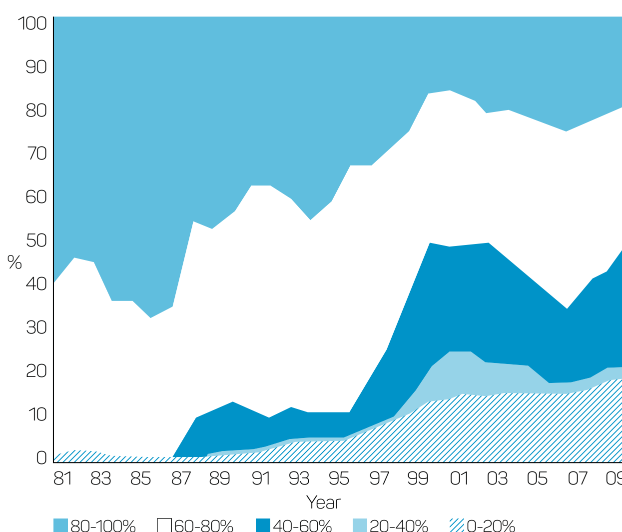
Intriguingly, Cremers and Petajisto's work also presents evidence that managers who maintain high levels of active share have delivered returns superior to those achieved by their less active peers. Furthermore, a subsequent paper by Cremers, written in conjunction with the economist Ankur Pareek, indicates that the superior performance of high active share managers is amplified for managers who hold positions for long (more than two year) periods.

Clearly, active share is not a 'cure-all'. An unskilled manager taking large bets can do more damage than an unskilled index-hugger. And the freedom of a manager to differ from a benchmark is proportionate to its breadth. For example, an actively managed portfolio of UK large cap companies benchmarked against the FTSE 100 will typically have lower active share than a US all-cap portfolio benchmarked against the Wilshire 5000, simply due to the fact that the UK index offers fewer companies to choose from. Finally, some critics note the 'snapshot' nature of the view provided by active share, which, unlike tracking error, contains no information in respect of the historic behaviour of the portfolio.

However, it remains the case that multiple studies have either extended[4] or, while critically assessing the active share concept, replicated[5] the findings of the initial work by Petajisto et al. that detected a significant pattern of outperformance among high active share managers. Given its additional usefulness as a simple yardstick with which to assess whether a manager is truly 'active', Intermede believes the measure earns its place in the toolkit of anyone assessing active managers, whether individually, or as a class. B

CHART 1: Evolution of active share, 1980-2009

The share of US mutual fund assets held in portfolios with greater than 80% active share declined from 60% in 1980 to 20% in 2009.[3]



Note: This figure shows the fraction of assets in US all-equity mutual funds in each active share category. The bottom category, with active share below 20%, contains pure index funds; the next two categories contain the closet indexers.

Source: Petajisto, Financial Analysts Journal, CFA Institute.

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1. 'The actuarial assumptions and valuations of the five state-funded retirement systems', State of Illinois, December 2014.
2. 'How active is your fund manager? A new measure that predicts performance', Cremers and Petajisto, March 2009.
3. 'Active share and mutual fund performance', Petajisto, Financial Analysts Journal CFA Institute, 2013.
4. 'Interpreting active share', Lazard Asset Management.
5. 'Deactivating active share', AQR. Note: AQR replicated the findings but challenged the conclusions of the work of Petajisto et al. Petajisto wrote a detailed rebuttal to this criticism, available online under the title 'Response to AQR's article titled "deactivating active share"'.

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