ViewPoints

Manager Research –
The Anatomy of an Investment Decision

Entasis

ASSET MANAGEMENT

We are long-term investors by nature, but our research is ongoing. As a result, there will inevitably be opportunities that arise that we believe have a strong likelihood of adding value to client portfolios. That does not mean we jump at every opportunity that comes our way. Experience has taught us not to pursue opportunities that simply try to target a "quick buck;" because the odds of success are much lower. Short-term ideas are generally not as well thought-out, or may be driven by too much emotion. And to be blunt, the market tends to punish ignorance, and it does not care about anyone's feelings. We favor a methodical, disciplined approach that gravitates toward opportunities that we believe have favorable odds to add value over the intermediate- to long-term. This approach allows us to stay up to speed on ever-changing market dynamics, while also keeping us ready to act when an attractive opportunity comes our way.

Two of those intermediate- to long-term opportunities came our way in the fourth quarter. For this ViewPoint, I'll focus on only one of the two trades, covering the most important aspects of our decision-making process. It is our goal to provide a better understanding of the data monitored and the process we followed that shaped our decisions. The decision highlighted in this commentary reduced the "Core" broad market, passive equity investment in portfolios and increased the amount invested in actively-managed strategies.

As a reminder, we manage client portfolios through the implementation of our "Core/Completion" philosophy. This means that we utilize both passively-managed and actively-managed investments across our allocation strategies. We commonly use passive strategies in areas of the market we believe are relatively efficient, while we use active strategies in segments of the market we believe active managers have a better opportunity to succeed over the long-term. Even though true passive strategies are always guaranteed to underperform the benchmark (by the amount of fees charged by the product and the cost of trading activity in the portfolio), true passive strategies allow us to gain broad market exposure and reduce aggregate fees (true passive strategies are less expensive compared to active strategies), while also helping to moderate inevitable, short- to intermediate-term relative performance swings from active managers.

Active vs. Passive – Cycle Management

As a starting point, it's important to note that the performance of active strategies relative to passive strategies (in the same segment of the market) tends to be cyclical. This cyclicality is highlighted in the chart on the next page, which looks at the rolling three-year rank of actively- and passively-managed large-cap domestic equity strategies

Charles (CJ) Batchelor, CFA
Chief Investment Officer - Equity

Summary

We will always have active and passive strategies in client portfolios. However, the percentage allocated to any investment type will vary over time.

We believe we may have entered a transition period where the environment is becoming more favorable for active managers to outperform their passive counterparts.

The most common, value-destroying behavior we witness on a regular basis is "recency bias." This refers to the belief that whatever happened in the recent past will continue in the future.

Investing in active managers is not simply a contrarian exercise and cannot can be determined solely by a review of charts.

In summary, be mindful of cycles – they're everywhere! Don't chase performance, be patient, invest for the long-term, stick to the process and know your investments.

Entasis Asset Management
300 N Corporate Drive
Suite 220
Brookfield, WI 53045
262-794-5299
Info@EntasisAM.com

in the Morningstar large-cap domestic equity peer group. What you can see in the chart is that passively-managed equity strategies (green line) enjoyed success relative to actively-managed strategies in the late 1990's and during most of the current equity bull market. However, sandwiched between those two periods, actively-managed equity strategies (blue line) performed very well.

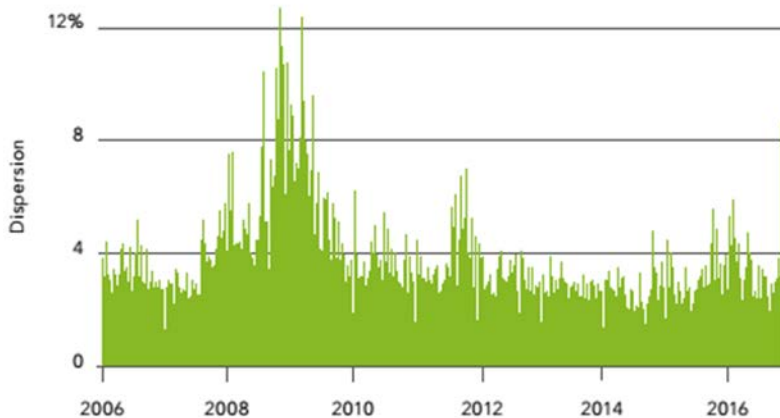
In hindsight, it appears that it would be relatively simple to just switch back-and-forth between different types of strategies. However, in practice, this would be far more difficult since you would have to accurately forecast relative performance for hundreds of active managers. We think this is a losing proposition. So, we don't do it. We will always have active and passive strategies in client portfolios. However, the percentage allocated to any investment type will vary over time.

Source: Hartford Funds "The cyclical nature of active & passive investing."

Passive to Active – Market Dispersion

We track and analyze a variety of market metrics, which we believe at least provide us with an indication of market conditions that are more conducive to results for active or passive strategies. One such metric is weekly equity market dispersion. This measure looks at the spread between the top and bottom performers in the equity market (or segment of the equity market) being measured. Generally speaking, higher levels of dispersion are beneficial for active managers (can better differentiate their holdings, and the performance of those holdings, relative to the benchmark), while low levels of dispersion create a more difficult environment for active managers.

As you can see in the chart from BlackRock's 2017 Global Investment Outlook below, equity market dispersion has been relatively low since 2010. This has made it more difficult for large-cap equity managers to perform well relative to the S&P 500® Index. However, what you can also see is that there has been a recent spike in dispersion (far right). In fact, this is the highest level of dispersion experienced since 2008. Our expectation is that dispersion will remain relatively high (compared to the last six years) for a number of reasons, but primarily because the U.S. has begun to shift from a sustained, easy monetary policy to a more restrictive monetary policy. We also believe we may have entered a transition period where the environment is becoming more favorable for active managers to outperform their passive counterparts.

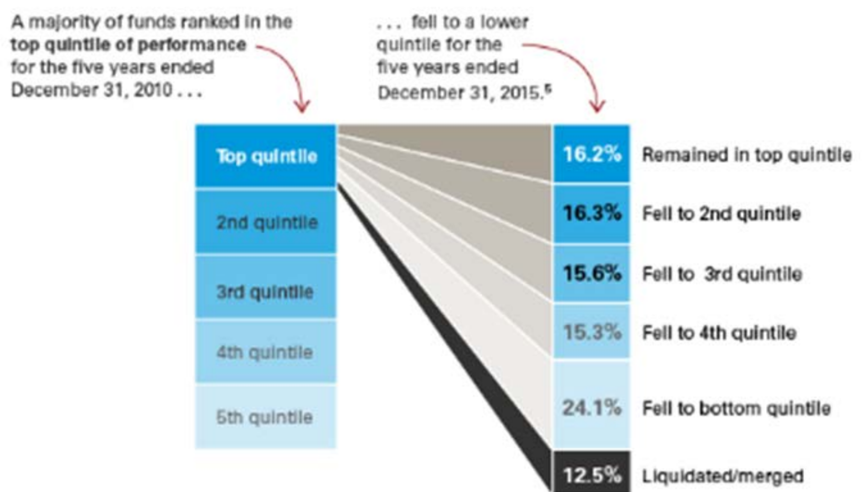


Patience – Plentiful in Thought, Rare in Practice

One of our firm's key tenants is that we follow a long-term, patient, value-oriented investment process. In other words, we don't get overly excited or worried by strong or weak results over the short-term. We won't sell a manager because they're underperforming and we won't buy a manager because their recent results look impressive. We actively attempt to limit the behavioral pitfalls that run rampant among investors.

The most common, value-destroying behavior we witness on a regular basis is "recency bias." This refers to the belief that whatever happened in the recent past will continue in the future. Said another way, many people absolutely love to chase good performance. Unfortunately, this is often a losing bet. As you can see in the chart below, a great long-term manager can be a terrible investment.

The chart illustrates that if an investor simply chose an active manager based on its peer group rank (top quintile, or top 20% of managers) for the five-year period ended December 31, 2010, they would most likely be disappointed in the results of that manager at the end of the subsequent five-year period. For instance, only 16% of the managers that finished in the top quintile at the end of 2010, remained in the top 20% of managers at the end of 2015. While this only highlights one particular period, results in other periods are similar.



Source: Vanguard Infographic "Reframing investors choices: Right mindset, wrong market" September 2016

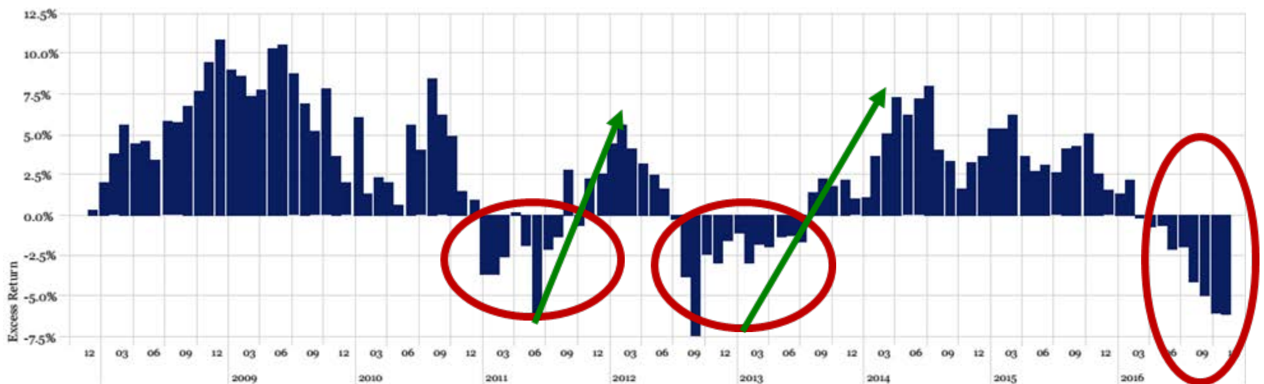
Manager Relative Performance – Another Cycle!

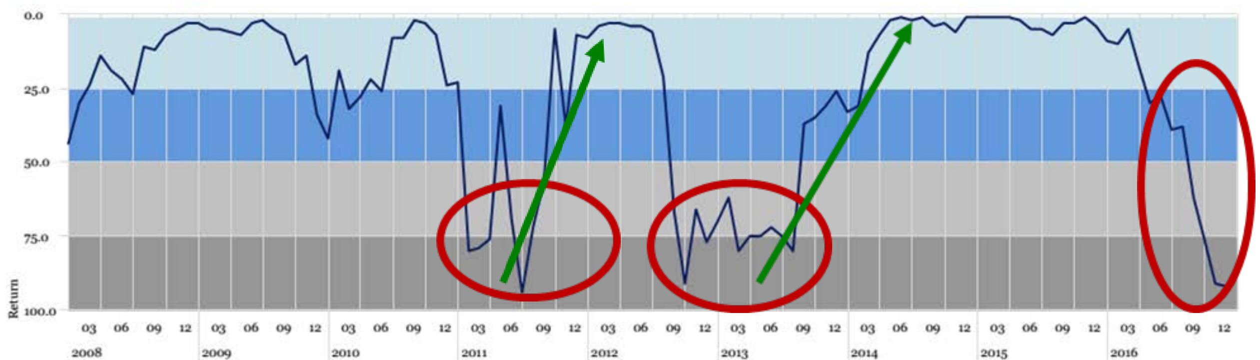
As I noted above, a great long-term manager can be a very bad investment if it is purchased at the wrong time. One way we attempt to mitigate performance chasing is being cognizant of our initial entry point when we make a new investment. One tool we use to assist us in the timing of our initial purchase is to examine each manager's relative performance cycle. The first chart on the next page displays the rolling 12-month performance of the active manager we invested in relative to its market benchmark (passive benchmark). The second chart displays the rolling 12-month performance rank of the same manager relative to its peer group (in this instance, it consists of all other actively-managed strategies in the Morningstar Large Blend peer group).

We utilize these charts as a tool because every active manager, including the manager highlighted in the charts below, will endure periods of underperformance. Our experience has taught us that consistent outperformance tends to accompany a lack of adherence to a stated investment process. Unfortunately, even well-known publications seem to forget this. Relative performance results are not linear!

Based on the charts on the next page you can see that this manager performed poorly in 2016. However, that doesn't necessarily make it a poor investment. To the contrary, making an investment now may be potentially prudent, especially for an investor with an intermediate- to long-term

investment horizon. However, there are many caveats that go along with that statement. Investing in active managers is not simply a contrarian exercise and cannot be determined solely by a review of charts. Many actively-managed investment products are destined to be perennial bottom-feeders. This is where an in-depth, qualitatively-oriented research process is necessary.





Qualitative Review – Prudence and Patience

In this example, the manager had already been subjected to our rigorous research process, which included an on-site “boots on the ground” due diligence review and multiple calls with portfolio managers and analysts. In fact, this manager has been followed for several years, but up until this point, I did not feel as if there had been an attractive entry point for investment. Obviously, this changed in 2016 as the manager endured poor results from a handful of its holdings, which led to relatively weak results for the year. However, before we made an investment, I needed to feel confident that the recent underperformance was not because of any factors that would harm my long-term view of the manager.

More specifically, I questioned:

- Were there any structural changes with the firm (ownership, etc.)?
- Has the investment team changed (manager/analyst departures)?

- Has anything changed in the way they research companies?
- In reviewing their portfolio holdings (current and historical), do any aspects of their recent holdings look inconsistent with the past?
- Has the investment process been altered?

Over the course of my review, and following discussions with the firm, I determined that nothing had changed at the firm, the investment team, or with the underlying investment process. As a result, I viewed the short-term performance issues as likely transitory in nature as opposed to structural.

As a side note, it's important to mention that we do not think we can pick the absolute bottom (relative performance) of a manager, or have the ability to perfectly time the purchase. What we are simply saying is that we would rather invest in a high conviction manager after a period of poor performance rather than invest after the manager has already performed very well for an extended timeframe.

Outcome

Our team decided that it was an attractive time to make an initial investment in this manager. Furthermore, we believed that it made sense to fund the purchase through a reduction in our "Core" broad market, passive equity investment considering the changes in market dynamics highlighted earlier.

In summary, be mindful of cycles – they're everywhere! Don't chase performance, be patient, invest for the long-term, stick to the process and know your investments.

If you would like to learn more about how we can add value to your portfolio, please contact us by clicking **here**.

The **S&P 500® Index** is a market capitalization weighted index that measures the performance of 500 leading companies in leading industries of the U.S. economy. The **Russell 1000® Index** measures the performance of roughly 1,000 U.S. large-cap companies. Past performance is no guarantee of future results. All indices are unmanaged. Investors cannot invest directly in an index. Index returns do not include expenses.

IMPORTANT INFORMATION

Statements may be forward looking and are not intended as specific investment advice without further review of individual circumstances. Commentary, opinions, analysis, and recommendations may be subjective, do not guarantee future performance, and could change at any time without notice. Under no circumstances does the information contained within represent a recommendation to buy or sell any security.

This information is provided for informational purposes only and does not constitute individualized financial advice or create an advisor-client relationship.

Copyright ©Entasis Asset Management. All Rights Reserved.