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# Investment strategy

## Is now the time to sell out of active managers?

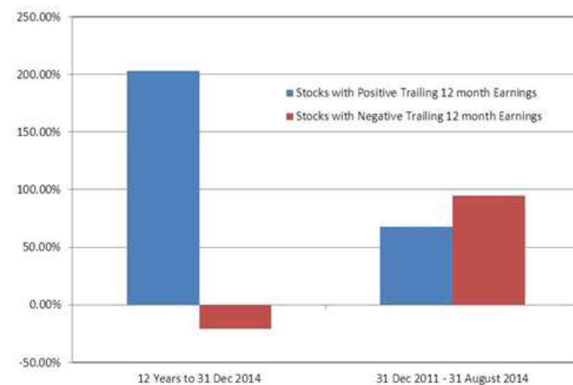
It comes in waves, the flow of articles and the debate around active versus passive investment strategies. Once you have seen a few of these cycles it becomes a little clearer. Not all market conditions are suitable for active managers. Active managers are typically the first to admit that themselves. Markets driven by momentum, "irrational exuberance" or other external factors (for example the "risk on" impact of quantitative easing and other central bank activities have had on equity market valuations over the last three years) are all environments where fundamental active managers are likely to struggle to outperform. Does that mean there is no role for active managers in your portfolio?

Let's look into the detail before we sell all of our active managers and move to 100% passive. Whilst there is a broad range of investment styles active managers undertake, a majority typically undertake some form of fundamental analysis looking to measure either the value, quality or earnings potential of a company before investing. With unprecedented levels of interference in the global economy by central banks it is unlikely to be a surprise that equity markets have been driven more by macro issues, rather than fundamental stock specific issues.

To support this view we look at the 56.6% return from the MSCI World Index for the three years ending 31 December 2014. This is a time when global real GDP growth has been in the range of 2-3%, solid growth, but definitely not boom times.

Let's break the return down further. Equity returns are made up of three components, dividend yield, earnings growth and valuation expansion or contraction. Over the last three years the Price-Earnings (PE) ratio of the index has expanded by 37%, which means around two-thirds of the return from equities has come from valuation / PE expansion, with earnings growth representing less than one-third of the total returns.

Taking this another step further, Epoch Investment Partners, a global equity manager recently undertook a study of US equities. The manager broke the S&P 500 index into two buckets, those companies with positive 12-month trailing earnings and those companies with negative earnings over the prior 12-month period. Undertaking this analysis over the last 12 years found, the share prices of companies with positive earnings returned in excess of 200% over the period, whilst those companies with negative earnings fell 20%. The outperformance of companies with positive earnings over those with negative earnings is in line with our expectations.




Amazingly, for the period from 31 December 2011 to 30 August 2014, companies with negative earnings gained 95% whilst stocks with positive earnings rose only 68%. Is that sustainable? Is this an environment where we expect our active managers to outperform?

Interestingly, since the quantitative easing in the US came to an end we have seen the most recent trend revert back to the long term trend with stocks with positive earnings generating a positive return, whilst stocks with negative earnings have declined. This coincides with an improvement in the relative returns of a number of global managers.

Ultimately we invest in active strategies to generate outperformance after all fees. But it is important to accept that whilst outperformance is a valid and achievable objective over the long term, there are periods of time where market conditions won't always suit a fund manager's fundamental approach to stock selection. Picking these exact points in time is a very difficult task, which is why we advocate maintaining a long term investment horizon, once you have identified those fund managers with a successful and sustainable investment process.

For those of you that don't want to be exposed to the potential for active managers to underperform, there are a range of passively-managed investment options available across all asset classes. You will need to be aware that passive strategies will also underperform the market (after taking into account their management fees – albeit lower than active fees) and they offer no protection during periods of market weakness. Active managers in general have performed better than the benchmark during periods of weakness.

Hopefully it is clear, we don't believe now is the right time to sell your fundamental active managers to move to a passive strategy. But as is always the case, please speak with your adviser if you would like to talk through the issues in more detail.

*By Sally Campbell, Executive Director, JBWere*