September 21

Trends in Evaluating Active Management and Other Strategies

IDC Webinar

Panelists

Thomas Kim, Moderator
Managing Director
Independent Directors Council

Karen L. Barr
President and CEO
Investment Adviser Association

Carol W. Geremia
President
MFS Investment Management

John P. Kavanaugh
Independent Chair
MFS Funds

Daniel Needham
President and Chief Investment Officer
Morningstar Investment Management LLC

Agenda

- Introduction and Overview
- Remarks – Karen Barr
- Time to Align – Presentation by Carol Geremia
- Remarks – John Kavanaugh
- Active Management: The Role of ETFs – Presentation by Daniel Needham
- Remarks – John Kavanaugh
- Conclusion

ACTIVE
MANAGERS COUNCIL
INVESTMENT ADVISER ASSOCIATION

Investment Adviser Association

- Represents investment advisory firms – from largest global asset managers to smaller shops
- Advances interests of investment advisers, which are critically important to investors, markets, and the economy.
- Advocates for investment advisers on key policy issues.
- Informs and educates members with a wide range of resources – including research, newsletters, surveys, webinars, and online practice materials.
- Provides numerous venues for our members to help shape our policies, share practices, and engage in peer-to-peer interaction through committees, forums, conferences, and events.

ACTIVE MANAGERS COUNCIL
INVESTMENT ADVISER ASSOCIATION

Active Managers Council

- Formally launched in 2018 by IAA member firms
- Mission
  - Foster education and thought leadership on active management
  - Curate and sponsor research on active and passive
  - Engage on relevant public policy issues
- Goal is to create a more balanced narrative
  - End the false dichotomy of active *versus* passive
  - Both active and passive play important roles for investors, the market
  - Active and passive work well together
- www.activemanagers.com

ACTIVE MANAGERS COUNCIL
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Council Publications

- Rethinking Survivorship Bias in Active/Passive Comparisons
- Sustainable Investing is an Active Process
- A More Balanced Narrative
  - Setting the Record Straight on Active Management
- Active Management and Market Efficiency
  - A Summary of the Academic Literature
- Active Investing and the Efficiency of Security Markets
- Challenging the Conventional Wisdom on Active Management
  - A Review of the Past 20 Years of Academic Literature on Actively Managed Mutual Funds

ACTIVE
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Public Policy Activities

- Meetings with:
  - U.S. Treasury officials
  - SEC and Department of Labor officials
  - Senate, House committees and legislators' staffs
- Outreach to non-U.S. trade groups
- Comment letters on proposed legislation and regulation

ACTIVE MANAGERS COUNCIL
INVESTMENT ADVISER ASSOCIATION

Changing the Narrative

FINANCIAL TIMES

Active managers underpin functioning markets

From Karen Barr, President and Chief Executive Officer, Investment Adviser Association, Washington DC, US

SEPTEMBER 29 2019

WP Is the active-vs-passive story really open-and-shut?

Dec 13, 2019

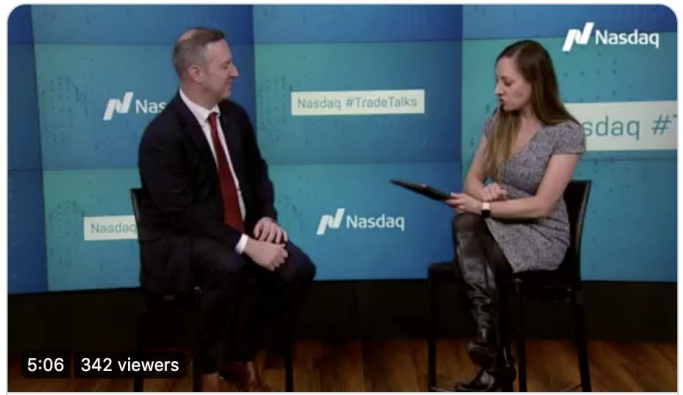
IGNITES

Group Gears Up to Fight 'False Dichotomy' in the Active vs. Passive Debate

By Francesca Friday August 29, 2019

TradeTalks @TradeTalks · Jan 22

.@Nasdaq #TradeTalks: Active Managers Can & Do Outperform their Indexes @NatixisIM @JillMalandrino



TradeTalks @TradeTalks

.@Nasdaq #TradeTalks: Active Managers Can & Do Outperform their Indexes @NatixisIM @JillMalandrino

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Client-Centric ESG Investing Needs To Be Active, White Paper Asserts

JULY 13, 2020 • TRACEY LONGO

FA FINANCIAL ADVISOR

Active Equity Investors Outperform Market And S&P 500 In Q2

AUGUST 31, 2020 • TRACEY LONGO

Time to Align

Carol Geremia
President, MFS Investment Management

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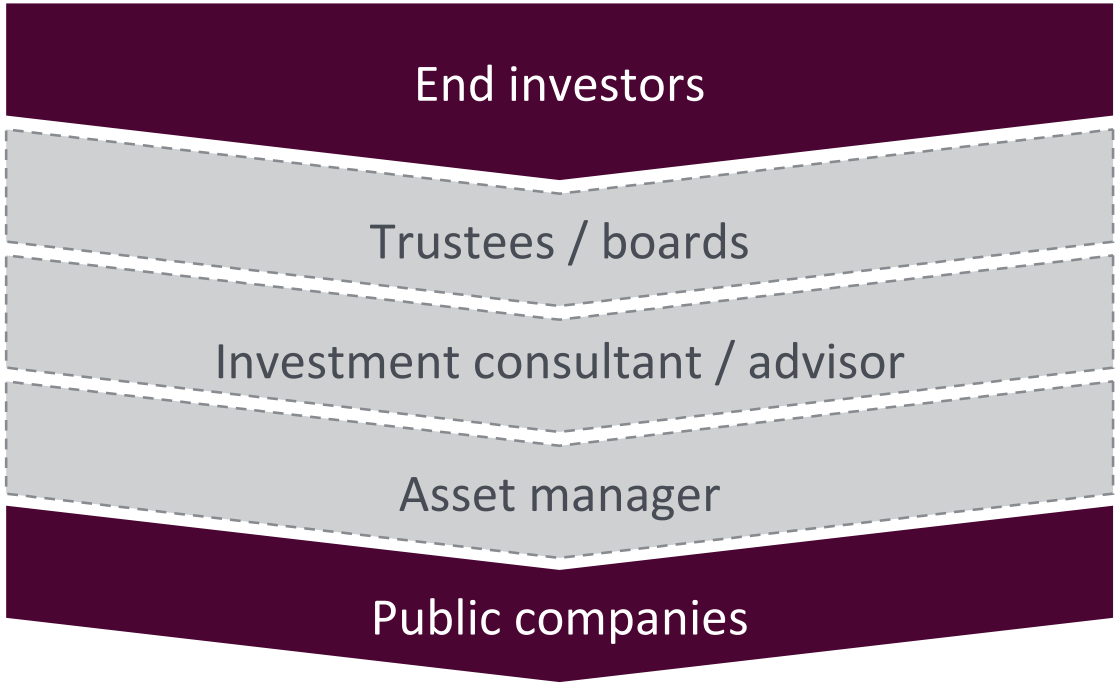
The investment chain has lengthened

Market maturity

- $112T by 2020 in investable assets[1]
- 80% public markets owned by institutions
- 133,000 funds

Lengthened ownership chain

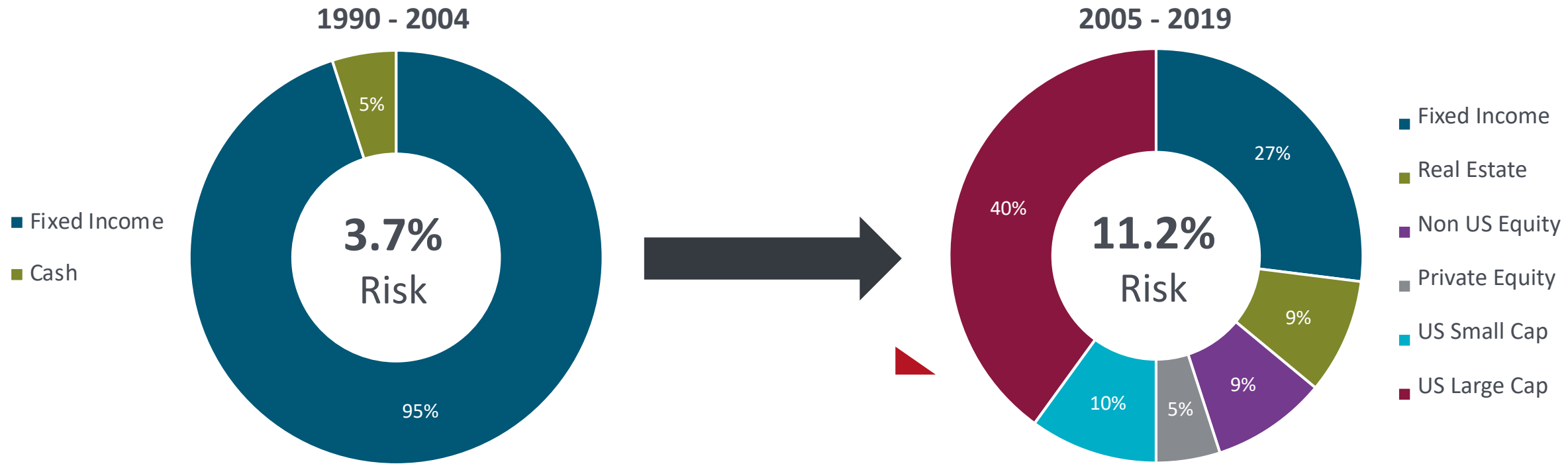


Sources: 1PWC Market research center analysis, 2020. 2Pensions and Investments online, April 24, 2017.

Searching for accountability has increased misalignment.

Investing Has Become Increasingly Complex

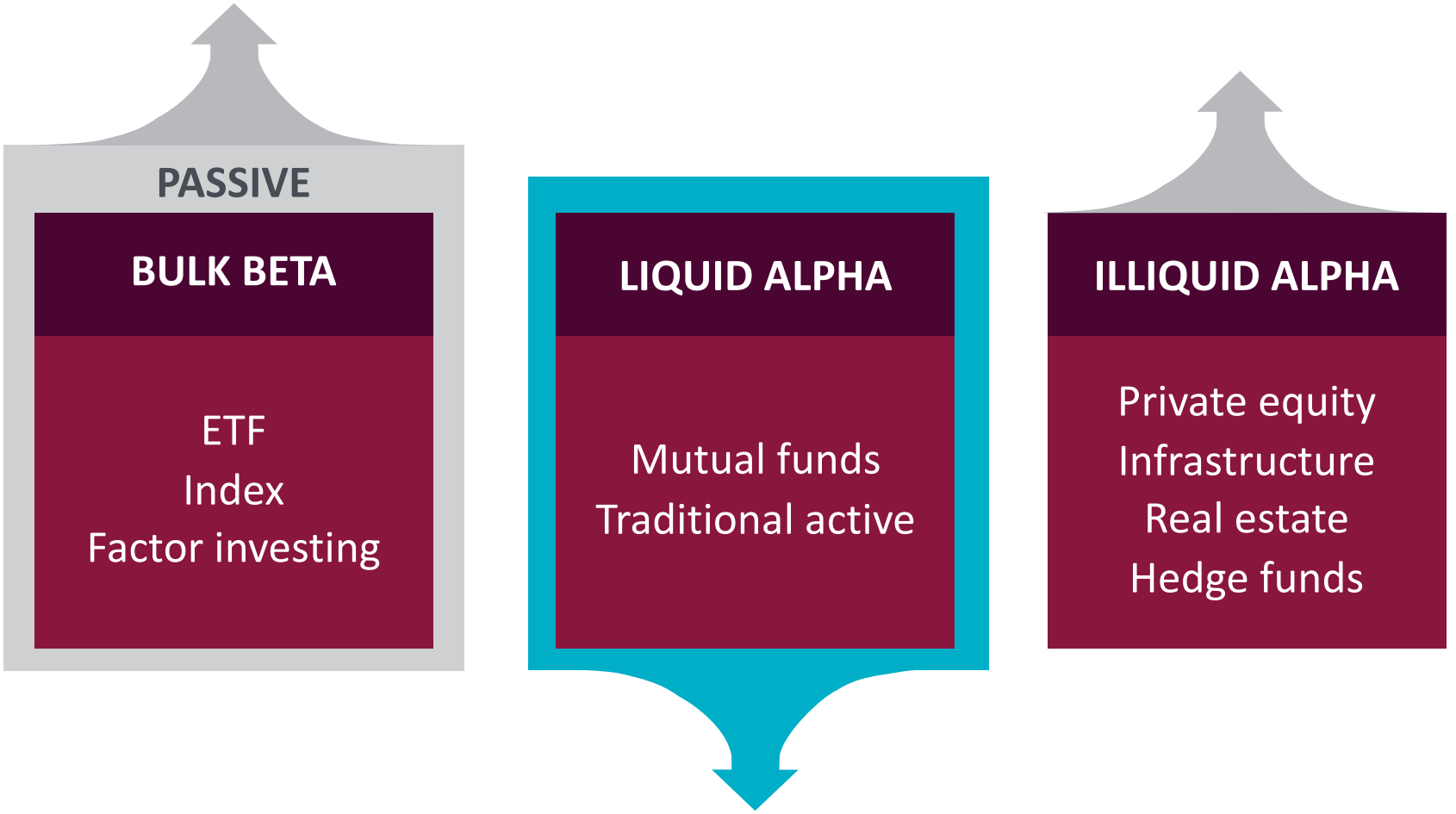
Asset Allocations with more risk needed to achieve the same returns



Hypothetical portfolios showing risk levels associated with achieving a 7.5% return.

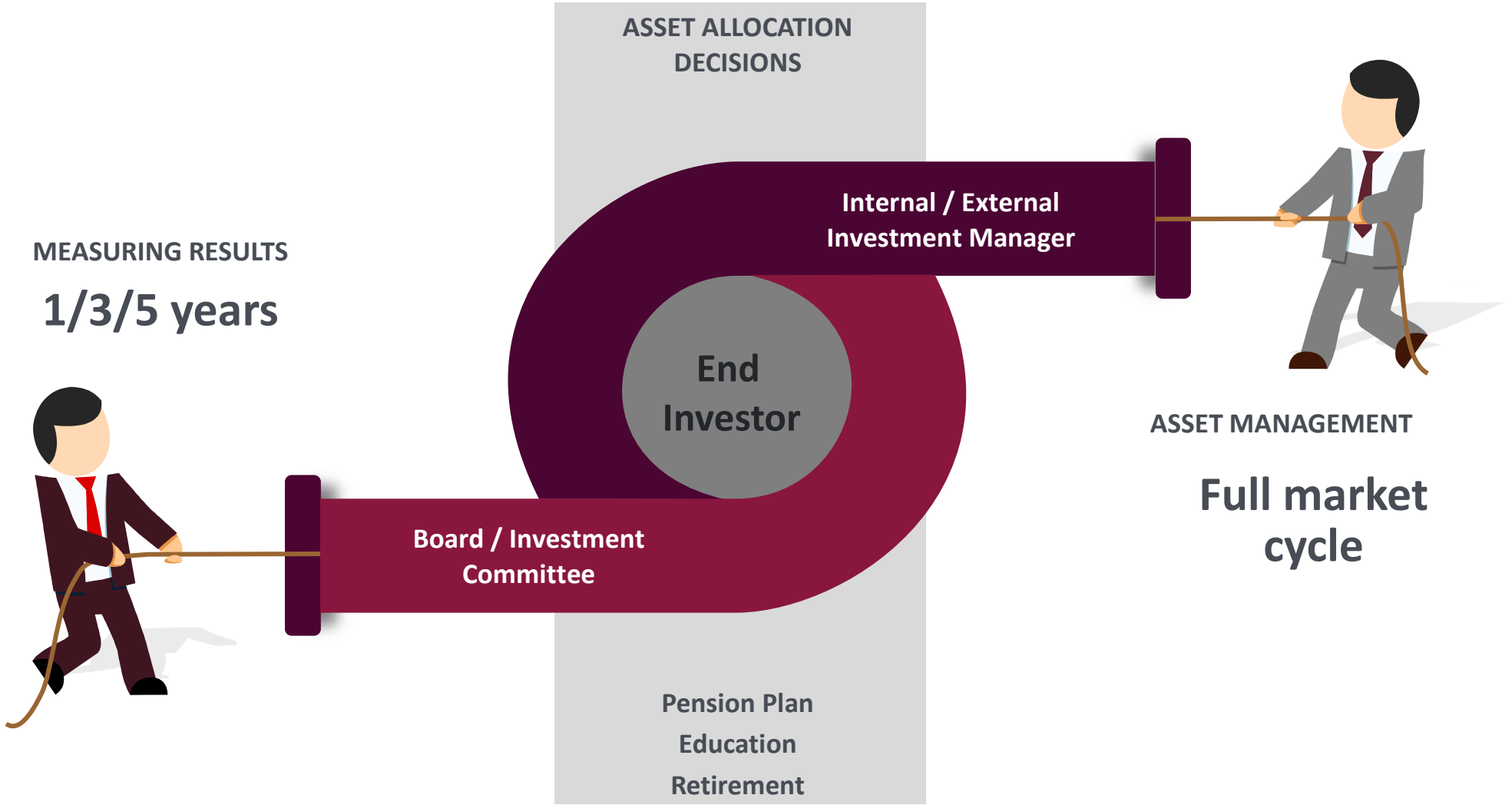
Source: Morningstar Direct. Hypothetical portfolios were created using historical index risk, return and correlations to achieve a 7.5% total return. Risk is measured by Standard Deviation, a measure that is used to quantify the amount of variation or dispersion of a set of data values. US Fixed Income is measured by **Bloomberg Barclays US Aggregate Bond index**, is a market capitalization-weighted Index, meaning the securities in the index are weighted according to the market size of each bond type. US Cash is measured by **US Treasury 90 day T bill**, which is a short-term debt obligation backed by the US Treasury Department with a maturity of one year or less. US Large Cap is measured by the **S&P 500 index,** which measures the broad US stock market. US Small Cap is measured by the **Russell 2000 index**, which measures the small-cap stock market of the bottom 2,000 stocks in the Russell 3000 Index. Real Estate is measured by the **FTSE NAREIT All Equity REITs**, which is a free-float adjusted, market capitalization-weighted Index of US equity REITs. Non US Equity is measured by the **MSCI EAFE index** is a stock market index that is designed to measure the equity market performance of developed markets outside of the U.S. & Canada. Private Equity is measured by the **Red Rocks Global Private Equity**, which is designed to track the performance of private equity firms which are publicly traded on any nationally recognized exchange worldwide. Portfolios are rebalanced monthly.

Risk allocation



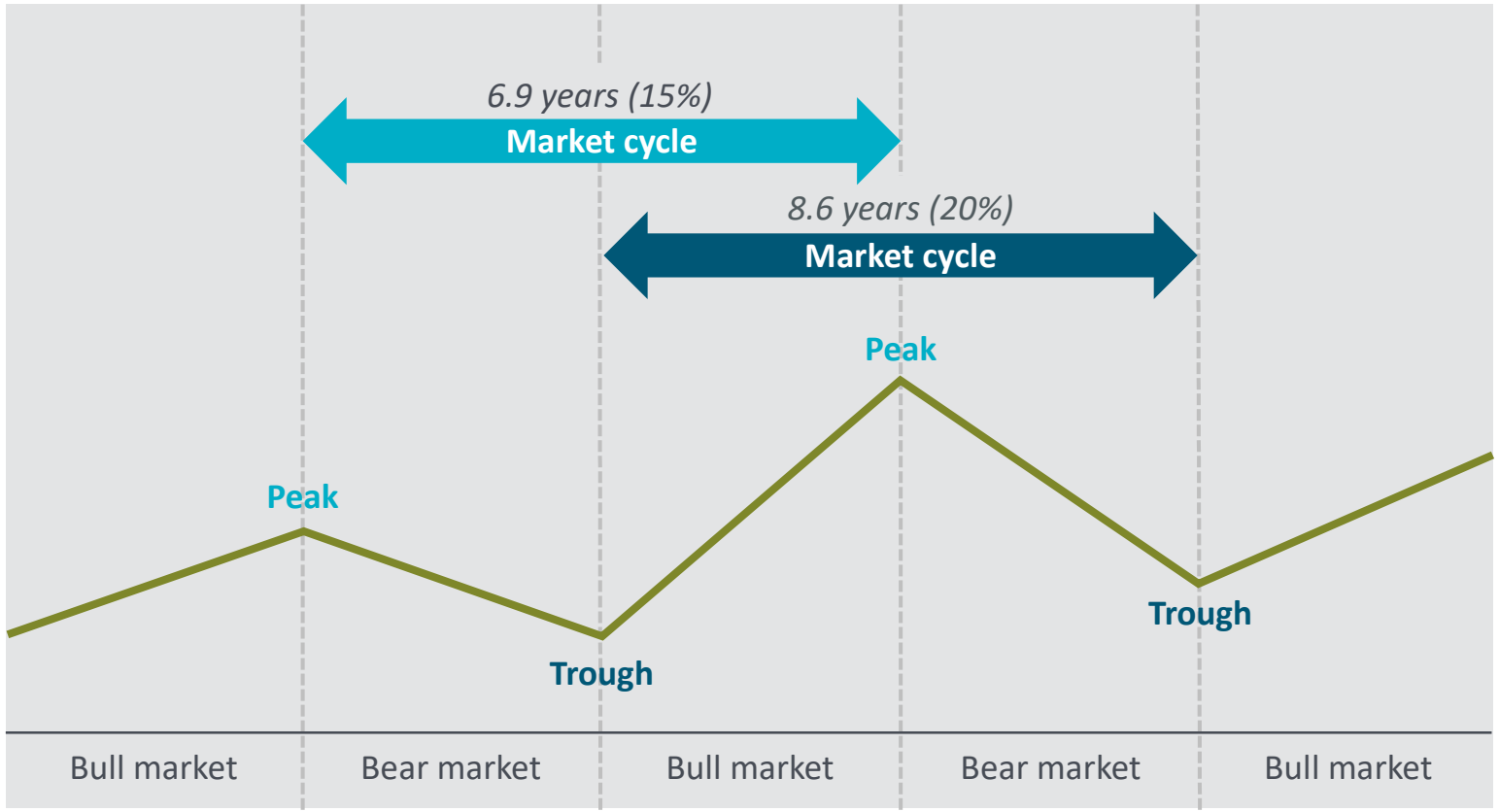
In a world that has become so short term, is liquid alpha still possible?

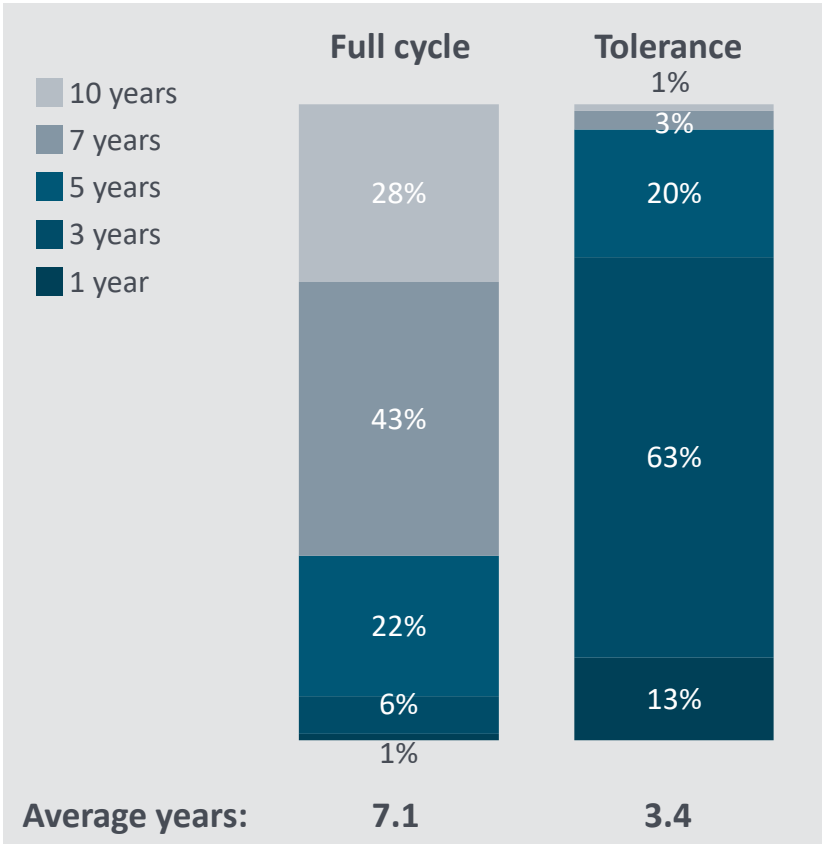
CONFLICT IN THE DELEGATION OF DECISIONS



Investing through a full market cycle

The reality of career and/or business risk in action

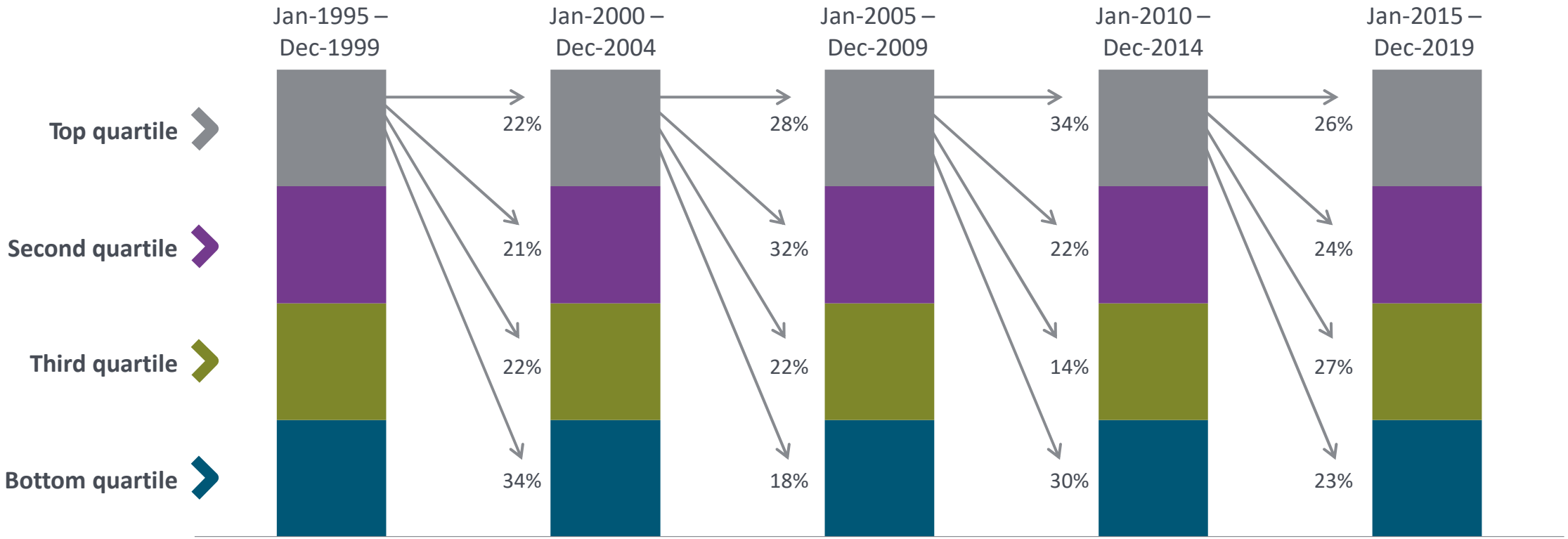




Source: "Defining a Market Cycle," Manning & Napier.
Source: 2019 MFS Investor Compass Survey (including 540 global institutional investors). Methodology provided on page __
Q28. What is your approximate definition of a full market cycle?
Q29b. What time frame are you given within your organization to generate a positive return (i.e., alpha) and how long are you willing to tolerate underperformance of active managers?

Time horizons don't align

Performance results of top quartile managers through different parts of a cycle



Source: eVestment Alliance. Data Analysis: MFS Investment Management
The universe includes 630 strategies in the eVestment Database with a Universe included in All US Equity and an inception date on or before 01/01/1995. Rankings include both surviving investments and those liquidated and/or merged prior to the end of the full calculation period (1/1/1995-12/31/2019). Performance is utilized for periods where it is available. Performance is calculated gross of fees. The entire universe of funds is analyzed during each five year period.

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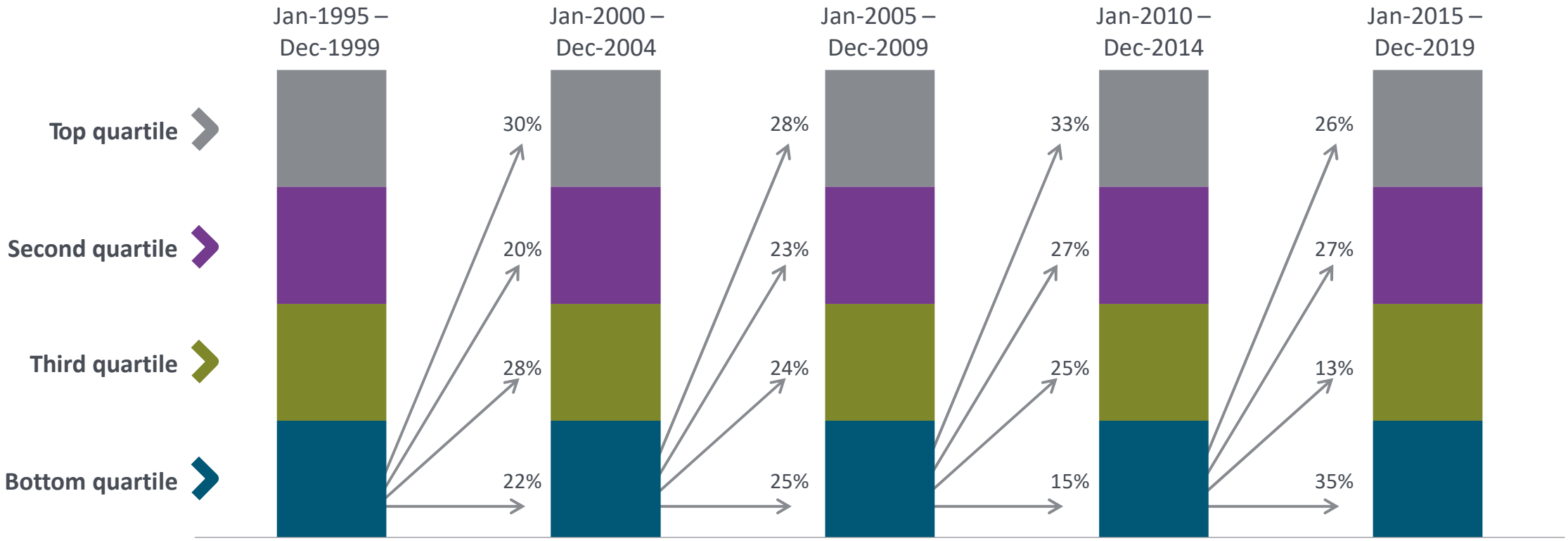
Performance results of bottom quartile managers through different parts of a cycle



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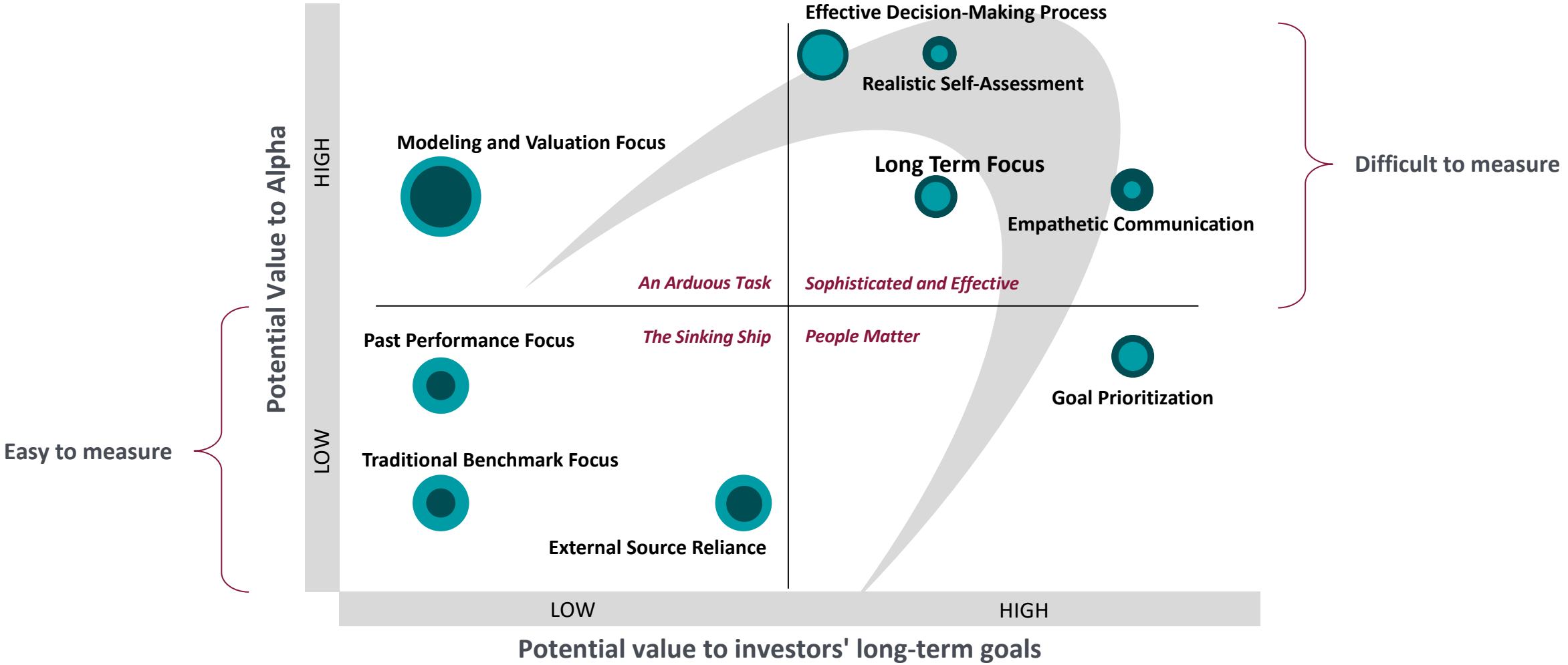
And promoting herding and procyclicality

State Street Research - "FOLKLORE OF FINANCE"



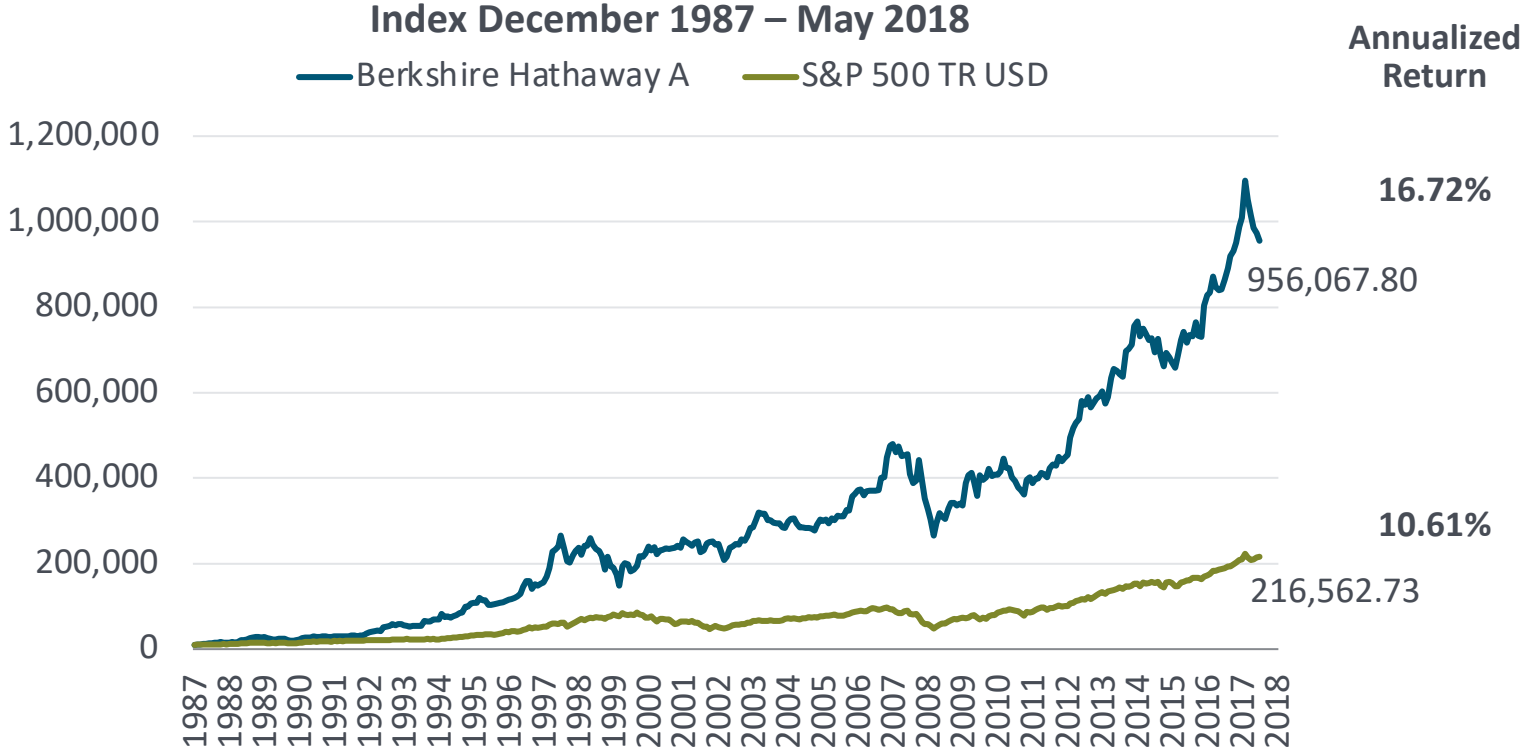
Folklore of Finance, How Beliefs and Behaviors Sabotage Success in the Investment Management Industry, December 2014

We need to change the dialogues

Setting expectations and staying long-term focused

"Time is the friend of the wonderful company, the enemy of the mediocre." — Warren Buffett

Growth of $10,000 of Berkshire Hathaway A vs S&P® 500 Index December 1987 – May 2018



Berkshire Hathaway A Underperformance Relative to S&P 500

% of periods underperforming	
1 year	43%
3 year	38%
5 year	23%
10 year	8%

Source: Bloomberg and Morningstar Direct

Past performance is no guarantee of future results. This chart and the company referenced is for illustrative purposes only and does not reflect the performance or holding of any MFS product. This material should not be construed as a recommendation to buy or sell any of the securities discussed. You should consult with your investment professional regarding your personal situation prior to making any investment decisions.

Even the best investors will underperform if you only look at 3-year performance

Focus on what you can control

What does alignment look like?

Active Management: The Role of ETFs

Daniel Needham
President and
Chief Investment Officer

Morningstar Investment Management

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Market Efficiency

Informational Efficiency – prices reflect all relevant information and investors cannot use this information to earn risk-adjusted excess returns

Fundamental Efficiency – prices correctly reflect fundamental value – that is the discounted sum of expected future cash flows

Allocative Efficiency – market prices allocate scarce resources to businesses with the most promising prospects

Finance academics refer to Informational Efficiency when discussing the Efficient Market Hypothesis, although "Prices are Right" refers to Fundamental Efficiency

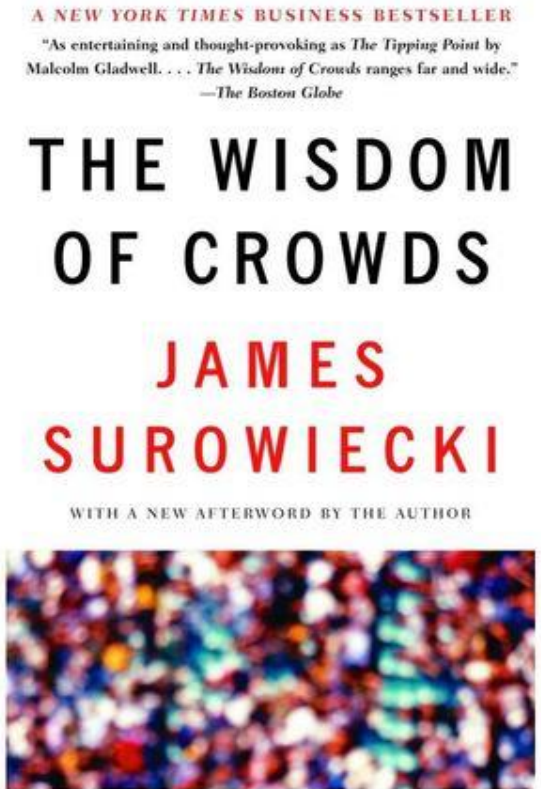
Source: The Economics of Short-term Performance Obsessions, Alfred Rappaport FAJ 2005; Capital Ideas Revisited – Part 2, Michael Mauboussin 2005

Traditional Finance Academics on EMH

With 40 years' hindsight, are markets efficient? Not always, and Gene said so in 1970. More recently, in our view, we have seen evidence that short- sales constraints and other frictions can lead to prices that are clearly informationally inefficient. The empirical question has always been to what degree a given phenomenon approaches an unattainable ideal.

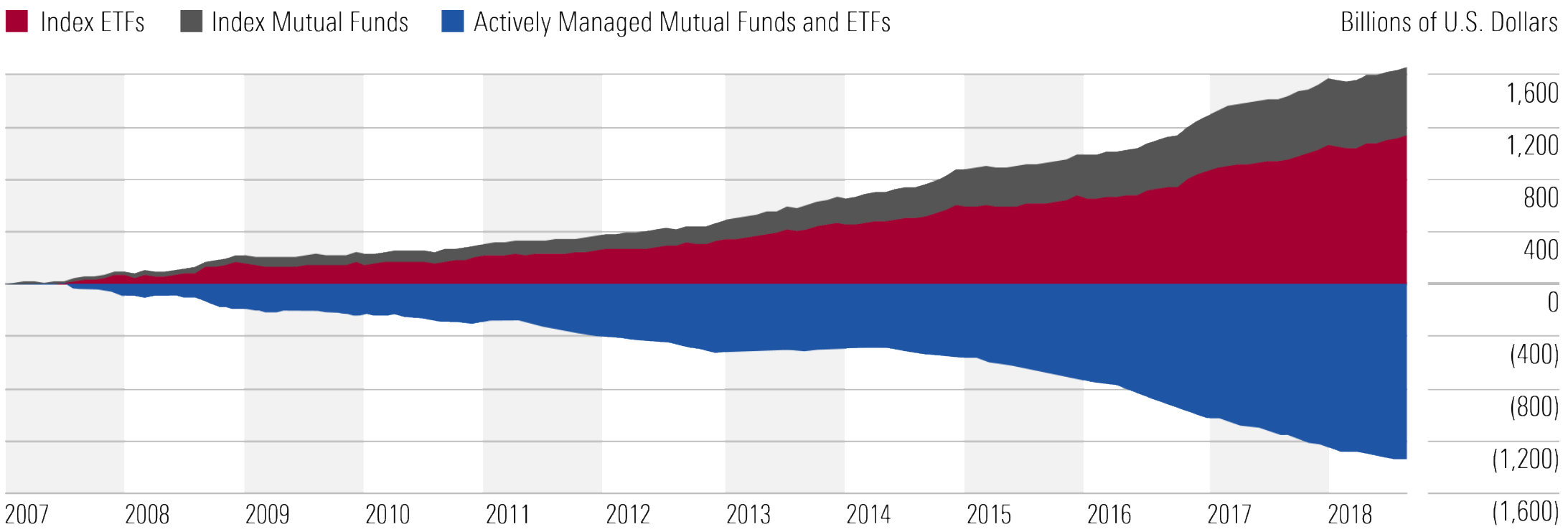
John H. Cochrane and Tobias J. Moskowitz
Efficient Markets and Empirical Finance

Complex Adaptive Systems and “The Wisdom of Crowds”



Criterion	Description
Diversity	Each person should have their own personal knowledge to rely on
Independence	Each person should form this opinion without any information about the opinions of others
Decentralization	Each person should be able to draw on different sources to form their opinion
Aggregation	There should be a sensible mechanism for combining the different opinions

Flows from Active to Passive Funds in U.S. Equities



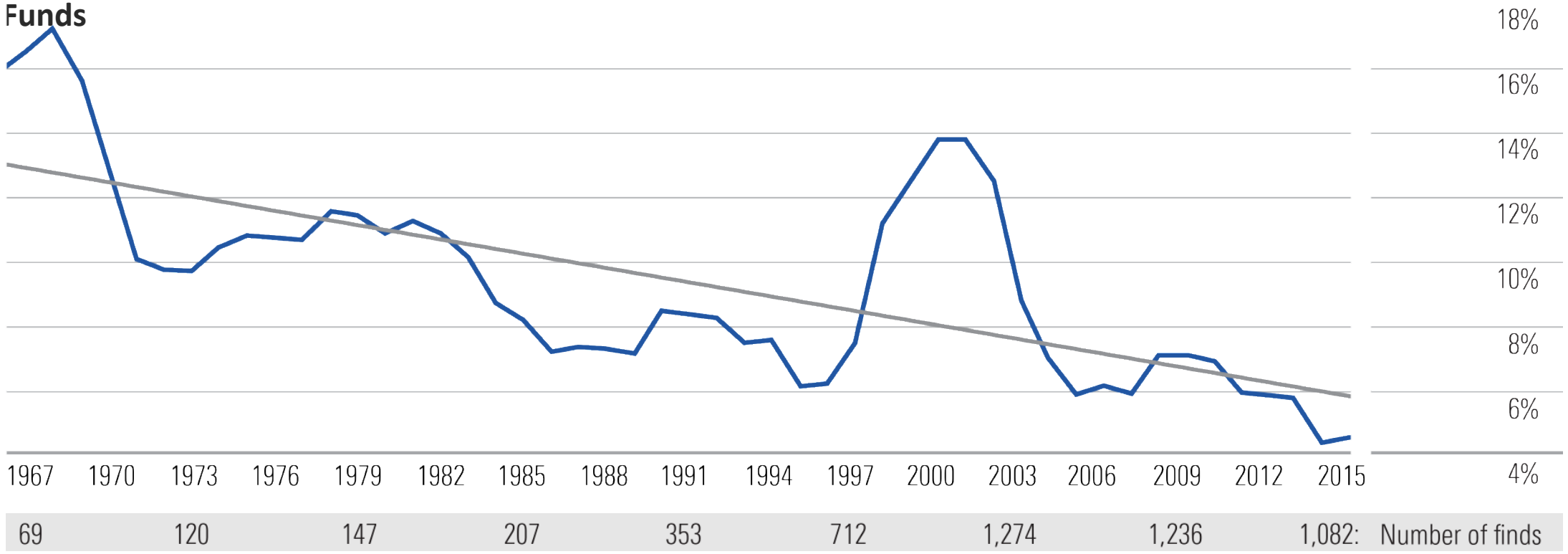
Source: Investment Company Institute; Simfund; Credit Suisse.

Note: U.S. domestic equity funds; figure as of 11/30/18

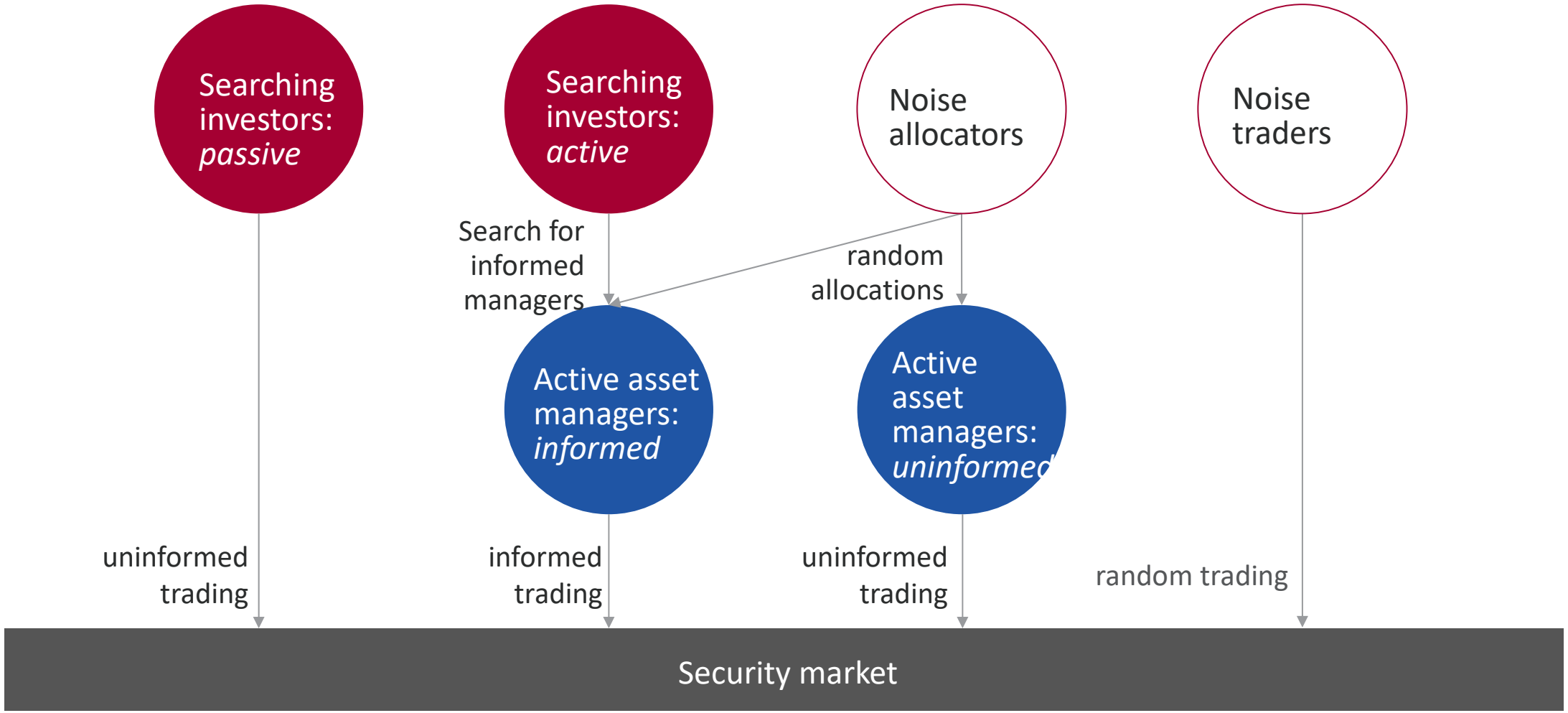
MORNINGSTAR®

Market Efficiency and the Paradox of Skill

Decline in Standard Deviation of Excess Returns for U.S. Large Capitalization Funds



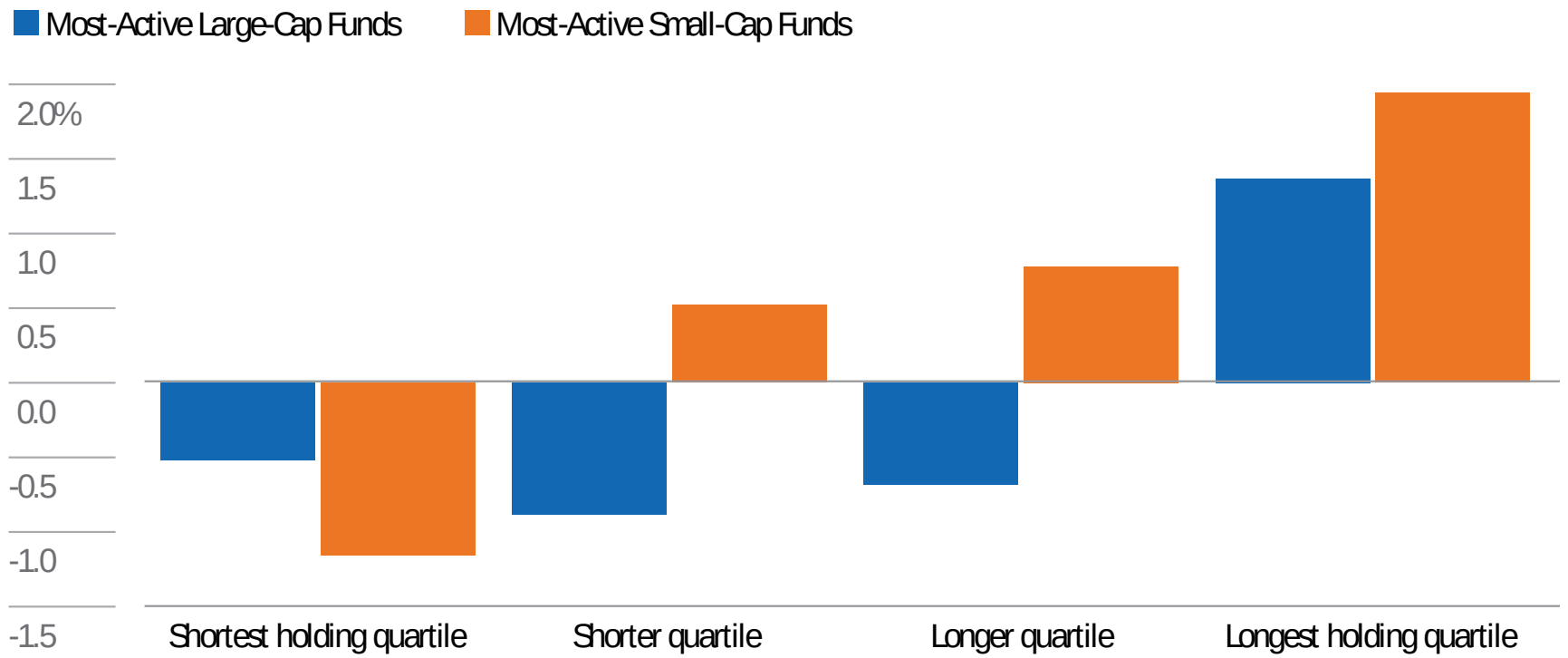
Source: Markov Processes International; Morningstar; Credit Suisse. Data as of 12/31/2015.



Source: Efficiently Inefficient Markets for Asset Management, Nicolae Garleanu and Lasse Heje Pedersen, 2016

More-Active Strategies Tend to Outperform Over the Long Term

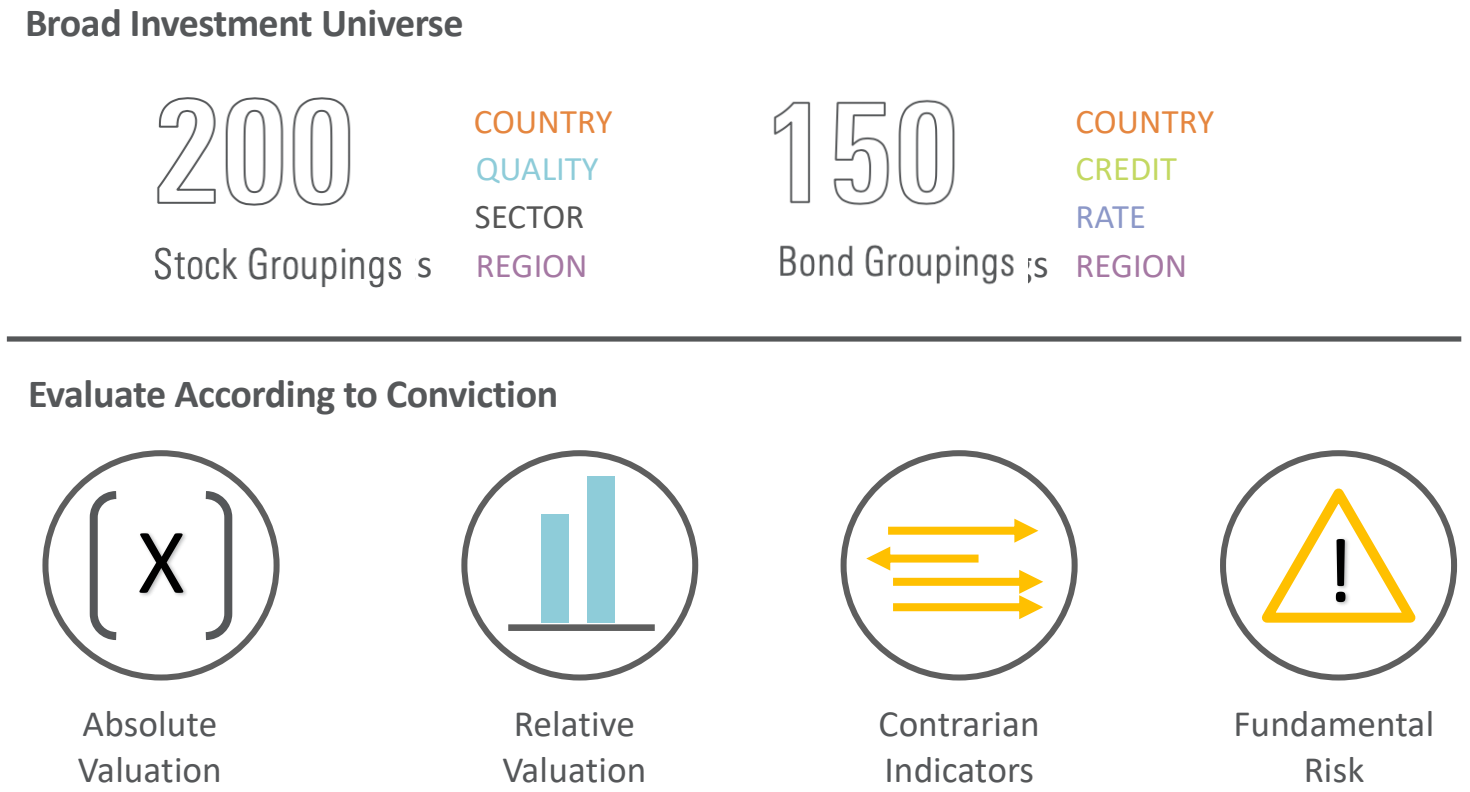
Annualized Abnormal Net Performance of Stock Duration Quartile Portfolios Among Top Active Share Quintile Funds Only, Separately for Large and Small Cap Funds, 7-index factor alpha p/y, 1990-2015



Source: Cremers, M. 2016. "Active Share and the Three Pillars of Active Management: Skill, Conviction and Opportunity." See online appendix at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2891047

Asset Class Selection: Identifying Investment Opportunities

- Asset class teams around the world conduct fundamental and quantitative research, assigning conviction scores across four key areas using 5-point scale
- Valuation-driven expected returns and risks are estimated across a large universe driving the absolute and relative valuation pillars
- Contrarian indicators are used to assess how extreme the negativity towards the asset is
- Fundamental risk is designed to mitigate the risk of value traps
- Conviction scores allow us to select the most-attractive assets within the broad investment universe



From Identifying Investment Opportunities to Investment Selection

Idea Generation

Through a monthly valuation-driven asset allocation process, investment ideas are surfaced

Implementation Approach

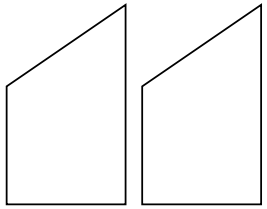
With our asset class teams, portfolio managers determine the most effective implementation option for each portfolio i.e. ETF, passive or active manager

Investment Selection

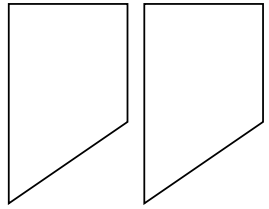
Portfolio managers engage in ETF, passive or active manager search, leveraging the resources of Morningstar's manager research services (MRS LLC) team

Key Performance Evaluation Factors

- Longer time horizon to evaluate investment results
  - More episodic returns for fundamental strategies
- Understand the role of the ETF within the investment strategy
  - Return generation, risk reduction, and/or diversification
- Assess an ETF's impact at the total portfolio level
  - Contribution to total return vs. excess return of ETFs



Nothing is easier than self-deceit. For what each man wishes, that he also believes to be true.



Demosthenes
***Third Olynthiac*, Section 19**

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Diversification and asset allocation are methods used to help manage risk; they do not ensure a profit or protect against a loss.

Past performance does not guarantee future results.

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Q&A

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