

Manager Insight - Montag & Caldwell

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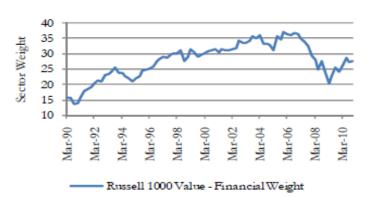
The Case for True Active Management

By James Francis, Montag & Caldwell Investment Counsel, Subadviser to the Aston Funds

The last several years have raised concerns about the ability of traditional active managers, particularly large-cap equity managers, to provide excess returns for investors over common indexes. As a result, many investors have shifted toward alternative asset classes for non-correlated returns or passive approaches in order to mitigate relative risk. Proponents of these strategies believe that markets are generally efficient and that traditional long-only active managers cannot outperform their respective benchmark. Thus, the thinking goes, they are unable to add value while taking on the additional risk of higher tracking error (greater volatility than the benchmark). We will explore these premises and demonstrate that true active managers can add value and that passive strategies do not reduce risk, but increase it.







Source: Vestek-data as of 12/31/10

Tracking Error Risk

Tracking error was created as a measure for indexing strategies to determine how closely a manager was able to "track" a desired benchmark. If an investor is trying to replicate the market's performance then this may well be an appropriate way to measure the effectiveness of a manager's discipline. The statistic later became popular as a tool to evaluate active management during the bull market of the 1990s, however. The focus then was a fear of not keeping up with the benchmark (opportunity cost), so looking at tracking error seemed logical. Ironically, once the concept of tracking error became fully integrated into the investor psyche, the market reached its height and the Technology bubble began to deflate. Investors using a low tracking error approach experienced large losses—locking in negative returns in sectors that became overvalued. While relative risk, in the form of lower tracking error may have been low, the absolute risk of losing money was substantial.

Overall, active managers have struggled to outperform market-cap weighted indexes when those benchmarks have been dominated by a few narrow themes. To keep up with the benchmark in these market environments, many managers have employed a low tracking error approach that typically participates in only part of the upside, but all of the downside. As you can see from the charts on the left, passive investors would have fully participated in the declines following the November 1980 peak in Energy, the March 2000 peak in Technology, and the October 2006 peak in Financials.

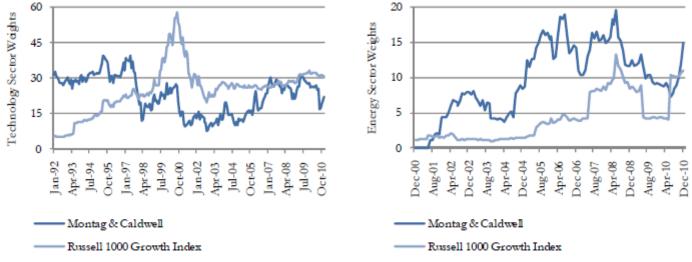
What drives this mentality? One of the problems is that some investors give into short-term performance pressures rather than focusing on long-term goals. Keeping up with the market in the near term overshadows common sense and the focus on building wealth over

time. The attention paid to tracking error leads many active managers to stray from their discipline in what is ultimately a losing strategy. It is the goal of the truly active manager to beat their comparable index, but in doing so it is practically a requirement that the manager be different from the index to achieve that goal over the long haul.

Trend Following

An index is a trend follower—increasing stakes in popular sectors while reducing exposure to out-of-favor sectors. Index weightings reveal current consensus opinion as to "attractive" sectors and which parts of the market are being neglected. Indices are not portfolios designed to control risk by allocating capital from over-valued areas of the market towards undervalued areas. Indeed, an index does just the opposite by adding names to sectors that are doing well, usually up to the point of collapse. This can result in a much greater exposure than one would logically want to any one sector.

Montag & Caldwell has taken an effective active management approach unhampered by an excessive focus on tracking error and benchmark matching. Montag & Caldwell was significantly overweight Technology throughout the 1990s until 1997, when we began to sell due to valuation concerns as other managers piled into an increasingly narrow group of Technology stocks with a "growth at any price" mentality. During the fourth quarter of 2000, our cautious outlook was confirmed as analysts revised earnings estimates down sharply for the sector. With hindsight, our underweighting of Technology in the latter stages of the "Bubble" was correct. This move did, however, run counter to prevailing thoughts, as the Russell 1000 Growth Index had moved to almost a 60% weighting in Technology as many believed that earnings could continue to grow at unprecedented levels. Key to our decision was the realization that valuations exceeded any historical precedent and that earnings growth expectations were unrealistically high.



Source: Vestek-data as of 12/31/10

Conversely, Montag & Caldwell has been overweight Energy for the past decade. We began investing in these companies in 2001, and our active position peaked in 2006 relative to the Russell 1000 Growth. We continue to believe the Energy sector will be a significant source of returns in the years ahead and as such continue to maintain relatively overweight positions due to expectations of strong earnings growth. If we had limited our exposure to the benchmark Energy weight, we would have missed the beginning of a significant opportunity arising from the tremendous demand for energy sources within Emerging Markets.

These two examples not only demonstrate the ability for active managers to find growth opportunities ahead of the market, but also illustrates the importance of "active risk", or having the conviction at times to look different from the benchmark in order to capitalize on opportunities inherent in the market.

Active Risk

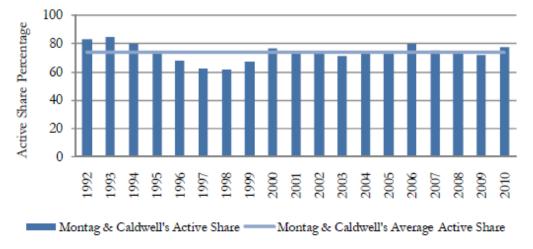
Efficient markets are defined as a market full of rational investors who drive prices to fair valuations based on all publically available information. Behavioral finance suggests however that 1) investors are not always rational; and 2) markets have periods of inefficiency that often have nothing to do with fundamental valuations. Active managers exploit

and capitalize on these pricing inefficiencies by taking active positions relative to the benchmark on information unique to the individual situation. This approach is not inherently "riskier", however. By focusing on fundamentals such as valuation and not speculating, managers that consistently utilize an active risk approach can deliver favorable risk statistics by avoiding the market's excesses.

The key to success for a truly active manager is making investment decisions anchored by a proven process that utilizes strong fundamental analysis and risk management specific to the companies being evaluated. Researching under-valued assets or identifying opportunities based on facts and trends is difficult, but not impossible. The approach that we use at Montag & Caldwell assesses risk based on each company's fundamental profile, which is then translated into our discount rate score. Companies must pass through minimum thresholds for financial stability, liquidity, net worth, and earnings predictability to earn lower discount rates. These factors are directly related to our focus on specific risk, which is used to determine what we are willing to pay for each company. Although many investors believe the large-cap space too efficient given all of the publically available information, successful active managers use publically available information better by spending their time trying to understand the underlying fundamentals and relevant associated risks.

Active risk approaches tend to run concentrated portfolios, as tracking error has little or no meaning for such managers. Not investing is their default position—meaning they have a lot of conviction in fewer names as opposed to owning much of the benchmark. Concentration is not in itself a deliberate choice, rather it stems from discipline—there simply may not be many attractive opportunities to be found within one's area of expertise. Studies have shown that approximately 12 to 18 holdings can account for much of the statistical diversifcation within a portfolio, so concerns about concentrated portfolios increasing investor risk often are exaggerated. Montag & Caldwell believes that an over-diversified approach actually increases investor risk because you become more benchmark-like with the greater number of stocks owned. Concentrated managers limit the number of holdings in order to maximize exposure to stocks with the greatest potential without diluting the impact of their best ideas.

In a 2007 white paper, *How Active Is Your Fund Manager? A New Measure That Predicts Performance*¹, Martijn Cremers and Antti Petajisto came up with a statistic called Active Share to accurately measure active management and its role in portfolios. Active Share compares the holdings of a fund to its benchmark index. When a fund overweights a stock relative to the index, it has an active long position in it; and when a fund underweights a stock or does not buy it at all, it implicitly has an active short position in it. Active share is thus interpreted as the "fraction of the portfolio that is different from the index." The premise behind this analysis is that a passive index adds zero value above and beyond the market, and that alpha (the expected value added for a given level of risk) can only come from positions that deviate from the index—this is what Active Share measures. It distinguishes those managers who are truly active by measuring exactly how active they are. The research was conducted only on funds that claimed to be active by comparing the holdings of a particular portfolio to its respective benchmark.



Source: Montag & Caldwell-Montag & Caldwell Large Cap Growth vs. Russell 1000 Growth Index as of 12/31/10

¹ Martijn Cremers, International Center for Finance Yale School of Management and Antti Petajisto, International Center for Finance Yale School of Management—How Active Is Your Fund Manager? A New Measure That Predicts Performance, January 15, 2007.

Cremers and Petajisto looked at more than 20 years of data and over 1000 funds. They found that until about 1990 almost all funds were active—meaning that their active share was very high. After 1990 they saw a clear shift towards less active management and towards closet indexing. Why? The industry had become much more focused on the benchmark by that point in seeking to minimize risk through lower tracking error approaches. The results of the study were that managers with the highest Active Share significantly outperformed their benchmarks— on average 2.0% to 2.7% per year gross of fees and 1.5% to 1.6% per year net of fees. Managers with an Active Share of 80% or more were considered active stock pickers, wheras managers with an Active Share of less than 60% were considered closet indexers and those with less than 20% index funds. Managers with a high Active Share were determined to have skill. Active Share is also a persistent measure, and typically very stable. If the Active Share measure was persistent, then performance was persistent—and the study found direct evidence of this.

The prevailing view is that active managers cannot add value relative to their benchmarks. This may be true on the surface in aggregate, but only because the majority of so-called "active" managers aren't really active. Those truly active managers able to outperform the passive alternative by even a modest amount over long periods, however, are capable of delivering asset values significantly higher than passive alternatives.

Patience and Longer Time Horizons Needed

Investors need to take a long-term view and realize that even the best managers will have some lagging years. Many of the most respected money managers have had periods of relative underperformance, and as a result suffered through periods of large redemptions. There have been and will be periods of underperformance during more narrow market environments due to factors such as speculation and extreme style and size biases. We are dogmatic in our approach to growth investing—and given our rather agnostic philosophy to benchmarks we naturally take some active risk in our portfolios. This is something that we strive to articulate to investors. For us, it is not a question of whether or not we can add value to passive index returns over time (as we clearly have), but whether or not our investment methodology can deliver results in line with the expectations of investors.

According to a March 2007 report by consultant DiMeo Schneider, approximately 90% of mutual funds with 10-year records in the top-quartile, across 17 categories, spent at least one three-year period in the bottom half of their peer group.² The report concludes that investors need to make better efforts to understand the investment philosophies, processes, and sub-styles of their managers in order to develop the patience required for long-term success.

Do-it-yourself investors are not alone in this respect either. Research has also been done on the hiring and firing decisions of retirement plan sponsors. Plan sponsors dissatisfied with a manager that underperforms in one year often replace that manager the next year with a manager that has been posting stellar returns. This practice has not proven to be beneficial. There have been several academic papers that have put numbers to this performance chasing, all with similar conclusions. "Managers most commonly fired outperformed those that were most commonly hired by 300 basis points over one year and by 100 basis points over five years." A *Journal of Finance* article from 2008 found that newly hired managers, on average, turned in middling performance during their first two years roughly equal to their benchmarks, but after three years the fired managers outperformed their benchmarks by 3.3 percentage points as their replacements outperformed by only 1 percentage point.⁴ All research showed switching managers to be common, and the most cited reason was because of performance. This was particularly true where decisions were based on a one-year return. Thus, the perceived underperformance of "active management" is often a consequence of short-term thinking by plan sponsors and investors believing that they can time the market and need to do something.

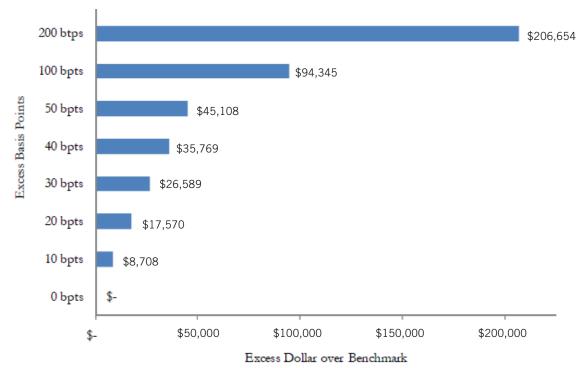
Conclusion

Today, too much focus is given to short-term relative performance. As a consequence, in order to maintain and grow assets some asset managers have chosen to focus more on the risk to their business—which is best combated through a low tracking error approach—than the risk to investors. The mismatch of a long-term investment process and short-term performance pressures has driven many managers to compromise their investment approach in an effort to look more like the benchmark. This performance/evaluation cycle is flawed in that good stock-pickers often chase the mediocrity of low

- ² Matthew Rice, CFA and Geoff Strotman, CFA, DiMeo Schneider & Associates, LLC, March 2007
- ³ Scott Stewart, Boston University School of Management, Advisor Perspectives, Maybe Smart Money...Isn't So Smart, 2008
- 4 Sunil Wahal, Arizona State and Amit Goyal, Emory University, The Journal of Finance—Vol LXIII, No 4, August 2008

tracking error, benchmark-centric models at the behest of their investors, which ultimately is not in the best interests of either.

The goal of a truly active approach is to produce significantly higher returns than the underlying benchmark over a long time horizon. To demonstrate the power of compounding relative outperformance, we have included an illustration. Those managers that can outperform their passive benchmark by even the smallest amount over long periods of time can produce significant ending values over passive investments. The table below describes a \$100,000 portfolio with a 20-year time horizon and calculates the dollar value *in excess* of the benchmark return. For this example, the benchmark annualized return over 20 years is 8%. Outperforming by only 10 basis points annualized over this time period increases the portfolio by \$8,707 over passive investing. A 200 basis point annualized excess return adds \$206,654.



Source: Montag & Caldwell

A solid fundamental discipline is essential for truly active managers seeking to add value beyond an index. This is not to say that an active manager can consistently beat an index year-in and year-out, but that over the long run a disciplined, active approach run by an experienced management team following a time-tested process can outperform an index. Although it sometimes may not appear so in the short run, especially during market environments dominated by speculation and narrow sector themes, over time experienced active managers have the advantage of being able to identify opportunities that can add value for investors.

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