



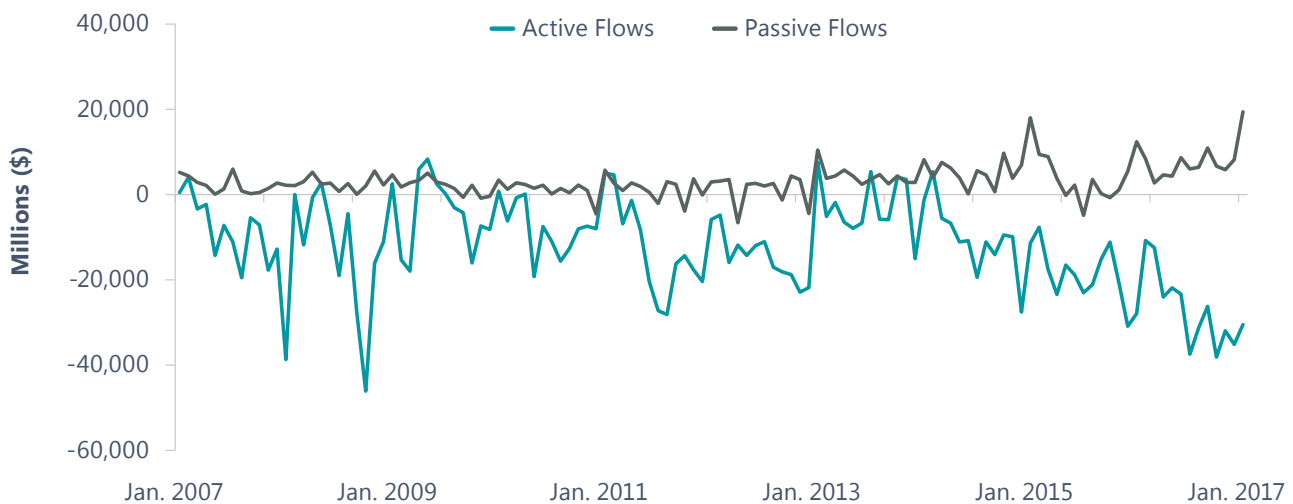
High Conviction Active Management Asserts Strength Over Time

Key Takeaways

- ▶ Over the last decade, active strategies with lower turnover and greater concentration have delivered better performance, down market capture and Sharpe ratios than more diversified, higher turnover strategies.
- ▶ As a result, active management is best evaluated on a strategy-specific level and on the degree to which active strategies differ from their benchmark.
- ▶ We believe conditions are improving for active managers and that a patient, high active share approach is the most effective way to capture the benefits of active management.

Active management plays a useful purpose in supporting the proper functioning of capital markets and providing long-term investors the chance to earn returns in excess of market averages. The intentional buying and selling of stocks at specific levels provides price discovery and liquidity, essential components in properly valuing the earnings potential, benefits and risks of individual businesses and allows shares to be efficiently transferred from one owner to another. Active management offers opportunities not available through passive strategies, such as leveraging mispricings in less efficient parts of equity markets. An active approach can also improve risk-adjusted returns through a dedicated focus on risk management, both ex-ante through fundamental security analysis that eliminates individual stocks or entire sectors from purchase consideration and ex-post by monitoring existing position sizes and portfolio construction. Despite these inherent advantages, active strategies are taken to task for their inability to outperform the market and thus justify their management fees. We acknowledge that in aggregate, active funds have failed to deliver consistent alpha in recent years as demonstrated by the underperformance of active U.S. large cap core strategies versus the S&P 500 Index.¹ But in a U.S. market with the choice of more than 1,000 actively managed large cap strategies, active strategies with certain characteristics that are repeatable over time have been shown to outperform market averages over full cycles.

Exhibit 1: Steady Inflows Have Supported Passive Strategies



As of Jan. 31, 2017. Source: Investment Company Institute.

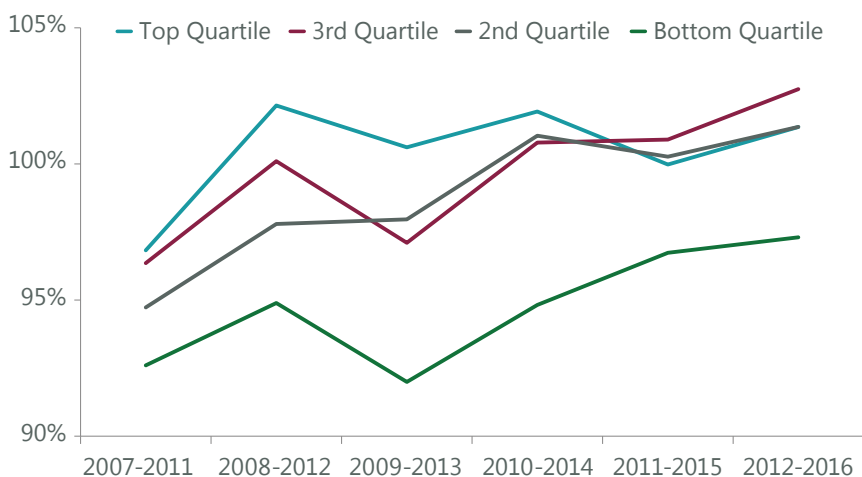
The efficacy of active management has come under greater scrutiny in an investment environment driven more and more by fiduciary concerns. The growing fiduciary emphasis on selecting prudent investments has made cost a key measure of a strategy's appropriateness. To justify the higher fees active managers charge compared to passive alternatives, these managers are expected to outperform their benchmark index net of fees. Among large cap active strategies in the eVestment database, the majority of active managers have fallen short of the market returns produced by passive strategies, thus failing to justify their higher fees.² This broad repudiation of active management, however, misses a practical point: investors do not choose a broad management style

active or passive but rather a specific strategy to meet their individual needs. In this context, it is impractical to lump all active funds into a single bucket when the active universe includes a wide variety of approaches and potential outcomes. While we agree that active strategies with index-like characteristics are unable to justify their higher fees, active approaches that produce portfolios which make measured choices against an index have a higher likelihood of adding value beyond those provided by passive approaches. We will discuss the characteristics of these active approaches in more detail later in the paper.

Recency bias has also worked against active managers as underperformance over the past few years has led to increasing flows into passive strategies, creating

buying momentum that furthers the performance advantage for passive (Exhibit 1). This phenomenon is illustrated in the growing popularity of smart beta strategies that follow a low volatility approach. The generally positive direction of U.S. equities during the bull market that started in March 2009 has also supported the outperformance of passive strategies. As we will discuss, this is consistent with our finding that in up markets, strategies with a larger number of holdings – a category that would include passive strategies – tend to outperform those with fewer holdings. By larger number of holdings, we are generally referring to strategies in the top quartile by number of holdings in

Exhibit 2: Down Market Capture by 5-Year Average Annual Turnover



Top quartile represents highest turnover U.S. large cap active strategies (turnover of over 74.2%) and bottom quartile lowest turnover strategies (turnover of less than 26.7%) over the reporting period from 2007-2016. Source: eVestment.

Exhibit 3: Sharpe Ratios by 5-year Average Annual Turnover

	2007-2011	2008-2012	2009-2013	2010-2014	2011-2015	2012-2016
Top Quartile	-0.02	0.07	1.04	1.03	0.91	1.37
3rd Quartile	-0.02	0.08	1.05	1.00	0.88	1.34
2nd Quartile	0.00	0.10	1.01	0.98	0.89	1.34
Bottom Quartile	0.02	0.13	1.07	1.07	0.94	1.43

Top quartile represents highest turnover strategies and bottom quartile lowest turnover strategies, among U.S. large cap active strategies. Source: eVestment.

the eVestment U.S. Large Cap Active Strategy universe; the top quartile averaged 90 or more holdings over the period from 2007-2016 while those in the 3rd quartile averaged between 58 and 89 holdings.

Given the wide range of large cap active strategies available, a prerequisite to judging performance is to screen the universe down to those strategies that provide true active management. Active share, which measures the percentage of stock holdings in a portfolio that differ from its benchmark, is one of the most straightforward ways to do this and one that ClearBridge monitors and supports across its portfolio management teams. Combining active share with metrics including tracking error, concentration level of top holdings and sector deviations can provide even more confidence that investors are evaluating truly active strategies – as opposed to those that bear close resemblance in portfolio construction and performance to their benchmark index. The original study on active share in 2009 by Martijn Cremers and Antti Petajisto separated active managers into five groups and found that “diversified stock pickers” delivered the most alpha while “closet indexers” added minimal value.³ A follow up study in 2015 by Cremers and Ankur Pareek identified a further qualifier to alpha generation: longer holding periods. Cremers and Pareek found that among high active share portfolios, only those with an

average holding period of two years or more delivered consistent outperformance.⁴ A ClearBridge analysis of the eVestment universe of active large cap strategies led to similar conclusions. This confirms our assertion that the type of active management approach managers deliver and their ability to consistently adhere to that approach over time should be a primary consideration when comparing active to passive strategies.

Not surprisingly, high active share portfolios tend to have lower turnover. Dividing the eVestment U.S. Large Cap Active Strategy universe into quartiles by active share, strategies in the second highest active share quartile had the lowest annual turnover in the two rolling five-year periods from 2009-2014, while strategies in the highest active share quartile had the lowest turnover in the two rolling five-year periods from 2011-2016. We believe having high conviction in the stocks in a portfolio is a critical quality of true active managers and is reflected in the longer holding periods indicated by lower turnover. A high degree of conviction in the individual stocks they own gives active managers the confidence to hold stocks through full market cycles that will inevitably include difficult periods. ClearBridge portfolio managers invest as business owners, leading to strategies with annual turnover in the lowest quartile of their respective peer groups.

Exhibit 4: Annualized Returns for Low Turnover Strategies by Number of Holdings

	2007-2011	2008-2012	2009-2013	2010-2014	2011-2015	2012-2016
Top Quartile	0.86%	2.73%	18.17%	14.97%	11.63%	13.90%
3rd Quartile	0.27%	2.31%	18.10%	14.82%	11.58%	14.04%
2nd Quartile	1.59%	2.48%	18.25%	14.88%	11.80%	13.90%
Bottom Quartile	2.48%	3.89%	19.18%	15.87%	12.78%	13.94%

Top quartile represents strategies with most holdings and bottom quartile strategies with fewest holdings over rolling 5-year time periods from 2007-2016. Universe limited to U.S. large cap active strategies in lowest turnover quartile over those periods. Source: eVestment.

Lower turnover strategies tend to hold up better during market downturns. Large cap portfolios with lower turnover outperformed portfolios with higher turnover during down markets in each of the rolling five-year periods that encompassed the last two bear markets that occurred between October 2007 and March 2009 (Exhibit 2). This is confirmed by the better down market capture of such strategies. In fact, strategies in the lowest 5-year average annual turnover quartile, which averaged turnover of less than 26.7% over the course of the study, consistently delivered the best down market capture over every time period from 2007 to 2016.

Lower turnover strategies have also delivered better risk-adjusted returns (as measured by Sharpe ratio) than higher turnover strategies (Exhibit 3). Given that the lower turnover group had higher Sharpe ratios despite lagging higher turnover groups during up markets, this suggests that preserving capital during periods of market turbulence is one of the primary drivers of long-term active performance. Active managers strive to provide downside protection by de-risking stocks – thoroughly understanding and modeling the worst possible outcomes for a stock – by waiting for an appropriate entry point that offers an attractive potential return for the given level of risk, and adjusting weights of individual holdings based on their relationship to the overall risk characteristics of a portfolio. These dynamic risk management capabilities are not available in passive strategies.

Comparing active large cap strategies by number of holdings produced similar results. Lower turnover portfolios with fewer holdings on average performed better than those with more holdings during the

rolling five-year periods that included bear markets (Exhibit 4). These more concentrated portfolios also demonstrated better down market capture and higher Sharpe ratios. ClearBridge portfolio managers choose to only own companies in which they have high conviction, an approach that leads to our large cap portfolios generally holding between 40 and 80 names. During rolling five-year periods that encompassed up markets, portfolios with the greatest number of holdings performed better. This may be a reflection of the accommodative, low interest rate environment that supported equities in general coming out of the global financial crisis. Easier monetary conditions over this period have enabled lower quality companies to compete more effectively with higher quality companies as the cost of capital has remained affordable.⁵

Looking at the active large cap universe, the strategies with the lowest turnover and fewest holdings tended to deliver better returns, Sharpe ratios and down market capture over the 10-year period ended 2016, compared to less concentrated strategies with higher turnover. This data suggests that active strategies that take a long-term, high conviction approach – qualities that guide portfolio construction at ClearBridge – are well suited as a complement or replacement to passive strategies in the highly competitive U.S. large cap asset class. We believe the right kind of active management can consistently deliver alpha over time. When choosing active strategies, these characteristics should be a determining factor.

Now may be a particularly good time to consider adding an appropriate active manager to your large cap allocation. After an extended period of high correlations

Exhibit 5: S&P 500 Equity Correlations Are Receding



Data shows rolling 65-day correlations of S&P 500 stocks as of May 2, 2017. Source: Strategas Research Partners. period from 2007-2016. Source: eVestment

that accompanied historically accommodative monetary policy from the Federal Reserve, correlations have begun to drop across asset classes⁶ and within the S&P 500 Index (Exhibit 5). The greater dispersion among stocks in the large cap universe enhances the potential for stock selection (and avoidance) to generate alpha. In recent months, both Ned Davis Research and Nomura Research have noted the extended cycle of passive

outperformance and reminded us that the advantages enjoyed by active and passive styles are cyclical. Nomura has further pointed out that rising interest rates are a key catalyst for mean reversion in favor of active management. ClearBridge believes a patient, high active share approach is the most effective way to capture the benefits of active management.

1 The median large cap core active strategy underperformed the S&P 500 Index return in four of the last five years, gross of fees, with underperformance becoming more acute in 2016, according to an analysis of eVestment data.
2 The median large cap active strategy underperformed the median large cap passive strategy, gross of fees, in five of the last six years, with underperformance becoming more acute in 2015 and 2016, according to an analysis of eVestment data.
3 Cremers, M., Pareek, A. "Patient Capital Performance: The Investment Skill of High Active Share Managers Who Trade Infrequently." Working Paper, December 2015.
4 Ibid.
5 ClearBridge Investments, "Why Quality Matters in Mid Cap Investing." May 2015.
6 Ned Davis Research, "Correlation of the S&P 500 vs. Other Asset Classes." March 2017.

About the Author



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