Longevity FINANCIAL CONSULTING

December 3 2015

Active Share is a Fuzzy Number

How Active Share can be manipulated and what you can do to prevent that

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Active Share has gained increasing visibility among investment managers, consultants and clients since the concept was introduced in 2006 by Cremers and Petajisto[1]. In our opinion, Active Share's popularity has largely been driven by two factors. First, it appears simple[2] and intuitive, measuring the degree of difference between any portfolio and its benchmark on a scale of 0 to 100. And second, the investment industry has become fascinated by the debate over the link between the level of Active Share and outperformance of the benchmark.

But as with many things in life, it may not always be as cut and dried as it seems. Some managers may be pleased to claim a "high Active Share" and infer this is a link to good performance, but the reality is more complex and potentially quite fuzzy!

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While Active Share appears simple, our research[3] has shown that any portfolio's Active Share is significantly dependent on the construction of the index against which it's benchmarked. In general, the more concentrated the benchmark, the harder it is to achieve an Active Share in the range generally considered "high" in the industry (80% plus, for example). For example, a manager of Canadian large caps would struggle to post an Active Share over 70%, while a US small cap manager would struggle to get Active Share below 80%.

And the second topic, the link between Active Share and outperformance, is still being actively debated by academics and practitioners.

However this article's focus is not on these admittedly important issues of how best to use Active Share, but on the even more basic issue of how to measure this number.

Why is this important?

Because with Active Share well on the way to becoming a central element of managers' sales efforts and of clients' portfolio analytics, the reality is that Active Share is a fuzzy number, open both to

[1] How Active is Your Fund Manager? A New Measure that Predicts Performance

[2] Active Share is the proportion of a portfolio's holdings that is different from the benchmark for that portfolio. Thus a portfolio that perfectly matched its benchmark composition has Active Share of zero, and one that has no holdings in common with its benchmark has Active Share of 100.

[3] "Is Your Portfolio's "High Active Share" Really High?" Brandes Institute and SEB Investment Management, 2015

inadvertent errors and to manipulative techniques. Our goal in this article is to explain the potential problems, and suggest practical steps to be taken by the industry as a whole, as well as by managers and clients.

Let's start with how it's even possible to manipulate Active Share. After all, the calculation definition (see footnote 2) does seem clear and unambiguous.

Let's take an example. Your portfolio is benchmarked against the S&P 500, and you have invested the whole portfolio into one stock, ticker symbol "SPY". SPY is not included in the S&P 500, so the Active Share definition would suggest your Active Share is 100: you have no holdings in common with your benchmark. But SPY is an Exchange Traded Fund designed to mirror the performance of the S&P 500, so in reality, your results should be substantially identical to those of the index, effectively an Active Share of close to zero.

That's an extreme case, but we use it to make the point that the system can be gamed. It opens the door to a number of gray areas, where deliberately or inadvertently, managers can tilt Active Share statistics in their favor. Why would any manager do this? Because the consensus among active managers and their clients seems to be that if outperformance is linked to Active Share, then the higher the Active Share, the better. This hits a manager's bottom line: all else being equal, a higher Active Share may increase the chance of being hired.

There are already active discussions in Europe on this topic between managers and regulators. There are four areas under debate, each of which can lead to gray areas of interpretation.

1. Using different securities of the same issuer
2. Disguising the underlying index exposure
3. Cash
4. Choose the wrong benchmark

Different securities of the same issuer: this can be a problem if the portfolio holds securities that behave substantially the same as the ordinary shares in the benchmark, such as depositary receipts (ADRs, GDRs, etc.) or different share classes (for example A, B, or C shares). These securities aren't in the benchmark, so using a strict definition, holding them would boost Active Share. A possible remedy is to count Active Share at the company level, not the security level. However, this could capture in the net securities that really don't behave like the ordinary shares, such as convertibles, preference shares and some of the "letter" share classes, thus reducing Active Share unnecessarily.

Disguising the underlying exposure: our earlier illustration of an ETF used to replicate index exposure is an extreme example. However use of derivatives, funds or synthetic securities can lead to misleading results as none of these are included in the benchmark. The logical remedy is to "look through" to the underlying exposure. This makes more work for the manager (but they were the ones who decided to use these instruments, so philosophically that's OK). But it also makes it hard for a client to verify that the resulting Active Share number is reasonable.

Cash: this is relatively simple to handle. Cash is an active decision of the manager, and is not in the benchmark. So cash holdings should be counted in the calculation of Active Share. "Equity-only" Active Share calculations should not be permitted (and as this would lower the Active Share result, most managers should be pleased to conform to this standard).

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Choice of benchmark: as Active Share is by definition calculated relative to a benchmark, use of inappropriate benchmark is a quick way of boosting Active Share. Detection may not always be easy. For example, suppose a manager's mandate allows them to invest across the whole spectrum of the US equity market, so they measure their Active Share against the Russell 3000, an "all-cap" index, with a result of (say) 92%. But an astute client notes that in the past decade the portfolio has owned only large cap stocks, so that while in theory the benchmark could be the Russell 3000, a much more appropriate one is the large cap Russell 1000. The manager's revised Active Share drops to (say) 73% as a result. A possible remedy for this problem is for the manager to use the benchmark that has the highest correlation with their long-term portfolio returns. This by the way was the approach used by Active Share creators Cremers and Petajisto in their original 2006 research study.

Given the potential for miscommunication, let alone abuse, what should be done to prevent these issues becoming major problems for clients and advisors?

In Europe, regulators in France and Scandinavia are already looking into the measurement and use of Active Share, although this issue has received less attention in North America. The sensitive issue in Europe appears to be mutual fund fee levels, and whether these are justified by the degree of active management (as measured by Active Share). Mutual fund fees are generally lower in the US than in Europe, so the topic has received less attention here. (The SEC is unlikely to get involved unless a manager is so foolish as to manipulate their Active Share while claiming a link between that number and outperformance.)

Even if regulation is not on the immediate horizon in the US, it still would be advantageous to agree on a standardized approach ("code of conduct") for calculating Active Share. This would benefit both managers and their clients by increasing transparency and improving the credibility of Active Share numbers.

So who is best suited to develop and monitor this Active Share Code of Conduct and make its use less "fuzzy"? Under the guidance of the CFA Institute, GIPS ("Global Investment Performance Standards") has become the worldwide code for presenting performance. While Active Share is not a performance measure (despite what some would claim) perhaps the GIPS code can be used as a model for the development of a CFA Institute best-practice Guide to Active Share Statistics (GASS?).

In the meantime, we hope this article is useful to both managers and their clients in raising awareness of these issues. Managers should use their judgment to make sure the Active Share they claim for their portfolios truly represent the underlying reality. For clients, the goal should be to be sufficiently aware of the potential problems to be able to ask the right questions to their managers. Hopefully this article provides the information to enable that to happen. It may not be possible to define Active Share with absolute clarity, but in our opinion, it should not be allowed to remain a fuzzy number!

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