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MFS® White Paper

Time to Align

Rewiring the conversation about active management

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In brief

- Driven by a longer investment ownership chain, increased institutional ownership of public companies and a more complex market environment, the current misalignment between asset owners and asset managers is causing investors to forfeit the full value of active management.
- The disconnect is most evident through mismatched investment time horizons, where asset owners expecting alpha over increasingly short time periods are failing to leverage active skill over a full market cycle and are leaving alpha on the table.
- A successful course correction could help investors avoid costly manager changes by working more effectively with their boards and investment committees to define long-term objectives and seek a better investment outcome.

With a recent MFS survey showing more than three-quarters of institutional investor assets currently allocated to actively managed strategies,[1] the active versus passive debate seems somewhat misguided. We believe the real issue confronting investors today is a misalignment between asset owners and asset managers — particularly when it comes to investment time horizons. It's a conversation that asset managers must initiate, as resolving this issue could help their clients reap the true benefit of active management: long-term liquid alpha.

Several factors are driving this misalignment, including a longer investment decision-making chain, rampant short-termism and an increasingly complex market environment. The consequences can be severe. We're seeing a misallocation of capital along the investment chain, costly manager replacements and the erosion of long-term value creation. To help investors manage these challenges and realign with active management, we offer this paper as a framework for course correction.

Misalignment: The drivers and the disconnect

The path to that course correction starts with understanding what caused the misalignment between asset owners and asset managers.

We see three primary drivers of the misalignment:

- A distinctively **longer investment ownership** chain today, with more intermediaries between asset owners and the companies they own, which has created added layers of measurement to ensure accountability.
- The **increased institutionalization of public company ownership**, which has made investing less about ownership and more about trading; less about long-term capital commitment and more about short-term alpha; and ultimately, less about building trust and remembering why that is so critical.
- An **increasingly complex market environment**, which creates tough asset allocation decisions, where investors either have to take three times the amount of risk to get the same return they did 20 years ago or lower their return expectations if they aren't willing to take on additional risk.[2]

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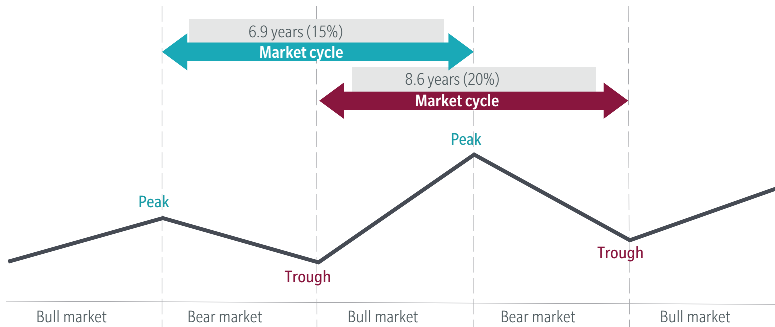
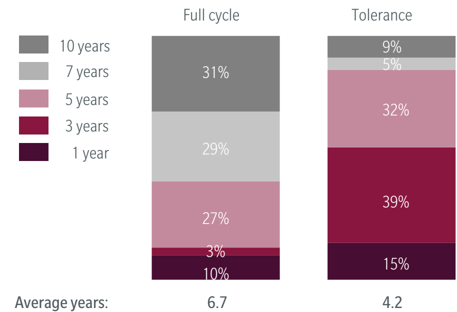
Exhibit 1: Defining a full market cycle and understanding tolerance for underperformance



Source: "Defining a Market Cycle," Manning & Napier, Dec. 2014.



Source: 2017 MFS Active Management Sentiment Study (including 360 global institutional investors)
Q [Full Cycle]: First, what is your definition of a full market cycle?
Q[Tolerance]: How long are you willing to tolerate the underperformance of external asset managers before initiating the search for a replacement manager?

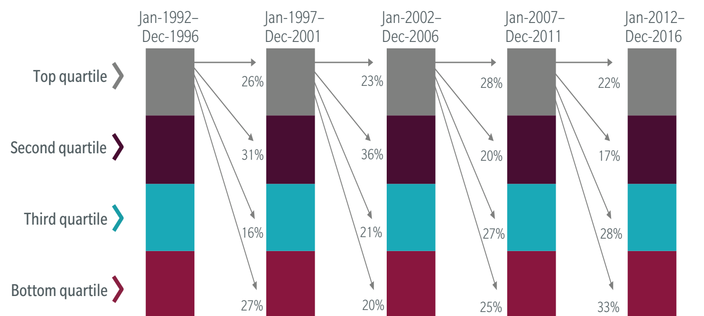
The most profound and troubling sign of this disconnect is that the investment time horizons of asset owners do not match those of asset managers. Whereas most skilled active managers need a full market cycle to generate meaningful alpha,[3] the industry is assessing active skill based on three- to five-year performance periods, with little discussion of aligning accountability metrics to actual long-term investment objectives.

In reality, a three-year time period is less than half as long as a typical market cycle, which can last seven to 10 years. And while a solid majority of investors know this, as shown in Exhibit 1, more than half of the investors we surveyed would only tolerate underperformance for three years or less. Couple that with the fact that 82% of the institutional investors we surveyed rank underperformance as one of the top three reasons for decreasing allocations to actively managed investments and it's easy to see a misalignment in investment time horizons between asset owners and managers.[4]

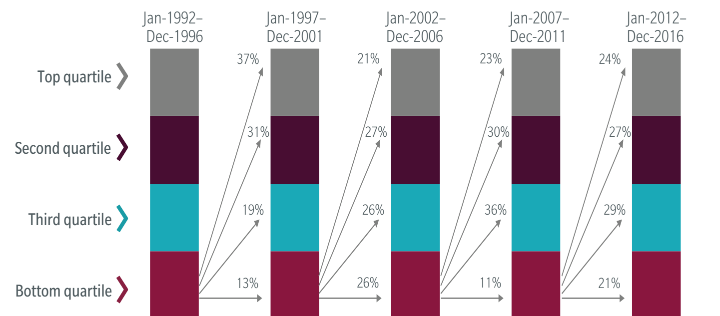
That intolerance for short-term underperformance could cause institutional investors to forfeit long-term alpha because it drives them to hire and fire active managers at potentially inopportune points in the market cycle — either immediately after a period of strong long-term outperformance or just before a period of underperformance. Such manager replacements — or "round trip decisions," as Willis Tower's Watson's Thinking Ahead Institute calls them — are costly for institutional investors. In fact, in its paper "The Search for a Long-Term Premium," Thinking Ahead suggests that avoiding short-term manager replacements is among the "eight building blocks of value creation via long-horizon investing" that could lead to a "net long-term premium of 0.5% to 1.5% annually."[5] Compounding that annually is not trivial on a long-term asset.

Institutional investors are constantly caught in a conundrum: Their boards do not appreciate the importance of countercyclical courage — a manager's willingness to stay disciplined and give their investment

Exhibit 2: Performance results of top-quartile US managers through different parts of a cycle



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



Source: eVestment Alliance.
The universe includes 467 strategies in the eVestment Database. Within the eVestment Database, we used their Universe, called All US Equity and an inception date on or before 1/1/1992. Rankings include both surviving investments and those liquidated and/or merged prior to the end of the full calculation period (1/1/1992–12/31/2016). Performance is utilized for periods where it is available (*i.e.*, based on whether or not managers reported their performance). Performance is calculated gross of fees. The entire universe of funds is analyzed during each five year period.

theses time to play out — especially during periods of negative alpha. As we see in Exhibit 2, the top-performing managers in one period could be at the bottom in subsequent periods, and vice versa. This is why active management is most effective through a full market cycle — either peak to peak or trough to trough.

How do we course-correct?

We need to challenge the model that drives the long-term allocation of capital. That means rethinking governance, measurement of skill and, ultimately, the factors that truly impact investment outcomes.

Improve governance

The conversation around governance begins at the board level, with a clear need to document investment objectives, beliefs and time horizons. If investors are going to hold their active managers accountable to a set of standards, then clarity around those standards is paramount. Yet the 2016 MFS Active Management Sentiment Study shows that nearly half of institutional investors we surveyed lack a written standard for measuring time tolerance when evaluating managers (see Exhibit 3), which is a key component of an effective investment policy statement.

Documenting those standards is only half the battle. Asset owners should also maintain consistency between manager selection metrics and ongoing measurement. During the selection process, asset owners spend a tremendous amount of time assessing the attributes that reflect a sustainable process, including research capabilities, risk management and investment culture. These attributes are more difficult to measure, but ultimately they have a greater impact on long-term outcomes. After hiring managers, however, measurement simply pivots to past performance, and often covers time periods that fall well short of a full market cycle.

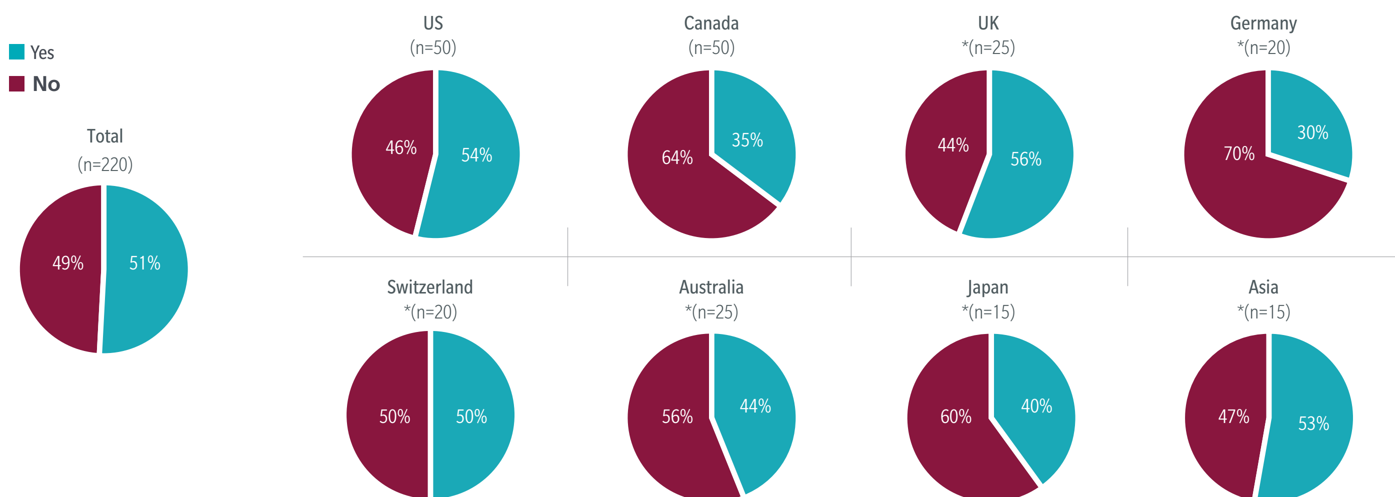
Revisit measurement

We need to change that performance paradox. While measurement is critical to accountability, measurement of the wrong metrics is counterproductive and often takes the long-term allocation of capital off track.

It's time to measure what matters, not necessarily what is easy. Investors will continue to look at short-term performance, and to suggest otherwise is impractical. Investors could, however, use that short-term performance not as a decision point, but as a marker on the path to a long-term destination. This might actually improve the evaluation process. As part of that effort, asset owners need to develop clarity about the percentage of time that they both expect and will accept underperformance. And asset managers need to do a better job helping owners understand how their strategy tends to perform in different market environments. Setting those parameters is about being countercyclical and managing expectations for active managers. It's a different mindset — rather than alpha all the time, it's long-term liquid alpha over time.

Exhibit 3: Roughly half of global investors we surveyed admit they do not have documented time periods by which they measure the performance of their external managers.

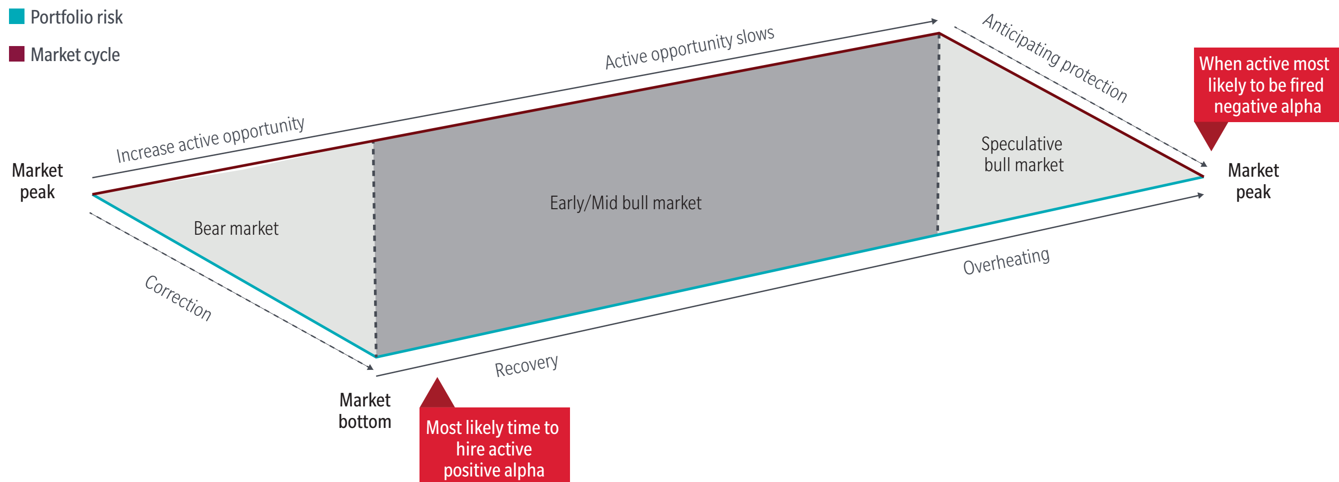
Incidence of documented investment performance time period



Source: 2016 MFS Active Management Sentiment Study (including 220 global institutional investors). *Caution: small base size. Q: Is there a specific investment time period documented, in either an investment policy statement or some other formal investment strategy document, in which you measure the performance of your external asset managers?

Exhibit 4: Leveraging a full market cycle

The ebb and flow of opportunities for active management



Source: "Defining a Market Cycle," Manning & Napier, Dec. 2014.

Set a context

Investors must always be cognizant of where they are in a market cycle when they hire an active manager and when they consider replacing one, as illustrated in Exhibit 4. Even the most skilled investors will underperform at different points in a market cycle. This is why countercyclical courage is so important. During periods of increasing volatility, underperformance could reflect active risk management, which sometimes means going against the grain in an effort to mitigate potential losses.

For institutional investors, the challenge is to help their boards understand the value of negative alpha at certain points in the cycle, in the pursuit of long-term outperformance. As Exhibit 5 illustrates, the top-performing managers over a seven-year window (2009–2016) spent 2–4 years underperforming their peers and benchmarks.

Putting this all together gives institutional investors a better way of measuring a manager over a full cycle, while helping their boards incorporate a longer view. While most would agree that the current measurement structure is broken, the industry has an obligation to change the model to better serve the needs of investors and curtail the damage short-term behavior does to long-term value creation.

Benchmarks

As an industry, we often focus on benchmarks and assume they are appropriate with respect to risk and reward. In reality, however, traditional benchmarks are not always the right answer, and in fact they can drive procyclicality — or herding behavior. Perhaps a better solution is for institutional investors to help their boards understand the expectation for alpha against a benchmark at different periods of the market cycle, a point illustrated in Exhibit 4.

Process

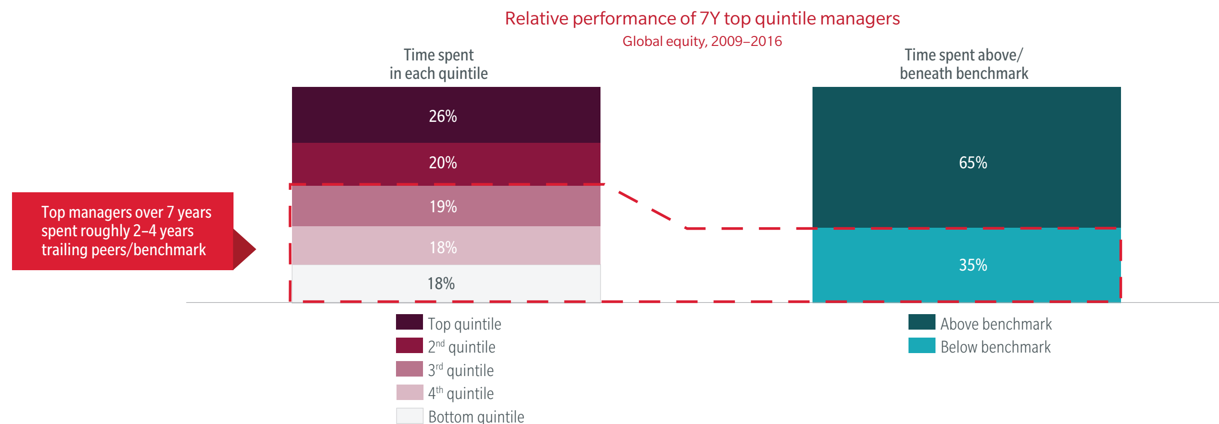
While institutional investors will carefully examine an investment manager's process, they tend to focus on research and portfolio construction. What they often underestimate is the importance of stewardship. Yet a manager's stewardship — which is about knowing what they own, owning good companies and holding them accountable for sustainable business practices — is essential to the responsible, long-term allocation of capital.

Assess skill

With a better measurement system in place, the logical question is, how do asset owners find skill? Many feel they lack the confidence to identify it, as our survey indicated. Globally, only one-quarter of the institutional investors we surveyed say they can tell the difference between a skilled and average active manager.[6] Finding skill is not the crux of the problem. In order to achieve the outcomes they need, investors must also align with skilled managers over the long term.

Still, we must acknowledge that identifying skill today has changed. We believe the clearest evidence of skill comes through an active manager's potential for developing an analysis advantage, driving engagement and investing with conviction.

Exhibit 5: Finding long-term outperformance will be buyers' most pressing need



Sources: Casey Quirk and eVestment.

Analysis advantage

Because we now live in an age of information democracy where all investors have access to the same information, the skilled active manager must have a research engine and process that turns that information into insights — before they become obvious to the rest of the market. The potential for that analysis advantage not only demands the best global information flow, but also an investment team that deploys the full strength of its diverse views and collective expertise. This is what truly matters when it comes to developing sound investment theses and more effective decision making.

Engagement

As it relates to active management, engagement should be a major factor in assessing a manager's value proposition. Importantly, engagement means far more than proxy voting. Rather, it's the process investors should expect from active managers: It's not just knowing what they own, but also interacting with portfolio companies regularly, whether through on-site meetings or consistent communications with management teams. Active managers have to know their portfolio companies extraordinarily well to be willing to allocate capital to them initially and continue doing so over time.

Moreover, some studies have shown that engagement can impact returns. In the Willis Towers Watson paper on the long-term premium, the authors found that "engagements with investee companies on average generated positive abnormal returns of 2.3% in the year following the initial engagement." [7]

While institutional investors recognize the value of engagement — two-thirds of those we surveyed rated it "important" — they don't necessarily understand the engagement process.[8] We believe active ownership is not only essential to the responsible, long-term commitment of capital, it's key to the environmental, social and governance (ESG) conversation. It's impossible to fully understand and integrate all long-term material factors that might impact the future value of a business without considering ESG factors. Part of that discovery process happens through active engagement with company management teams.

Rather than approach ESG through a screen, as a product or a separate outcome, we believe an active management process focused on identifying the materiality of ESG factors is what truly makes a difference. In a study from Harvard Business School called, "Corporate Sustainability: First Evidence on Materiality,"[9] the authors found that stocks that scored high on material factors and low on immaterial factors had returns that were twice those of stocks that scored high on immaterial factors but low on material factors. So what institutional investors should expect when hiring skill is for active managers to be very good at determining what is material versus immaterial.

Importantly, as stated in a paper by Empirical Research,[10] "not all ESG factors are created equal." The authors point out that some factors are much more material than others (especially by industry). They say that matters because most of the MSCI ESG rankings are "driven by factors that may well be immaterial for a stock's industry." In addition, they conclude that "a ranking of stocks based on the overall ESG score is likely driven quite heavily by noise."

Conviction

Conviction could also be an effective metric for assessing skill. While conviction is typically discussed as a weighting against a benchmark — often referred to as active share or concentration — it's equally important to focus on the holding horizon, or how long a manager commits capital to a particular company. A paper by Lan, Moneta and Wermers shows that funds with longer holding horizons have generated better risk-adjusted returns than funds with shorter holding horizons, outperforming them by 2.4%–3.8% annually.[11] Further, the authors suggest that "superior long-term performance of long

holding horizon funds is due to their superior skills in picking stocks with higher future cash flow growth." The authors conclude that fund managers must "truly understand the long-term competitive position of a firm to hold a position in that firm for the long run."[12]

Holding horizon becomes critical to skill assessment when viewed as a reflection of investment philosophy. For example, a long holding horizon would reflect a manager's long-term philosophy, and vice versa. Yet here we see another disconnect. In our research, 95% of the institutional investors we surveyed rank investment philosophy as most important when selecting an investment manager and 70% rank philosophy as a top criterion in assessing a manager's long-term view. Yet only 56% of the institutional investors we surveyed rank holding horizon as important to manager selection, and 75% pay little attention to portfolio turnover (another way of assessing a long-term philosophy).[12] If investors are not considering holding horizon or portfolio turnover as indicative of a manager's long-term philosophy, what metric are they using? We believe holding horizon is, in fact, the clearest metric in determining whether a manager truly employs a long-term approach.

On course and actively aligned

Implementing some of the practices in this course correction will take time. But it's time to recognize the value and the impact of achieving that active alignment. For institutional asset owners, it's a matter of

- improving governance to drive more effective standards around manager selection and replacement
- identifying, measuring and monitoring active skill, including the use of metrics such as holding horizon, which can be a good indication of a manager's long-term philosophy
- focusing more on a manager's active ownership and attention to materiality, which can be vital to identifying companies with more sustainable long-term competitive advantages

A successful course correction could help fuel more responsible long-term allocation of capital, while supporting investors as they work with their boards and investment committees to define their long-term objectives and hire those managers that are better positioned to meet them. Finally, this change in thinking could help constituents along the investment chain not only understand the power of what it means to invest long term, but also fortify the trust needed to support successful relationships between asset owners and asset managers.

Methodology

About the MFS active management sentiment study

For the past 3 years, MFS Investment Management® has partnered with CoreData Research, an independent third-party market research provider, to conduct this survey of financial advisors, institutional investors and professional buyers in North America, Latin America, Europe and the Asia-Pacific region.

Starting in 2015 and ending with this latest 2017 wave, the survey results include the views of 258, 220 and 360 institutional investors, respectively. To qualify, institutional investors had to be responsible for the management, selection or oversight of pension, endowment or foundation assets in excess of $20 million.

Endnotes

[1] 2017 MFS Active Management Sentiment Study. For all MFS Active Management Sentiment Surveys, please see survey methodology.

[2] Callan Associates, Inc., 2016 Capital Market Projections.

[3] We believe skilled active managers are those who can demonstrate conviction through high active share and long holding periods, add value in volatile markets and collaborate on investment decision making.

[4] 2017 MFS Active Management Sentiment Study

[5] The Search for a Long-Term Premium, Thinking Ahead Institute, Willis Towers Watson, May 2017.

[6] 2015 MFS Active Management Sentiment Study.

[7] The Search for a Long-term Premium, Thinking Ahead Institute, Willis Towers Watson, May 2017.

[8] 2017 MFS Active Management Sentiment Study.

[9] Khan, Mozaffar; Serafeim, George; and Yoon, Aaron, SSRN, "Corporate Sustainability: First Evidence on Materiality," March 9, 2015. http://ssrn.com/abstract=2575912.

[10] Holding Horizon: More Evidence of a Steep Equity Yield Curve, Empirical Research Partners, November 28, 2016

[11] Source: Holding Horizon: A New Measure of Active Investment Management, Lan, Chunhua; Moneta, Fabio and Wermers, Russ, American Finance Association Meetings 2015 Paper. Short horizon funds, on average, hold stocks for 1.91 years, where long-horizon funds hold stocks for 6.85 years. Universe is US actively managed equity mutual funds, which was created through the intersection of Thomson Reuters mutual fund holdings database and the Center for Research in Securities Prices (CRSP) mutual fund database. Final sample was 2,969 equity funds.

[12] Ibid.

[13] 2017 MFS Active Management Sentiment Study.

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