Outrunning the Bear: An Active Managers Survival Guide

November 4, 2014

Dear Fellow Investors,

Two long-time friends go up in the mountains on a hunting trip. At 4:30 A.M. of the second day, one of the men wakes up at one end of the tent to find his buddy dressing and putting on his running shoes at the other end. He asks him what he is doing. His friend says, “There is a bear outside our tent.” The other guy exclaims, “You can’t outrun a bear!” His friend replies, “I don’t have to outrun the bear, I just have to outrun you.”

In all aspects of life, we think you’re always outrunning someone. In the case of the equity mutual fund world, we think who you outrun has changed over the years. We break this down into three phases since 1950. The first phase was introductory. Diversified common stock ownership was made much easier, more accessible and democratized for small investors from 1950 to the 1980’s. This was the era of John Templeton’s Templeton Growth Fund, John Neff’s Vanguard Windsor Fund and Fidelity’s Magellan Fund, run by Peter Lynch. There wasn’t anyone besides do-it-yourself investors and professionals to outrun.

We call the second phase the adoption phase and place it from the mid-1980’s to about 2005. Financial advisors and registered investment advisors moved toward financial planning and asset allocation and many passed the stock selection baton to active managers. We saw this phase originate in the form of separate accounts and later moved heavily toward mutual funds. This second phase was all about outrunning the other active managers. Beating the results of your peers and the average of your peers earned huge assets-under-management (AUM) totals and the adulation of investors and competitors alike. Legg Mason’s Bill Miller and Capital Growth Management’s Kenneth Heebner outran their tent mates and other managers alike. Firms such as T. Rowe Price (TROW) and Franklin Resources (BEN) flourished in that environment.

Phase three looks to us like it will be all about outrunning the bear and your hunting buddy. The bear being low-cost passive indexes made available in both mutual funds and Exchange-Traded-Funds (ETFs). This is a real gut-check in the world of active management and could threaten the existence of many active equity funds and the companies that manage them. Here is a picture of U.S. equity money flows which shows how tough it has been for active managers to outrun the bear (passive funds and ETFs):

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Passive indexes have a few distinct advantages over active managers. The most obvious advantage is the low annual expense ratio. Less than 0.10% of annual AUM is very common in the large-cap space. The average large-cap equity fund annual expense was 1.31% as recently as 2012. Therefore, to outperform the index through stock selection you must first overcome the annual expense deficit.

Indexes have very low turnover and this creates a big advantage over active competitors. Using the S&P 500 Index as a proxy, its turnover averaged around 5% for the 20-year stretch ending in 2012. Turnover at that low of a level creates almost no annual trading cost. The average large-cap U.S. equity fund spends 0.81% per year on trading expense as a result of average turnover of 62%. Putting it all together, the S&P 500 Index starts the year with somewhere around a 2.02% lead over the stock pickers who run large-cap, actively managed U.S. equity funds.

To beat the index/outrun the bear and your peers, there are certain things that we believe active managers must do. They must seek to drive their annual expense ratio below the average of their peers. As we see things, active managers should practice a long-duration stock picking discipline to drastically reduce their costs associated with trading. We like to think of it as “arbitraging time.”

If active managers practice low turnover, they take away the indexes advantage in two ways. The trading cost drops and the benefit of the portfolio’s best performing long-term positions pass through to shareholders. The S&P 500 holds its winners to a fault and gains the entire benefit for shareholders of its best long-term performers. In the current era, Apple (AAPL) would be the poster child for a capitalization-weighted index like the S&P 500 and letting winners run to the benefit of the end owners. This is true for competing against other active large-cap funds as well.

Why do many active funds give up the expense associated with what we call “too much” activity? The answer has to do with another of the inherent index advantages. The active managers want to portray that they can provide a market timing advantage via their activity. These managers believe that financial professional’s, who run portfolios, want their clients returns smoothed and their continued employment is tied to that smoothing. The index ties itself every quarter and to keep their clients, most active managers seek to do the same. Keeping the existing money puts a great deal of pressure on active managers.
Howard Marks has pointed out in the latest edition of his book, *The Most Important Thing: Uncommon Sense for the Thoughtful Investor*, that those who seek to outrun the bear and their peers must be doing something very different from the crowd. Our favorite quote on this subject comes from John Maynard Keynes. He said of investing, “It is the one sphere of life and activity where victory, security and success is always to the minority and never to the majority.” In the mutual fund world we measure this by what is called active share. Your active share is the percentage of your portfolio which is not matched with the index. You must choose to be lonely to outperform/outrun the index and your tent mate.

The active manager must do a superior job of long-duration security analysis in two ways. They must find and heavily overweight undervalued securities. This is a big advantage over the bear/index and especially so at popularity extremes. A capitalization-weighted index almost always ends up with most of its money in the most popular securities and sectors at the worst times. Think techs and telecom in late 1999.

On top of buying under-valued securities, the successful active manager must also make those over-weighted positions among businesses which can withstand the test of time. This allows for low ongoing turnover and low trading costs. Good picks which get turned over usually exceed any stock picker’s ability to find extremely worthy new replacement investments and overcome the expense associated with the activity.

The willingness to underperform the index and peers at certain junctures, possibly for two years or more, was a critical component of most great track records which outran both the bear and the peers. A good example of this thought is the Sequoia Fund, which has crushed the S&P 500 Index over 44 years. A $10,000 investment in the fund at inception has grown to over $3.8 million as of last year compared to the S&P 500 Index which grew $10,000 to over $892,000. However, it has outperformed the index in only 24 of the last 44 years and started in 1970 with four consecutive years of underperformance.

Lastly, we believe the active manager who wants to outrun the bear and their peers must use research methods which emphasize factors that expose quality and have proven to be alpha creators over long-duration time periods. Ben Inker’s research at GMO has shown that factors like balance sheet strength, consistently high profitability, earnings stability and low stock trading volatility contributed to alpha over stretches exceeding 20 years. We have our own eight criteria we use to expose these factors and also seek company longevity through moat analysis. The bear/index does not eat a steady diet of those factors and most of your peers won’t put on those running shoes.

Warmest Regards,

*William Smead*

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