

Building Long-Term Sustainable Outcomes for Clients

Attributes of a successful active investment manager

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In brief

- At this point in the cycle, investors should consider focusing on risk management and mitigating downside risk in investment markets, a process inherent in active management.
- Active managers have historically performed better in difficult markets (Exhibit 1), and top-quartile active managers have historically added substantial excess return in down markets (Exhibit 2).
- Even top-quartile active managers routinely underperform. Investors should consider developing a tolerance for underperformance and using a long-term performance time period to assess skill.
- Identifying the attributes of a skilled active manager may be critical to driving long-term outcomes.

Without a doubt, 2020 will go down as one most remarkable years on record, marking the end of the longest-running bull market and all-time-high spikes in volatility. In a few short weeks, the coronavirus pandemic revealed to all what we have been pointing out for some time: that investors have been paying above-average prices for below-average earnings. As the rosy outlook on earnings disintegrated, investors rushed to the sidelines, stocks fell into bear market territory and bond yields declined to levels few expected. Despite economic and earnings uncertainty, the easing of lockdown restrictions and US Federal Reserve actions have catalyzed a second round of risk taking and a rapid market rebound. As long-term investors, we stress the importance of sticking with a disciplined plan, keeping emotions in check and investing through the market cycle. After all, we think one of the best times to invest can be when markets look their worst — or cheapest.

The importance of alpha

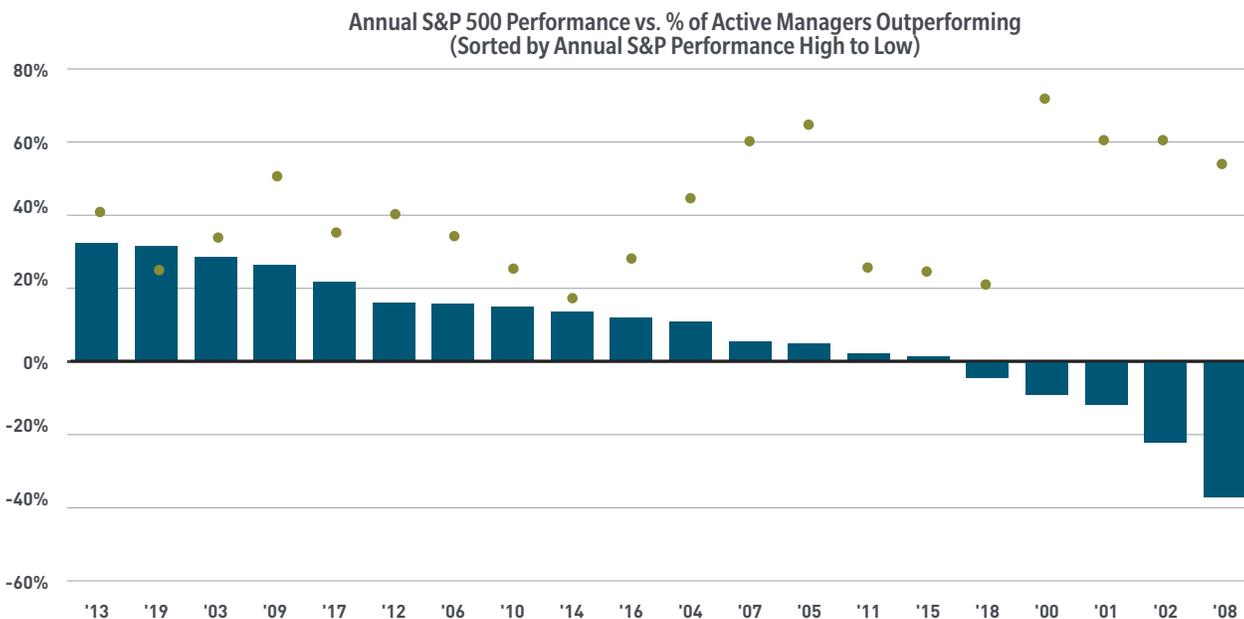
Despite market prognosticators' best efforts, no one knows with certainty if we have entered a prolonged economic downturn or if economies will bounce back once reopened. However, three things seem clear to us: The low-volatility environment of the past 10 years has likely ended, capital market returns will be low over the next 10 years and finding alpha during difficult markets will become increasingly important for driving long-term results.¹ The opportunity for alpha generation and above-average returns for active managers that invest over a complete market cycle could be powerful. Moreover, in a more volatile environment that has investors waiting for the other shoe to drop, we believe that they should focus on risk management and mitigating downside risk. Active management will certainly play a critical role in doing so.

Active managers have delivered in tough markets

Strength in stocks and bonds over the past decade has coincided with a large shift from active management to passive management. For some, the move has suggested a desire to reduce fees; for others, the move has shown that many active managers have trailed their benchmarks. However, looking back at the 20-year period from 2000 to 2019, active managers generally performed better in tough markets (Exhibit 1). Put another way, active managers have proven their worth on the downside. Given the current environment and likelihood of more bad news, the ability to preserve capital in down markets will be key to driving excess returns over a full market cycle.

Exhibit 1: Active managers generally performed better in tough markets

■ S&P 500 Performance ■ % of Active Managers Outperforming

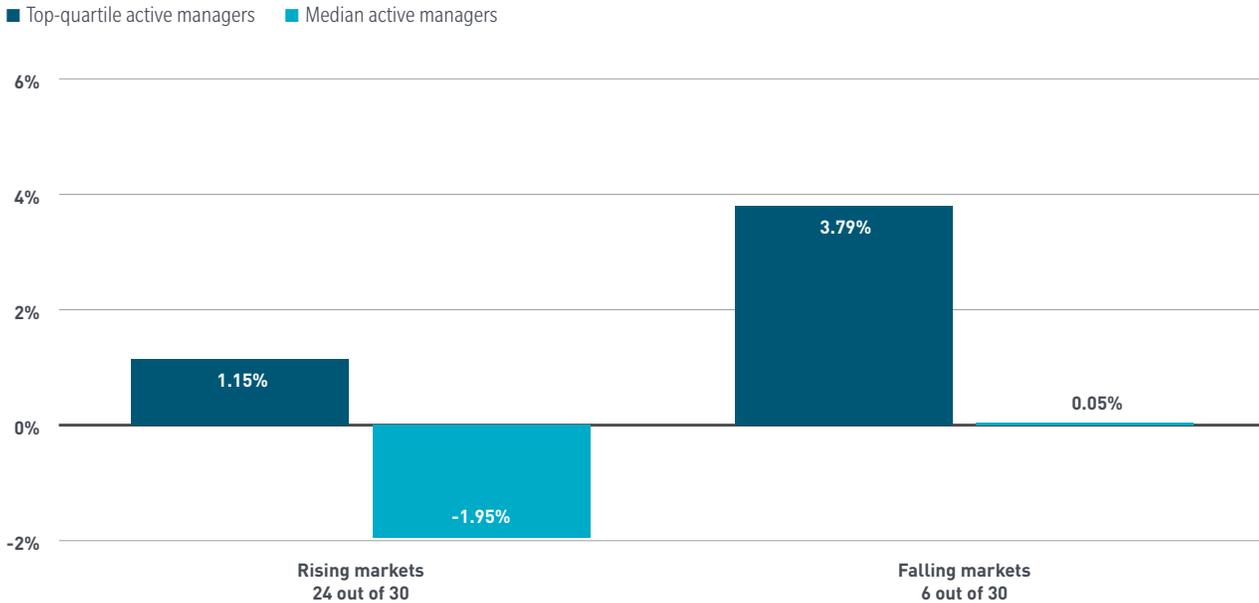


Source: Strategas Research Partners, December 2019. Analysis is based on US-based large-cap mutual funds from the Morningstar Large Blend Category, examining each calendar year (2000 to 2019) and identifying the percentage of managers that outperformed the S&P 500 TR Index during each year. Analysis includes all share classes and excludes index funds, net of fees. S&P 500 stock index measures the broad U.S. stock market. Index returns do not take into account investment related fees or expenses. It is not possible to invest directly in an index. Past performance is no guarantee of future results.

Active skill and risk management matters

More to the point, not all active managers are created equal. As Exhibit 2 shows, from 1990 to 2019, top-quartile active managers added value above the S&P 500 Index in all market environments. In rising markets, median managers typically have had trouble keeping up with skilled managers, while top-quartile active managers have both added value in up markets, and more important in our view, shone in down markets. In poor markets, active risk management has been rewarded, a process that is less robust in passive portfolios. For example, active managers select securities rather than "owning the index" and can avoid companies or industries with low-quality, unsustainable earnings. Passive does not allow the same risk assessment. In other words, what you don't own is just as important as what you do.

Exhibit 2: Top-quartile managers outperformed in rising and falling markets



Source: Analysis using Morningstar data. Excess returns of top quartile (25th percentile) and median (50th percentile) active managers taken from the Morningstar Large Blend Category, 1990 to 2019. Rising and falling markets based on calendar year returns when the S&P 500 Index rose or fell (1990 to 2019). Excess returns, net of all fees (including 12b-1) but excluding sales charges, calculated against the S&P 500 TR Index. Analysis covers all share classes and excludes index funds. The falling markets are 1990, 2000, 2001, 2002, 2008 and 2018. Past performance is no guarantee of future results.

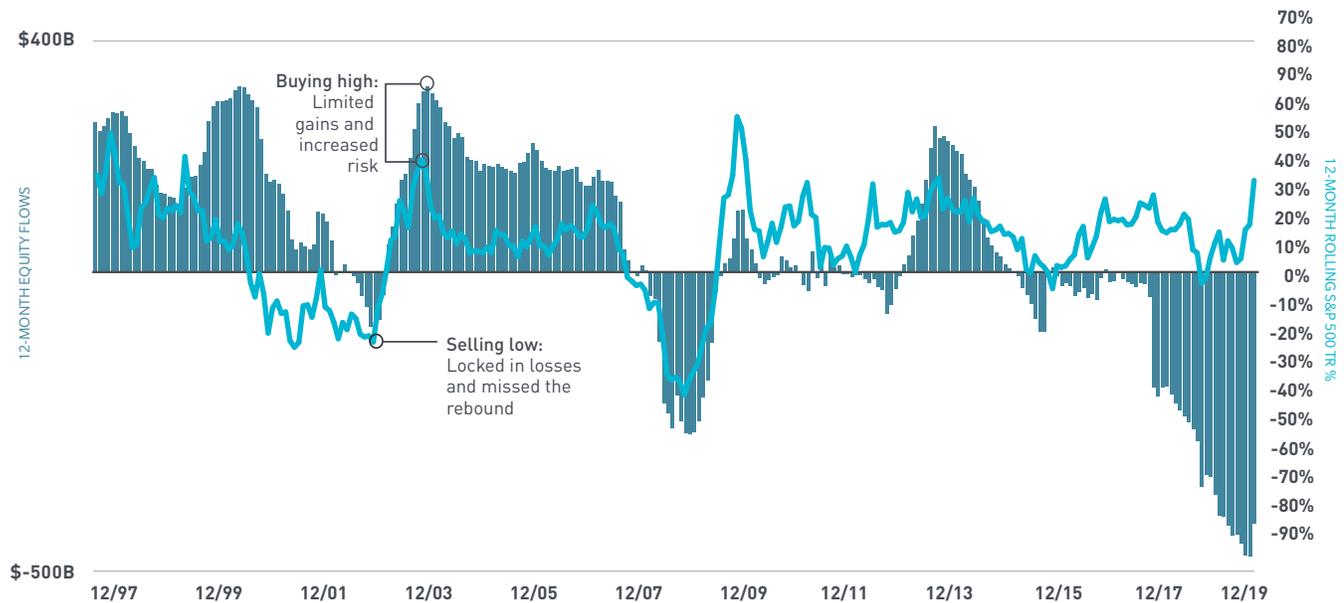
At MFS, rather than chasing short-term gains, we actively manage risk when the markets are inefficient and seek to add value by managing volatility and navigating changing market cycles more effectively. Because if you can lose less value in a down market, you can begin to grow it from that higher capital base. That is how you compound long-term returns and how we believe investors should be thinking about risk today.

Short-termism: Why have average investors underperformed?

It is a fact that even skilled active managers underperform at times. This can be challenging for investors. Mutual fund flows have shown that many investors chase performance, investing near market peaks only to bail out close to market bottoms (Exhibit 3).² As a result, the average investor has underperformed.³

Exhibit 3: Investors chased performance

■ 12-Month Equity Flows ■ 12-Month S&P 500 Total Return



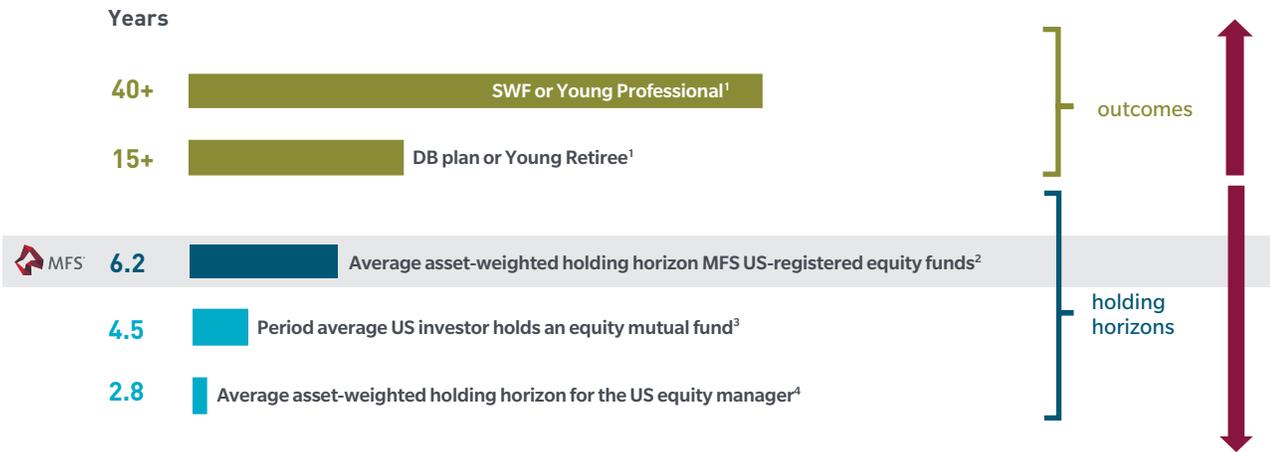
Sources: Strategic Insight Simfund/TD; SPAR, FactSet Research Systems Inc. Data is from 12/97 – 12/19. Index charts are for illustrative purposes only and not intended to represent future performance of any MFS® product. Past performance is no guarantee of future results. The S&P 500 (Total Return) Index measures the broad US stock market. Index performance does not include any investment-related fees or expenses. It is not possible to invest directly in an index.

We think that a misalignment of time horizons is one of the reasons why. Most skilled active managers look to generate consistent alpha over a full market cycle, which typically takes 7 to 10 years.⁴ However, the industry has anchored around three- and five-year performance time periods to assess skill. In reality, a 3-year time period is less than half of the historical time period of a full market cycle. While a majority of investors know this, few seemingly will tolerate negative alpha on a 3-year basis.⁵ Yet when discussing objectives, not many — financial professionals or asset managers — discuss the metrics to measure skill and the time frame of a "full" market cycle. To us, however, it does make sense to discuss the use of longer-term-performance time periods when assessing skill.

The misalignment makes even less sense when you look at the time horizon associated with most investors' reason for investing — typically saving for retirement (Exhibit 4). The average asset-weighted holding period for a US equity manager is only 2.8 years. While this does align with a 1- to 3-year performance period, it does not align with investors' long-term goals. MFS' average asset-weighted holding period for US-registered funds is more than double the industry average and more closely aligned with investor goals. We have high confidence in our long-term performance, where fundamentals typically prevail. Market sentiment, rather than fundamentals, is more likely to drive what our performance will look like over the next quarter or year.

Investors may be better served by developing a tolerance for underperformance — what we call countercyclical courage — that may potentially lead to more value creation and a better outcome over time. When markets sell off, good active managers often use weakness as a rationale for buying when they have conviction in a company and the patience to ignore market noise and wait for a potential rebound. The recent downturn is a prime example and demonstrates what separates above-average active managers from median managers. MFS investment teams understand their companies, their operations and their best- and worst-case scenarios. During a downturn, our teams can quickly assess what has changed and what companies are attractive long-term buying opportunities. To take advantage of a decline, your analysis — especially scenario modeling — needs to be in place. If you wait until volatility occurs to analyze companies, you will be too late.

Exhibit 4: Long-term horizon clashes with short-term investing



¹ MSCI, as of 12/14.

² Based on the MFS US Retail Equity Funds, as of 12/31/19. Please see mfs.com for individual fund information. The MFS US-registered funds are generally only available to US residents with a valid US tax identification number (and to certain other qualified investors). Holding horizons vary by fund and are calculated differently than holding period. Holding horizons for MFS and the average equity manager are based on the inverse turnover calculation (100/1 year turnover). Turnover methodology: (Lesser of Purchase or Sales)/Average Market Value of the Date Range.

³ Annual DALBAR Quantitative Analysis of Investor Behavior Study, 2020.

⁴ Morningstar (US) Equity Categories, ex index funds and fund of funds, as of 12/31/19.

Identifying skilled active managers

We believe that skilled active managers — those who demonstrate conviction through high active share and long holding periods, manage risk thoughtfully and bring together different perspectives — can add value in all markets environments. MFS has always adhered to this philosophy and a single purpose: to create value by allocating capital responsibly for clients. Our focus on the long term has been part of our history for nearly a century. And as we think about sustainability, we actually believe it is synonymous with long-term investing. So rather than approach sustainable investing as a separate practice, MFS has integrated material ESG factors into our research process; it is part of how we analyze investments from many angles. As an active manager, we believe this drives long-term returns and is a critical part of being good stewards of capital and investing responsibly.

Allocating capital responsibly also relies on a differentiated investment process and culture. At MFS, our process and culture are built on three distinct pillars: collective expertise, active risk management and long-term discipline.

Collective expertise

We believe that teams of diverse thinkers, contributing different perspectives and actively debating them within a shared value system are more likely to understand and incorporate all financially material factors, enabling better investment outcomes. The goal of our investment teams is to uncover sustainable opportunities or identify pitfalls that other managers may have missed. Our investors engage directly with the companies we own to understand what could impact the sustainable value of those companies, and they use our voting power to influence issues that matter.

Active risk management

Our risk aware culture leads us to try to understand which risks — whether fundamental, secular, macroeconomic or ESG — are material to a company's long-term sustainability (rather than just noise) and how those risks may evolve over time. It is about thinking through the risks that you see and trying to anticipate the risks you do not see — *e.g.*, the coronavirus. We believe the pandemic will likely have long-lasting impacts on governments, consumers, companies and industries. Active risk management is essential in accurately assessing risks in this uncertain environment, as well as avoiding entities that may stumble or fail. And we cannot stress enough that owning the index — passive — does not allow for the same risk assessment.

Risk management is also about understanding how those risks we anticipate compare with the risks our clients are taking. In other words, we leverage our risk capabilities to fully understand the risks inherent in clients' portfolios, because we recognize that, for our clients, how you get there is just as important as getting there. That is why we closely monitor capacity management and close strategies to help protect the interests of clients and the management of the long-term performance of their assets.

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Long-term discipline

MFS believes in long-term thinking for two reasons. First, we think that it leads to better investment outcomes for our clients. Therefore, we focus on factors that create a sustainable enterprise capable of driving long-term returns. Factors like unit growth, pricing power, sustainable competitive advantages, free cash flow, debt levels, financial materiality and management strength, to name a few. Second, is time horizon. By holding stocks for longer, we take advantage of the greater return dispersion between the best- and worst-performing stocks and the potential to improve returns for investors. The strength of our research, garnered through collective expertise, gives us the conviction and patience to let investment ideas play out over time. Compensation for investment teams reflects this: we reward our teams for long-term performance, not for chasing short-term gains.

Conclusion

In our view, skilled active management is a critical component of any investment portfolio and especially relevant in the current environment. As active managers, we strive to identify companies that can sustain a competitive advantage over the long term. For us, active management is our culture, our DNA and how we create long-term value for our clients responsibly. At a time when the industry is facing great pressure and consolidation, our focus is on allocating capital responsibly over the long-term for the end investor. Period. We operate from a position of strength — our process, our people and our clarity of purpose — to seek the best investment ideas for the benefit of our clients. For nearly a century, we have aligned our active investment approach with the way we serve clients: bring together different perspectives, have conviction in our investment ideas and thoughtfully manage risk, all with the goal of delivering long-term, sustainable outcomes for clients. ▲

Endnotes

¹ Annualized return over the next 10 years. MFS Long-Term Capital Market Expectations, January 2020.

² Data sources: Strategic Insight Simfund/TD; SPAR, FactSet Research Systems Inc.

³ Source: Dalbar, 2020 QAIB Report, as of December 31, 2019. The Average Investor refers to the universe of all mutual fund investors whose actions and financial results are restated to represent a single investor. This approach allows the entire universe of mutual funds investors to be used as the statistical sample, ensuring ultimate reliability.

⁴ Source: "Defining a Market Cycle," Manning & Napier.

⁵ Source: 2018 MFS Active Management Sentiment Study (including 540 global institutional investors). (Q) How long are you willing to tolerate the underperformance of active asset managers before initiating the search for a replacement manager?

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