“The performance gap between active managers and passive ETFs: challenges and opportunities”
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Fact – Mutual funds underperform benchmarks

SPIVA Scorecard 2016 U.S. (S&P Dow Jones)

More than 80% of US funds underperformed benchmarks on 3, 5, 10, 15 years.
Fact – Mutual funds underperform benchmarks

SPIVA Scorecard 2016 Europe (S&P Dow Jones)

| REPORTS |
|-----------------|-----------------|-----------------|-----------------|-----------------|
| Report 1: Percentage of European Equity Funds Outperformed by Benchmarks |
| FUND CATEGORY  | COMPARISON INDEX | ONE-YEAR | THREE-YEAR | FIVE-YEAR | TEN-YEAR |
| DATA IN EUROS (EUR) | |
| Europe Equity | S&P Europe 350 | 80.41 | 73.64 | 74.17 | 88.25 |
| Eurozone Equity | S&P Eurozone BMI | 79.96 | 84.46 | 87.84 | 90.41 |
| Nordic Equity | S&P Nordic BMI | 39.13 | 46.51 | 52.78 | 75.76 |
| Global Equity | S&P Global 1200 | 88.52 | 90.47 | 97.95 | 98.45 |
| Emerging Markets Equity | S&P/IFCI | 93.62 | 86.94 | 98.17 | 100.00 |
| U.S. Equity | S&P 500 | 77.20 | 97.08 | 97.86 | 97.91 |
| France Equity | S&P France BMI | 68.97 | 66.67 | 77.87 | 84.12 |
| Germany Equity | S&P Germany BMI | 87.91 | 78.02 | 79.65 | 82.30 |
| Italy Equity | S&P Italy BMI | 60.78 | 64.00 | 57.89 | 76.09 |
| Spain Equity | S&P Spain BMI | 65.52 | 67.11 | 70.33 | 81.97 |
| Netherlands Equity | S&P Netherlands BMI | 62.50 | 81.82 | 93.75 | 97.06 |

Eurozone equity:
More than 79% of funds underperformed on 1, 3, 5, 10 years

Source: S&P Dow Jones Indices LLC, Morningstar. Data for periods ending Dec. 31, 2016. Outperformance is based on equal-weighted fund counts. Index performance based on total return. Past performance is no guarantee of future results. Table is provided for illustrative purposes.

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Why this consistent underperformance?

- The common explanation: the fees.

- The fees of active managers are the main reason for the underperformance vs. ETFs, that have a much lower fee structure.

- This is the commonly assumed reason, right?

WE SAY WRONG!
Over the last 12 months the SP500 index recorded a gain of around 20%.

But the performance distribution across the same stocks in the index has been quite extreme.

The top 20% gained on average 61%.

The bottom 20% produced - 9%.

This huge returns dispersion is in all the markets most of the time.
It is a big opportunity to beat the benchmarks

- With this broad distribution of performance an intelligent, «evolved» stock picking should make a big difference, by selecting some of the winners and avoiding the losers.

- The differential of average performance even from the top 50% performers and the bottom 50% is enough to make up for the fees several times.

- Market conditions support «real value creation» of stock selection if properly executed.

- But this is the problem! Wrong stock selection – what else?
So what does not work in active management?

- **Reason 1**: Some managers rely too much on fundamentals – they put all the eggs in one basket. Price action may take time to reflect the fundamentals and in the meantime fundamentals can change. The risk is being out of sync with real price trends.

- **Reason 2**: Other managers are hostage of a fully discretionary, judgmental approach. Prone to biases, emotions, overconfidence, tendency to forecast, disposition effect, need to find an explanation for everything.

- **Reason 3**: a trading mentality. Capturing a small part of the upside potential. 21% of uptrends produce a gain well in excess of 100%.
And what is the solution?

• First recognize that a change is needed. New factors impacting markets (ETFs, social media, algo).

• Then realize that making money is all about capturing trends.

• Consider including momentum analysis in the decision process to identify opportunities and risks, and to validate ideas and holdings.

• Make sure that the model is robust, well validated, best if self-adjusting.

• Momentum analytics can complement an investment strategy adding discipline, objectivity, measurability, intelligence.

• If models beat experts then models can help experts.
What is momentum

- Momentum: the tendency for a stock rising to continue to grow and for a stock dropping to continue to fall.
- A more sophisticated way to recognize that long term trends exist and continue for some time.
- Momentum analysis measures, rates, compare the direction and strength of price trends that last from a few months up to 2-to-3 years.
- Momentum does not forecast price objectives (Who can?) – trap avoided.
- Momentum does not pretend to explain the whys? (the need of explanations) – trap avoided.
- The success of momentum investing flies squarely in the face the efficient-market hypothesis (EMH).
Validation of Momentum:

WHY IS MOMENTUM SO IMPORTANT?

Momentum factor investing is growing « strategies employed by asset owners have evolved over time with an increasing share using momentum and multi-factor strategies and declining usage of fundamentals « Smart beta survey 2016 FTSE Russell«.

Academic evidence:
A Century of Evidence on Trend-Following Investing, Brian Hurst, Yao Hua Ooi, Lasse H. Pedersen, Ph.D.
Anomalies and Market Efficiency, G. William Schwert
Dissecting Anomalies, Eugene F. Fama, Kenneth R. French
Fact, Fiction and Momentum Investing, Clifford S. Asness, Andrea Frazzini, Ronen Israel, Tobias J. Moskowitz
Momentum, Narasimhan Jegadeesh
Price Momentum In Stocks: Insights From Victorian Age Data, Benjamin Chabot, Eric Ghysels, Ravi Jagannathan
Profitability of Momentum Strategies: An Evaluation of Alternative Explanations, Narasimhan Jegadeesh
Returns to Buying Winners and Selling Losers: Implications for Stock Market Efficiency, Narasimhan Jegadeesh, Sheridan Titman
Value and Momentum Everywhere, Clifford S. Asness, Tobias J. Moskowitz, Lasse H. Pedersen

«Using unique historical data on stock returns spanning 140 years, we examine the returns on one of the most popular mechanical trading strategies-momentum. We confirm that momentum investors have enjoyed large abnormal risk-adjusted returns.»

Momentum delivers superior risk-adjusted returns

Dozens of Academic Studies Have Concluded that Momentum Produces the Best Risk-Adjusted Returns

(Date Range: 1963–2015)  Source: Kenneth R. French data library

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Momentum is becoming part of most strategies

- Amongst the most analysed and adopted factors Momentum stands out.
- Momentum has been widely validated by dozens of academic studies.
- Momentum is strong and persistent across different market cycles.
- Momentum can easily fit into most strategies and processes adding efficiency and discipline.
- For example value and momentum make a perfect fit due to the negative correlation.

Sources: Kenneth R. French data library; Bloomberg
More on momentum

- Plenty academic research confirming that a disciplined momentum investing strategy handily outperforms strategies which invest in cheap stocks.
- The premier market anomaly is momentum.
- That momentum investing works embarrassingly well.
- Momentum strategies consistently make more money over time than simply buying cheap stocks.
- Momentum investing is about making money, pure and simple.
- Momentum investing is downright cynical.
- Momentum investing exploits the irrationality of market players.
- *(quotes from Marketwatch, nov. 30 2016)*
Raising the bar on performance

• Smart beta products are raising the bar.

• ETFs based on Smart beta indices beat market cap weighted indices.

• New indices are coming to the market.

• Smart active managers can profit from proven models and improve their investment strategies.

• Easy to join thanks to new technology. Dangerous to dismiss this trend.
“Asset managers need to do heavy investments in research and state of the art technology and data analytics to deliver superior performance.” (Digital Transformation: The Central Challenge for Asset Management Firms) - Accenture.

“Technology will impact every aspect of asset and wealth management” – PwC

“Investment performance must consistently meet/exceed benchmarks or the manager will be dropped”. – Accenture
I CAN’T UNDERSTAND WHY PEOPLE ARE FRIGHTENED BY NEW IDEAS.
I AM FRIGHTENED BY OLD ONES.

(JOHN CAGE)

INVESTMENT INTELLIGENCE TO IMPROVE PORTFOLIO RETURNS