MFS® White Paper

Time to Align

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In brief

- A misalignment between investors and their asset managers could be causing them to forfeit the full value of active management.
- The disconnect is most evident through mismatched investment time horizons, where investors expecting alpha over increasingly short time periods don't invest through a full market cycle, often leaving alpha on the table.[1]
- Correcting the misalignment by helping investors define long-term objectives and more effectively assess and measure active skill could result in better investment outcomes.[2]

Through all the talk of market short-termism and the value proposition of active management, it's clear that investors and asset managers are out of sync, particularly on investment time horizons. Investors who expect alpha over increasingly short time periods may be leaving alpha on the table by failing to give active managers the full market cycle they need to potentially outperform.

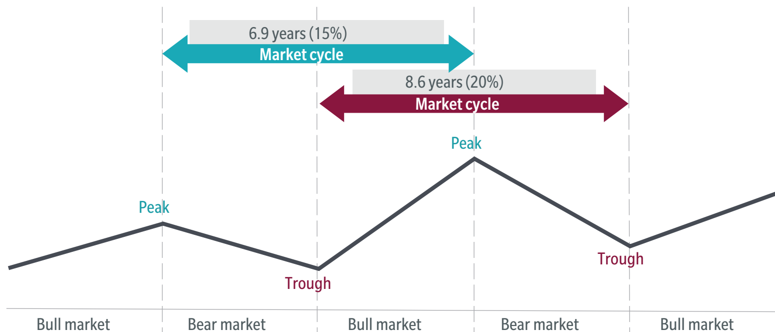
For investors, the danger of that misalignment is not only giving up long-term value but also potentially falling short of their desired outcomes. Advisors and intermediaries can be part of the solution, by setting expectations for what active management is meant to deliver and using more effective metrics to identify active skill and align it with their clients' long-term objectives.

What's the impact?

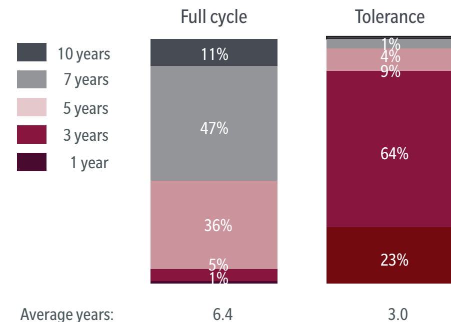
The impetus for correcting the misalignment comes from understanding its impact on investors. What we find most troubling is that investors are making short-term decisions despite having long-term objectives, and their shorter investment time horizons don't match the market cycle needs of most active managers. Our industry seems to have developed an intolerance for underperformance, with active managers being measured on shorter time frames — often three years or less, despite the average market cycle being seven to 10 years.

This is a challenge for advisors and intermediaries, who feel pressured to respond to the short-term performance demands of their clients. Yet even here we see a disconnect. An MFS study found that roughly three-quarters of retail advisors around the globe believe that longer market cycles allow more opportunity to distinguish an active manager's skill from luck. But most would only tolerate underperformance for an average of three years before initiating a search to replace a manager.[3]

Exhibit 1: Defining a true full market cycle



Source: "Defining a Market Cycle," Manning & Napier, Aug. 2012.



Source: 2016 MFS Active Management Sentiment Study. Data represent 300 US financial advisors surveyed.
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?

Based on short-term pressures, investors and their advisors could be buying actively managed strategies at their peak just after a period of outperformance or selling low just after a period of underperformance. This intolerance for underperformance could eclipse an active manager's potential to tap into good entry points for investment at market inflection points. Still, while the effects of the misalignment are troubling, this is an opportunity to course correct.

Rethink, revisit, reassess

Here's where the solution begins. We believe advisors and intermediaries need to rethink the way they identify and measure active skill for their clients and reassess what truly drives successful investment outcomes.

Consider that 68% of retail advisors surveyed use a period of five years or less to select active managers, while 79% use that same time frame to measure the performance of and decide whether to retain, active managers.[4] Moreover, more than three-quarters of retail advisors and professional buyers consider manager underperformance relative to their peers or benchmark cause for manager review/replacement.[5]

To change that performance paradox, we need to reset expectations for how active management expects to deliver over a full market cycle. As part of the process, investment professionals need to keep the hire/selection criteria for their active managers the same as their measurement/retention criteria. While the selection process might include a deeper dive on a manager's investment process, portfolio construction and even culture, the periodic evaluation criteria often focus more on short-term performance. This is where we need to step back and measure what matters, not what's easy.

Also, set definite standards and time frames over which to expect outperformance and accept underperformance. Look for a solid process, not personalities. Most important, review evaluation standards with clients and be sure to set a context for measurement — that is, at what point in the market cycle you hired and/or replaced a manager. During periods of increasing volatility, underperformance could reflect active risk management, which sometimes means going against the grain in an effort to mitigate risk.

Identifying skill: Understand what impacts the outcome

Advisors and intermediaries are tasked not only with finding active skill, but also aligning it with client objectives. This requires truly understanding what drives investment outcomes. We believe that for clients with long-term objectives, a long-term investment philosophy tops the list.

But how do you identify who is truly long-term, beyond looking at an active manager's stated philosophy? What are the key metrics? We believe the best reflection of an active manager's long-term philosophy and active skill is a long holding horizon. In fact, one study showed 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.[6]

Holding horizon matters because we believe it shows that an active manager has done robust research, identified what they believe are strong long-term fundamentals and thus built conviction in their investment thesis. That conviction isn't just active share or concentration, but rather a willingness to commit client capital long term based on what they believe is an analysis advantage — insight that the market could potentially reward.

As we consider holding horizon and the value of a long-term view, we hear more about sustainability, responsible investing and the growing trend of ESG — environmental, social and governance factors. We believe these should not be separate outcomes, but rather, exactly what you should expect when you hire a skilled active manager with a long view, because that manager should know what they own on your behalf. Active managers should be doing their fundamental research, and, in addition to assessing financial factors, they should be engaging with companies to understand which E, S or G factors could put them at risk, all as part of their process of evaluating the future success of the business. We believe this is the active skill needed to drive responsible ownership and sustainable investing for clients.

Correcting the misalignment between investors and asset managers will take time. But it's time to recognize the value and impact of achieving that active alignment. For advisors and intermediaries, reassessing the way you identify active skill, rethinking the way you measure it and recognizing the value of a long-term philosophy could support better long-term value creation for clients and potentially improve their investment outcomes.

Methodology

About the MFS active management sentiment study[3]

For the past three 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. The 2016 survey results represented here include the views of 125 professional buyers across the United States, Canada, the United Kingdom, Germany and Switzerland and 500 retail financial advisors across the US, Latin America and Italy.

Endnotes

[1] Alpha is a measure of the portfolio's risk-adjusted performance. When compared to the portfolio's beta, a positive alpha indicates better-than-expected portfolio performance and a negative alpha worse-than-expected portfolio performance. Beta is a measure of the volatility of a portfolio relative to the overall market. A beta less than 1.0 indicates lower risk than the market; a beta greater than 1.0 indicates higher risk than the market. It is most reliable as a risk measure when the return fluctuations of the portfolio are highly correlated with the return fluctuations of the index chosen to represent the market.

[2] MFS believes skilled active managers show one or more of the following behaviors: They demonstrate conviction through low portfolio turnover and high active share. They add value in volatile markets. They integrate research and reward collaborative thinking.

[3] 2016 MFS Active Sentiment Study.

[4] Ibid.

[5] Ibid.

[6] 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, whereas 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.

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