

## Synopsis: The Case for Active Management

By: SEI Investment Management Unit

*“The reports of my death are greatly exaggerated.” – Mark Twain*

SEI’s Investment Management Unit recently released a paper that highlighted the continuing value of active management. The main points:

- Investors had a challenging year in 2008. The vast majority of portfolios—both passive and actively managed—failed to protect investors from steep losses during the continuing credit crisis.
- While less than half (44% according to Lipper) of active managers outperformed their benchmarks, the double-digit losses racked up by the indexes provided little solace to passive investors.
- Just as passive investments had their time in the spotlight in 2008, active management is showing its value in 2009. The average U.S. stock mutual fund was up 7% through June 30, according to Morningstar, versus a gain of 3.16% for the S&P 500.
- The media’s focus on passive outperforming active in 2008 may have created a perception that active investing is dead. But 2008 marked only the third time ever that investors redeemed more money out of actively managed stock funds than they invested<sup>1</sup>. With 86.8% of mutual fund assets still entrusted to active managers<sup>1</sup>, it’s a bit premature to plan a funeral.
- The heavy focus on a single year (despite the fact that most investors have far longer time horizons) ignores the reality that investing is a cyclical endeavor; active managers won’t always beat their benchmarks, nor should they be expected to do so.
- SEI believes that the current wave of negative sentiment is both overstated and symptomatic of the cyclical nature of our business. We continue to believe that over time, active management is the best way to help investors meet their goals.

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<sup>1</sup> MarketWatch, February 27, 2009

## Passive and Active—the Basics

The concept of passive investing is aligned with, although not dependent on, the Efficient Market Hypothesis (EMH). In its strongest form, EMH states that, in an efficient market, all private and public information is known about every security, and therefore is reflected in the security's market price. In essence, a security's market price represents the best possible estimate of the value of the underlying assets.

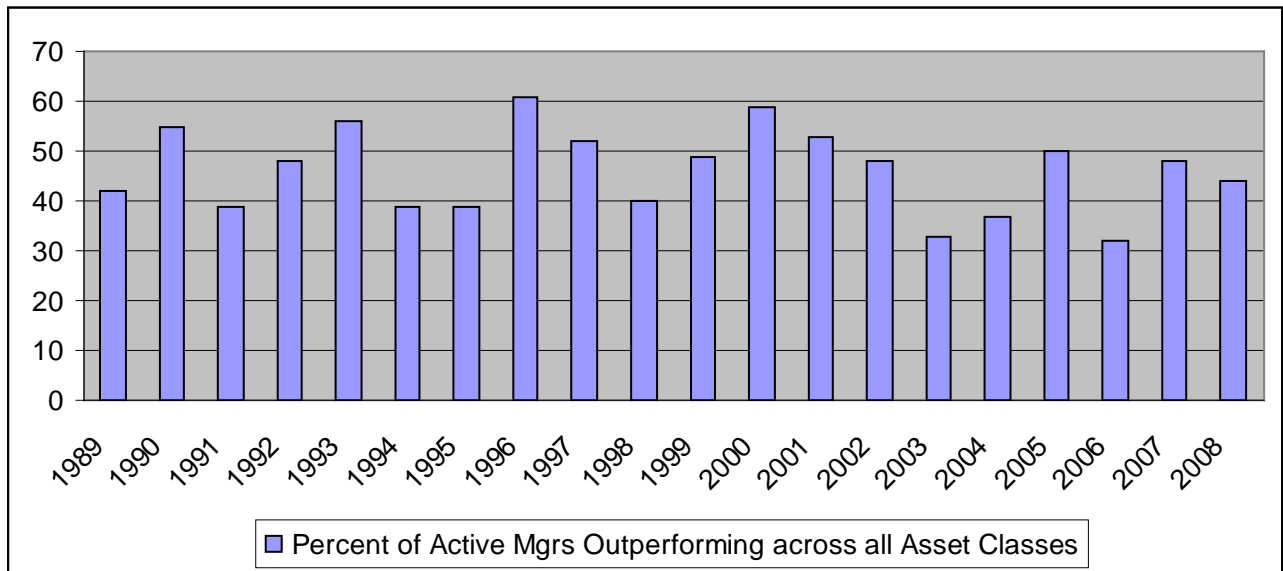
Proponents of active management believe that markets are subject to the irrational behaviors of their participants; emotional investors follow the herd and cling to their own biases even when information changes drastically. Driven by fear and greed, investor biases prevent them from acting in a logical manner. While the size of the market and the rapid flow of information improve efficiency, it does not make the markets perfectly efficient—or remove the biases.

NOTE: Even proponents of EMH generally agree that the market prices of securities, which arguably reflect the best available information, are estimates—and estimates are not always accurate. For this reason alone, active managers will always seek diamonds in the rough.

### Nobody Does It Every Year...But Somebody Always Beats The Benchmark

The often-repeated argument that most active managers fail to outperform passive benchmarks is certainly true. If it wasn't, nobody would buy an index fund. On the other hand, every year some number of active managers do beat their benchmarks. Looking back over the past two decades, even during the worst of times, more than 30% of active managers outperform their benchmarks as shown in Exhibit 1.

**Exhibit 1: Even During The Worst of Times, More Than 30% of Active Managers Beat Their Benchmarks**



Source: Lipper, SEI

This holds true across the spectrum of investments from large-cap to small-cap, international equities to fixed income. Exhibit 2 shows performance results from a variety of market segments.

**Exhibit 2: Benchmarks are Beaten in Every Category Every Year**

<b>Percent of Active Managers Outperforming Benchmark</b>	<b>1998</b>	<b>1999</b>	<b>2000</b>	<b>2001</b>	<b>2002</b>	<b>2003</b>	<b>2004</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>
Large Cap Equity	35	39	68	63	55	21	28	37	34	57	64
Small Cap Equity	40	40	86	72	75	31	54	71	21	53	34
Mid Cap Equity	87	42	75	37	67	13	28	74	19	80	44
International Equity	12	78	44	55	42	21	9	50	21	50	46
Emerging Markets Equity	46	60	61	51	63	52	45	44	46	36	40
Global Equity	34	56	89	62	72	22	22	29	43	60	67
High Yield Bonds	61	67	46	36	18	24	35	51	39	43	64
Emerging Markets Debt	20	87	67	74	27	94	88	95	84	35	26
Core Fixed Income	23	41	20	34	13	65	40	26	42	14	15

Source: Lipper

**The Current Bear Market—Real Opportunity for Active Managers**

After the credit crisis hit in 2008, putting an end to the bull market, just about everything was going one way—down. The only exceptions were assets perceived to be the safest, such as government bonds and cash. Until recently, fear and the search for safety had been the primary drivers, trumping any consideration of valuations and making it hard for active managers to generate excess returns by uncovering undervalued securities. The irony of the current situation is that, while the widespread and indiscriminate selling across all asset classes has been painful for active managers, as just about everything was jettisoned regardless of its underlying intrinsic value, the premiums now available and the breadth of opportunity for distinguishing between winners and losers has increased enormously.

**What About Fixed Income?**

The extreme flight to safety which dominated the markets during 2008 severely impacted the performance of all non-Treasury sectors. Unlike prior episodes of broad-based active management underperformance, this period is unique in sheer magnitude, as the median level of underperformance among investment-grade bond managers topped 8.00% for calendar year 2008.

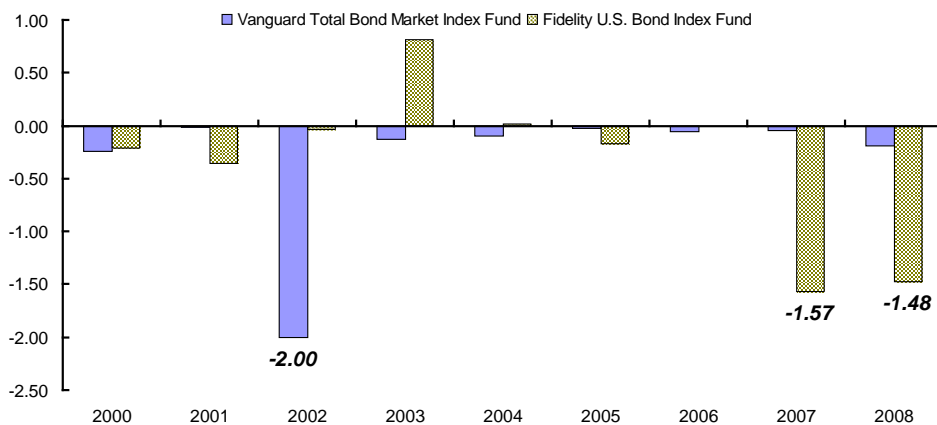
Even a modest active exposure to non-Treasury securities would have produced substantial underperformance when compared to the benchmark.

## A Passive Fixed Income Portfolio Still Requires Active Management

Given the inability to purchase all benchmark holdings, the passive fixed income manager is forced to adopt a “sampling” strategy, choosing a sample of cash and synthetic instruments that will best represent the risk and return characteristics of the index. Some of these characteristics are easily managed, most notably duration, or interest-rate sensitivity. Others, however, are much more difficult, such as the idiosyncratic risk of individual corporate bond holdings. The more difficult the exposure is to replicate, the more active management will be needed in constructing the “sample.”

To further examine the replication problem, calendar-year performance of two well-known index funds is detailed in Exhibit 3. The returns shown below for the Vanguard Total Bond Market Index Fund and the Fidelity U.S. Bond Index Fund are relative to the Barclays Capital U.S. Aggregate Index.

### Exhibit 3: Index Fund Performance vs. Benchmark



Sources: Vanguard, Fidelity

*The chart above shows performance versus a benchmark and not actual returns. In the periods shown the funds may have experienced positive and/or negative returns.*

In some years, both of these “index” funds have shown success at delivering index returns with a small amount of tracking risk or volatility of relative returns. However, during periods of stress, even small differences between *sample* portfolios and the benchmark can lead to meaningful deviations in performance. During the last credit crisis of 2002 the demise of Enron and WorldCom led to a significant increase in corporate bond risk; the Fidelity Fund fared relatively well, but the Vanguard Fund underperformed by 200 basis points. These roles have reversed in this most recent crisis; the Fidelity Fund has underperformed by over 300 basis points for the prior two years while the Vanguard Fund has largely delivered index performance.

A similar pattern is emerging with regards to the nascent universe of fixed-income exchange traded funds (ETFs). ETFs can face many of the same challenges as passive mutual funds with the added volatility associated with being traded on an exchange.

## The Fixed Income Bottom Line

Since “passive” managers must adopt an *active* management technique (sampling) in an attempt to match the risk and return characteristics of the market indices, fixed-income passive management becomes simply another style of active investing. Therefore, the passive fixed-income investor must accept many of the same risks associated with active management, but they have minimal exposure to any potential upside.

## Conclusion

SEI believes the current wave of negative sentiment toward active investing is both classic over-reaction and symptomatic of the short-term cyclical nature of our business. We believe that the best way to help investors meet goals is through active management. The financial advisors we work with believe it too, and billions of dollars placed with active managers globally stand behind the approach.

Investing styles go in and out of favor in response to a wide variety of economic factors. Predicting the changes and staying in front of them 100% of the time is an impossible task. Similarly, some investors believe that it might be prudent to invest passively during bull markets, then switch to active management in down markets. Seems simple enough, but the problem is the same—nobody can predict with any certainty when the next down market will hit. Furthermore, while it is possible to identify whether we are in a bull or bear market at a given point in time, timing the *transition* from one to the other is often difficult to do. Even the experts don’t know when the next transition will start.

Just as passive enjoyed a period of relative outperformance in 2008, we think active management is poised to demonstrate its value once again as markets move back to trading securities based on fundamentals rather than on fear. The first half of 2009 is well on its way to demonstrating this point.

A full-length paper is available if you wish to learn more about this timely topic.

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