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Melanie Blue is 18 Asset Management's Head, Canadian Equities. In her role, Melanie is responsible for the day-to-day management of 18 AM's All-Cap Canadian Equities mandate.

Over a 20-year career, Melanie has built a solid investment management foundation, attaining both her Chartered Accountant and CFA designation as well as gaining valuable experience in portfolio management, security selection and risk management.

Her considerable portfolio management experience includes an emphasis on large- and small-cap Canadian equity portfolios. Melanie is a natural leader with a strong team orientation.

The Return of Returns

In 2013, according to Pavilion Advisory Group, active Canadian equity pooled fund managers enjoyed their best year since 2001 with over 90% beating the S&P/TSX Composite Index (TSX). Reports in the financial press and data from other pooled fund providers such as Russell Investments and RBC corroborate the recent success of active management in Canada.

The purpose of this paper is to help our clients understand what is happening with the money they have invested in Canadian equities. We present and discuss our analysis of the drivers of active management. We hope that by understanding how active managers outperform, investors can have confidence in the active management opportunity.

Active management has not always met with the success it enjoyed in 2013. The global financial crisis in 2008 resulted in severely shaken investor confidence which, over five years later, has yet to fully rebound. During the crisis, actively managed funds suffered poor performance as strategies that once outperformed no longer worked and failed to protect investors from declines. These events precipitated a flight from equities like never before. Over the past five years, significant dollar amounts have flowed out of equities, into bonds, alternatives, or under mattresses. Those that continue to hold equities have opted for passive strategies as index funds in various forms have amassed record amounts of fund flows.

These fund flows clearly indicate clients' low levels of enthusiasm for Canadian equities, generally, and for active management, specifically. For all active Canadian equity managers, these fund flows pose a daunting reality. How do we, as active managers, face the challenge of confronting the current level of client pessimism? In a word – Performance or more specifically, Outperformance. Thankfully, signs of a recovery in Canadian active management returns began in 2012 and continued throughout 2013.

Active equity management comes in a wide variety of forms. It includes portfolios with a style bias, such as Growth, Value or Income. It includes portfolios seeking to take advantage of a perceived anomaly such as low volatility or small capitalization. Similarly, portfolios that seek to exploit industry sector views, macroeconomic opinions or technical factors are classified as actively managed portfolios. With so many variations in active management philosophies, the fact that so many managers outperformed in the same period is very intriguing.

Examining relative performance requires an understanding of how an actively managed portfolio differs from the benchmark. This involves two considerations: i) the philosophy bias of the manager to select or deselect stocks for their portfolio and, ii) variations in portfolio construction relative to how a benchmark is derived.

WHAT'S IN A BENCHMARK?

The TSX is the most recognized and widely used benchmark for Canadian Equities. Its purpose is to represent the Canadian economy as a whole and act as a proxy for the universe of publically-traded stocks in this country. To meet this purpose, the index includes over 200 companies from ten different industry sectors. Striving to create a diversified collection of companies to represent this country's economy causes two interesting issues (and opportunities). One, the TSX, at any given time, contains 'good' companies as well as 'bad' companies. That is, it contains, for example, both cheap and expensive companies, companies with strong growth and companies with negative growth, those with low volatility and those with high volatility. Two, the index is constructed by placing the largest weights on the largest companies, not the 'best' companies, however the manager defines it.

Active managers believe they can take advantage of these two opportunities by:

- Adhering to their investment philosophy to select companies with the most desirable characteristics or at least avoid companies in the benchmark with undesirable characteristics.
- Constructing their portfolio by determining the weight a stock will have based upon its attractive characteristics and not its weight in the benchmark.

In a simplified example, a Value manager might only select 30 companies from the TSX for her portfolio and weight each name equally, resulting in a portfolio that looks significantly different from the benchmark. Without a doubt, these differences between the portfolio and the benchmark are purposeful. The greater the variation from the benchmark, in both the types of holdings and the weights of those holdings, the greater the potential variation in performance from the benchmark.

THE CONSENSUS

We encounter the following common themes as rationale for why and when active management works or does not work:

- **Sector exposures:** Being over or under a sector's weight in the benchmark is commonly used to explain relative performance in a given period. For the sector attribution to be informative, it is important to know if the relative exposure is based on a conscious decision of the manager or merely an outcome of following a specific investment style.

- **Small cap performance:** A common belief is that small caps generally outperform large caps. This notion is supported by the theory that there are inefficiencies in trading small caps that can be exploited. Thus, if an active manager has excess exposure to small caps relative to the benchmark, people commonly attribute any outperformance to a small cap 'bet'.
- **Intra-stock correlation:** If stock prices are moving in unison, as they did during the financial crisis, then the opportunity to be different is diminished.
- **Price dispersion:** Despite correlation levels, there could be a large gap in returns between the best and worst performing stocks. Owning some high flyers or avoiding some losers can be a common explanation for performance differences.

We fully agree that the common explanations, stated above, can and do impact active management performance. However, it is important to distinguish the cause of an outcome from the effect. These explanations overlook the significant contribution coming from the manager's investment style or philosophy. We assert that that unless these common factors drive the manager's decision making, they are merely secondary explanatory variables.

CHALLENGING THE CONSENSUS - BACK TO BALANCE SHEETS AND INCOME STATEMENTS

In this paper, we propose that the most important explanation of returns is often overlooked. Consider the CEO operating a business, trying to maximize what is commonly referred to as: "the company's fundamentals", that is, the quality of the company as defined by its financial statements and/or future prospects. We are firm believers that these "fundamentals" ultimately drive stock prices. Further, we believe that the majority of active managers rely on some subset of these fundamentals to select securities regardless of their investment philosophy.

Our hypothesis is that when the fundamental drivers of stock prices - balance sheets and income statements - are being rewarded, active managers outperform. While this may seem an obvious statement, we observe that performance is rarely attributed to the extent to which fundamentals are being rewarded in the market.

In support of this premise, we examined the efficacy of a large number of common fundamental factors, such as price/earnings, return on equity and earnings estimates that we believe intuitively represent an investment style. We looked at a variety of time periods within a variety of universe sets. The analysis is constructed as follows.

For a given factor, we rank all companies within our selection universe, using that factor, from best to worst. We then construct one portfolio of the best 20% of companies and one portfolio of the worst 20%. On a monthly basis, we re-rank the selection universe and rebalance both portfolios, each time re-selecting the best and the worst 20%. We capture the performance of these portfolios monthly (results are summarized annually). To isolate the return drivers, the evaluation is independent of sector and market cap constraints. The only driver is the fundamental factor - the one that intuition suggests should impact future stock price change.

The table below is an excerpt of our analysis, focusing on four common factors. It shows the net annual return of the best minus the worst portfolios for each factor. We then compare these net returns to the performance of active managers each year.

Return of Best Factor Portfolio minus Return of Worst - Rebalanced Monthly					(1)	(2)
	VALUE	QUALITY	INCOME	GROWTH		
Year	Price / Earnings Ratio	Return on Equity	Dividend Yield	Earnings Growth	Active Manager Outperformance*	Median Mgr Excess Return*
1995	-7.4%	3.1%	2.0%	4.8%	47%	-0.1%
1996	23.6%	15.9%	27.3%	23.4%	69%	3.1%
1997	70.9%	81.0%	53.2%	39.6%	87%	5.8%
1998	9.6%	22.4%	21.2%	6.7%	55%	0.8%
1999	-48.0%	-13.0%	-6.7%	-4.7%	29%	-8.0%
2000	29.0%	33.3%	23.9%	23.0%	93%	12.8%
2001	61.8%	39.8%	34.9%	26.4%	98%	12.1%
2002	47.0%	46.8%	25.1%	10.0%	82%	5.5%
2003	-0.8%	-14.7%	-1.4%	16.6%	57%	0.4%
2004	18.9%	8.2%	12.3%	23.6%	78%	2.1%
2005	12.7%	27.9%	10.9%	18.9%	48%	-0.1%
2006	-8.5%	-1.7%	-29.2%	13.2%	53%	0.0%
2007	24.6%	27.8%	7.3%	23.5%	52%	0.2%
2008	-8.2%	-7.3%	28.4%	-8.9%	64%	1.2%
2009	0.1%	-56.4%	-44.3%	-45.4%	47%	-0.3%
2010	9.2%	-3.7%	-15.8%	7.0%	48%	-0.1%
2011	0.6%	4.0%	36.2%	-2.2%	46%	-0.5%
2012	25.4%	14.7%	18.8%	-2.2%	73%	2.2%
2013	11.2%	28.2%	34.9%	8.9%	93%	6.7%
Average	**14.3%**	**13.5%**	**12.6%**	**9.6%**	**64%**	**2.3%**
Frequency **	**63%**	**58%**	**68%**	**68%**	**68%**	

* Data source: Pavilion Advisory Group (1) % of active managers in the Pavilion Canadian Equity Universe that beat the S&P/TSX Composite Index, (2) Difference between the median manager return and the S&P/TSX Composite.

** Frequency of >5% return differential, or frequency of >50% active manager outperformance.

Let's use 1999 to explain what is being displayed in this table. In that year, stocks exhibiting the worst Value did better than stocks exhibiting the best Value by 48%. In other words, the average return of stocks with the worst price to earnings ratios generated returns that were 48% greater than the average returns of stocks with low (attractive) price to earnings ratios. This is counter-intuitive but such anomalies can persist in the short run. Clearly, 1999 was a challenging year to be a Value investor. However, the returns of the best minus worst portfolios are also negative for our Quality, Income and Growth factors, making 1999 a challenging year for these styles as well. Poor active management returns in 1999 are evidenced by the Active Manager Performance column showing that only 29% of managers beat the TSX. Lastly, the final column shows that the median manager was 8.0% behind the benchmark. In 1999, fundamental factors, as evidenced by the negative numbers in the first four columns, did poorly resulting in active managers being behind the benchmark.

In 2013, all four of the style factors shown here illustrate that excess returns were generated by owning stocks exhibiting the best of a given factor versus the worst. In fact, this situation was true for the vast majority of the factors we tested. In 2013, fundamentals were rewarded. Regardless of your investment philosophy or style, if you adhered to your style, you were rewarded.

From the table, several overall observations can be made.

- In years where the majority of active managers (>70%) outperformed, all styles or style proxies were rewarded.
- In years where the minority of active managers (<50%) outperformed, fundamental factors did not work or there was little advantage in owning the best of a given factor. In these years, against intuition, owning the best companies was not rewarded relative to their worst counterparts.
- Style adherence matters. Sticking with your stated style will add value over the long term. This can be seen by the fact that on average and with more frequency, the portfolios with the best characteristics outperform regardless of the chosen style.
- This analysis clearly demonstrates that not all styles work at the same time, therefore investors benefit from diversification of styles.
- There can be prolonged periods where styles are out of favour. Adapting the portfolio by systematically allocating to different styles provides the opportunity to add value by mitigating the risk of being in a style when it is out of favour.

Our analysis shows that there is a very strong link between factor performance and active management success or failure because the factors drive the decisions. However, the benefits of factor performance will come most fully to managers who zealously adhere to their stated style. Adherence can be an immense challenge as there are many distractions (including the misuse of traditional attribution) which might cause a manager to drift from her style.

For instance, a manager, in a quest for stocks that fit her investment style, might find many attractive stocks within a particular industry sector or capitalization bucket. If she believes in style adherence then the resulting portfolio will have a tilt toward that industry sector or capitalization bucket. This tilt comes as a consequence of adhering to a disciplined investment process and not because of a sector or capitalization 'bet'. Traditional performance attribution provides little information in this example. Such analysis assesses the manager's ability to make a sector or capitalization call when in fact they did not even make one.

Reliance on traditional attribution may also create unwanted changes in behavior. A portfolio manager, in an effort to keep her weights much closer to the benchmark, might purchase some stocks that do not perfectly fit her style. Consequently, style adherence is diluted. This could be disastrous for clients for two reasons. One, style adherence is the key risk and return lever. Two, as style adherence fades, a client risks losing the knowledge of how their money is being managed. Simply put, knowledge is power. It is informative to know how sector and market capitalization affected returns. However, unless these are conscious decisions, factor performance carries a much greater explanation of returns.

GAINING ACTIVE MANAGEMENT BENEFITS

Every portfolio manager has an underlying investment philosophy or style. It is what drives their decision making, and what allows them to minimize regret should the outcome of their decisions not follow the expected path. Following an investment philosophy (or more correctly, proving that it is being followed) is the key mechanism by which clients gain an understanding of how their money is being managed. There is no perfect philosophy, no perfect process, no style that works in every circumstance, nor over every time period. Regardless, each manager has a belief that their philosophy can add value relative to their benchmark. For every active portfolio manager, the keys to success are 1) sticking to their style *and* 2) time. Therefore, the questions clients need to ask are:

- How will I know that my manager's stated investment process or philosophy is being followed?
- What style(s) might work well when my manager's style isn't?
- How much patience is required?

The financial crisis tested the patience, resolve and conviction of investors and portfolio managers alike. Many have simply given up on active management. However, we believe the opportunity to add value continues to exist. Understanding how styles behaved historically and how investors reacted to the crisis has motivated our innovation and fresh thinking. Recognizing that fundamentals and styles both a) experience unfavourable periods and b) work in the long run, we have developed a unique process to take advantage of these circumstances. Our process allows our portfolio to move between and across styles, while strictly adhering to each style when it is chosen.

With a focus on fundamentals active management can succeed. It is not just a blip on the screen.