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Implementation Insight

New Equity Perspectives

Emerging markets, ESG and the active/passive debate

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Contents

bfinance is an independent, award-winning consultant that provides investment implementation advice to institutions around the globe.

With highly customised processes tailored to each individual client, our aim is to empower investors with the resources and information to take key decisions.

The team is drawn from portfolio management, research, consultancy and academia, combining deep specialist expertise with global perspective.

bfinance has conducted more than 800 engagements for over 300 clients in 32 countries. The firm is headquartered in London, with offices in Paris, Amsterdam, Munich, Montreal and Sydney.

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Why read on?

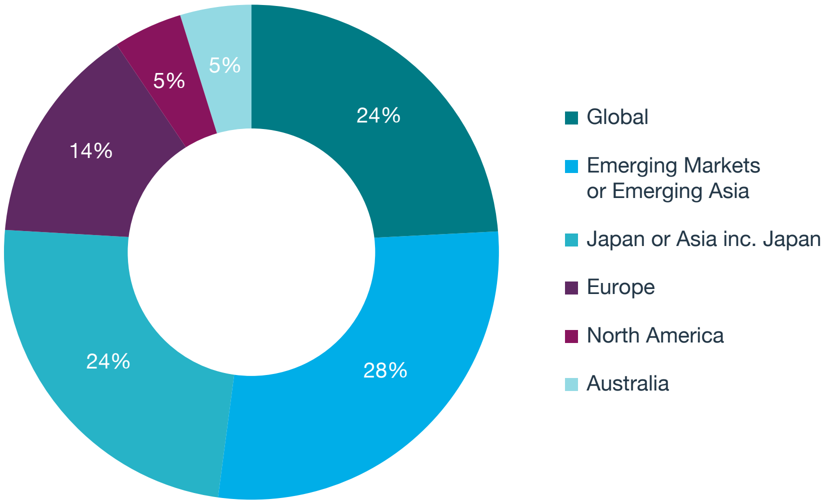
The past year has seen dramatic shifts in new equity mandates and portfolios, according to bfinance client data.

Changes in new manager selection patterns, which tend to foretell changes in portfolio composition, are deeply revealing for the year to October 2017. Searches for **emerging market** and **Asia-focused** equity managers shot up the priority list while the US fell from grace. **Smart beta**, one of the most popular segments in 2014-16, contributed only 10% of new mandate activity in the past 12 months. ESG, an important area of focus, is becoming increasingly relevant beyond the traditional developed markets.

Looking more closely at the figures, 28% of all new equity manager selection projects initiated between October 2016 and September 2017 were for emerging markets, versus less than 15% in the previous year – **an increase of more than 100%**. Although "Global Emerging Markets" searches proved more popular than "Emerging **Asia**," the strong appetite for Japan, "Developed Asia" and "Asia inc. Japan" made this region the runaway winner in terms of regional allocations. The contrast with the previous year, when Global Equity mandates made up nearly 40% of the total (now 24%) and the US dominated the regional picture, could not be more stark.

The shift in allocations has been accompanied by some fascinating trends on the factor side, with value roaring back into favour in late 2016 only to slump through 2017. In a period of exceptionally low volatility, a narrow universe of stocks – those showing high resilience and strong earnings growth – have driven outperformance.

New equity mandates, year to October 1 2017 (by destination)



Source: bfinance. These figures only represent searches initiated after October 1st 2016 and do not include previously initiated searches that continued through this period.

For "New Equity Perspectives," a series of articles by bfinance's equity specialists, we asked the team to address three key themes that have dominated recent conversations with investors and the industry: **Emerging Markets, ESG** and the **Active/Passive Debate**.

What has really changed, based on the latest manager research? How are these fundamental themes not only evolving but colliding and conflicting with each other?

In "Emerging markets and the ESG challenge," the team examines the difficulties of integrating sustainability into Emerging Markets strategies and finds interesting patterns in terms of performance. Manager performance is also under the spotlight in "Will the real active managers please stand up?" as Justin Preston rebuts the now-conventional wisdom favouring higher active share, lower turnover and higher concentration. Finally, we put Joey Alcock on the spot with a journalist's brainteaser: is ESG compatible with passive management?

We hope you enjoy the read.

Kathryn Saklatvala
Director - Investment Content

Emerging market equity and the ESG challenge

By **Joey Alcock, Julien Barral, Robert Doyle, Justin Preston**

The resurgence of investor appetite for emerging markets is proving to be the most significant allocation trend of 2017, at least according to bfinance data on new mandates in the quarterly *Manager Intelligence and Market Trends* reports.

The positive macro tailwinds witnessed in the aftermath of President Trump's election have simultaneously sent emerging market equity funds to the top of the performance rankings - especially those with lower exposure to Brazil or commodity-sensitive markets such as Russia.

There have been significant changes within the emerging market equity manager universe since the last great surge in investor appetite in 2009-10, such as the **greater feasibility of segregated accounts** thanks to improved market liquidity, the deepening bench of **specialist regional and country** managers, and the stronger investor demand for **top-down** macro insight.

Yet one of the most noteworthy developments is the **increasing relevance of ESG** in this space. In this article, the bfinance equity strategists – Justin Preston (Senior Director and Head of Equity) and senior associates Julien Barral, Robert Doyle and Joey Alcock – discuss the key developments including the supposed outperformance of ESG EM indices, the potential relationship between governance and returns, the obstacles to ESG integration and the impact on fees.

Q: Is ESG linked to outperformance in emerging markets?

Alcock: "Do ESG-oriented emerging market equity managers produce better returns on average due to an ESG tailwind? There has been quite a lot of publicity this year around the performance of the ESG-focused MSCI Emerging Markets index, which has beaten its non-ESG counterpart. I'd be very wary about inferring too much when thinking about active managers, particularly in light of recent commodity price dynamics."

Doyle: "There does – at least on the surface –appear to be a positive relationship between managers' governance scores and investment performance in bfinance emerging market equity manager analysis in 2017. It's not robust enough to conclude that there is a connection, but it is interesting. There's certainly a stronger connection between ESG and performance than we find in developed markets."

Barral: "To be honest, we were initially quite surprised that the managers scoring highly in our ESG analysis, particularly on the governance side, were all also performing very strongly in non-ESG EM equity selection processes."

Alcock: "Yes. It was also interesting that some of the managers that scored well in this ESG analysis had not received good scores from PRI (Principles for Responsible Investment). This community is currently playing catch-up in terms of disclosure and communication of the way in which ESG is integrated. It also underpins the importance of not placing too much weight on those PRI scores when considering ESG, as noted in the recent white paper *ESG Under Scrutiny: Lessons from Manager Selection.*"

> There does – at least on the surface – appear to be a positive relationship between managers' governance scores and investment performance
>
> **Robert Doyle**

Emerging market equity and the ESG challenge continued

Q: What are the major obstacles to ESG integration in EM?

Preston: "When it comes to the integration of ESG criteria, investors should not expect these managers to compare with their developed market counterparts. That being said, the governance element (the "G") has always been very significant in emerging markets, particularly given the crises of the 1990s. This does not just apply on a corporate level but on a country level also - we see managers that will rule out entire countries on a governance basis, such as Russia."

Alcock: "One of the greatest difficulties that managers face is the lack of data. Companies in developed markets recognise that ESG-related issues are a major concern for shareholders: they report on the relevant criteria. There is simply less ESG-related information available from emerging market companies. Providers such as MSCI produce ESG ratings for these markets but those scores are often based on less information. Furthermore, they're usually restricted to benchmark stocks – the ones in the index – while many EM managers invest a significant proportion of assets off-benchmark. The way in which managers deal with that data challenge represents a significant differentiator in terms of our ESG. Those that are proactively dealing with these weaknesses, such as developing in-house ratings rather than relying on external suppliers, will tend to score more favourably."

Preston: "This also ties back to overall manager strategy and style. Those with more concentrated, higher conviction, low turnover portfolios will find it more straightforward to assess ESG in emerging markets than those with a more diversified approach."

Q: What does it cost?

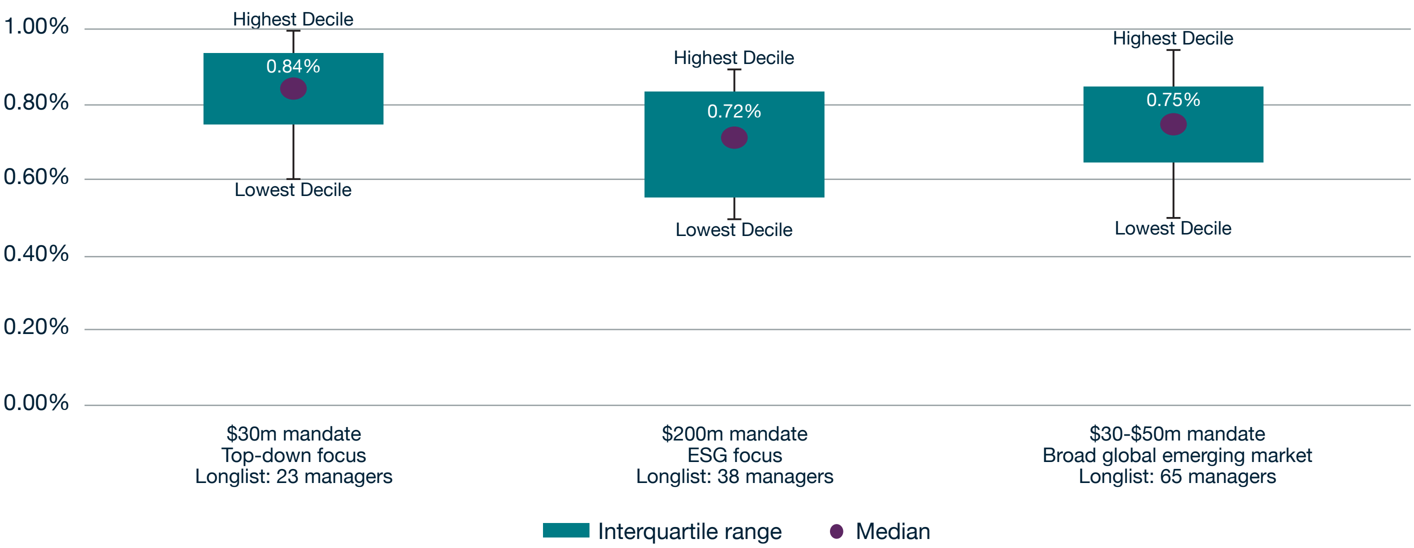
Barral: "The quality of ESG integration is not linked to notably higher fees in emerging market equity. The median fee quoted for all global emerging market equity searches so far in 2017 (prior to negotiation) has been **69bps**; the median quoted fee for ESG-specific searches was just above 70bps. As shown in the chart below, which gives data for three specific equity searches this year, other factors – such as mandate size and structure – make a far greater difference to fees than the ESG dimension."

Preston: "Interestingly, emerging market equity manager fees overall have shown surprising resilience, at least according to our data from live manager selection engagements. Many managers have been suffering from outflows during 2015-16 but they haven't, as a rule, been dropping their prices."

"The quality of ESG integration is not linked to notably higher fees in emerging market equity"

Julien Barral

Quoted management fees for three global emerging market equity searches in 2017



This article contains excerpts from, "***Emerging Market Equity Returns to the Spotlight***," published in the August issue of LAPF Investments Magazine: www.lapfinvestments.com/2017/08/emerging-market-equity-returns-to-the-spotlight/

Will the real active managers please stand up?

By **Justin Preston, Senior Director, Head of Equity**

The year was 2009. Amid a climate of investor cynicism, disappointment and self-examination, two papers were published that would fundamentally change the way that the investment industry viewed active equity management.

The first, which bore the deceptively dry title "*Evaluation of Active Management of the Norwegian Government Pension Fund Global*," catapulted into mainstream consciousness the notion that investors' equity returns could largely be attributed to a set of well-known risk factors such as value and momentum.

Ang, Goetzmann and Schaeffer ushered in a tidal wave of related academic research that, among other things, underpinned the emergence and rapidly increasing popularity of Smart Beta. **Few equity managers in 2009 could have told you the factor attribution of their portfolios. Today, products such as Style Research's Skyline have become almost ubiquitous**. Various managers even base their more sophisticated marketing efforts on their low combined exposures to these factors, claiming a high degree of "idiosyncratic" or "stock-specific" risk.

In the second, "*How Active Is Your Fund Manager?* A New Measure That Predicts Performance," Martin Cremers and Antti Petajisto first advanced the concept of Active Share. Although the argument that high Active Share is correlated with positive outperformance has since been undermined by other studies, which instead found that high active share was merely linked (as intuition would suggest) with high performance dispersion, the metric has become extremely popular.

"Clients have clamoured for 'real active managers' and managers have marketed themselves accordingly."

Investment Management Fees: New Savings, New Challenges (bfinance, 2017)

Will the real active managers please stand up? continued

In 2016-17, low active share scores – or “closet tracking” – regularly dominated headlines the asset management press. Morningstar’s influential paper *Active Share in European Equity Funds* branded a fifth of European large cap funds with the “closet tracker” label. Today, **managers advertise their high active share percentages** as a testament to their active credentials.

There is no doubting the influence of factor attribution analysis and active share percentages on investor consciousness. Investors have been increasingly vocal in recent years with demands for ‘real’ active managers and refusal to ‘pay for beta dressed as alpha’ – an appetite which has driven the increasing popularity of ‘unconstrained’ or ‘benchmark-agnostic’ strategies. There is also no doubting the instinctive appeal of attractive, comprehensible graphs that appear to reveal what managers are up to and may even, at the extreme, present a case for considering cheaper systematic forms of investment. It’s a tantalising prospect.

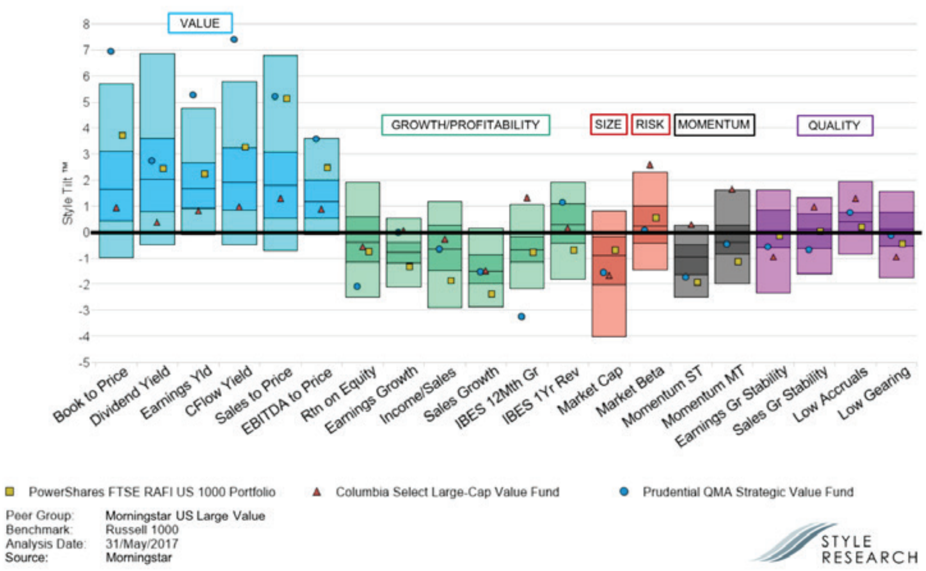
But how helpful are these and other metrics – really – in selecting active equity managers that will outperform going forwards? The answer, at least according to equity manager data analysed here at bfinance, is: “handle with care.”

Neither a Skyline analysis nor an active share number are hugely meaningful without a deeper understanding of a manager’s approach, especially when viewed at a single point in time. Active share, style exposures, information ratio, turnover, tracking error, concentration and the rest are all useful, to a certain degree, but none of them in isolation hold the key to establishing what a ‘real active’ manager – much less a good active manager – looks like.

For example, disciplined Quality-focused managers may appear to have changed their risk exposures, with a shift from value towards growth. Managers with tracking errors below their historical norms (as we are seeing today) may simply reflect a less volatile market where stocks tend to move in tandem. Virtually all active global equity managers vying for significant institutional mandates through bfinance have high (>70%) active share percentages and, it’s worth noting, there is no statistical evidence in our research that those at the lower end of the active share spectrum are underperforming those at the upper end.

> “The now-conventional wisdom that managers with higher active share, lower turnover and higher concentration will tend to do better is flawed at best and misleading at worst.”

An example of a Skyline analysis from styleresearch.com



Source: styleresearch.com

Will the real active managers please stand up? continued

That being said, there are some intriguing suggestions that emerge from recent manager analysis. While not conclusive, these do appear to merit further investigation. For example, unconstrained or benchmark-agnostic long-only active equity managers assessed for our institutional clients do appear to be outperforming their benchmark-relative counterparts. This is a preliminary finding, which we will scrutinise and question through further analysis.

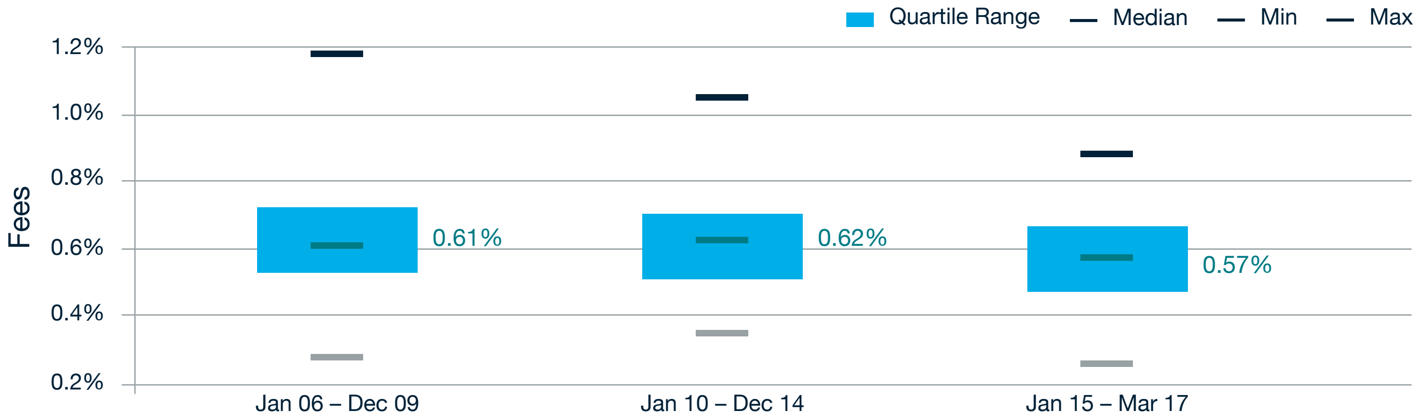
Managers have another very strong incentive for showcasing their active credentials, especially when it comes to their factor exposures: fees. **Active managers in the more systematic sub-sectors of the universe have been under the most severe pricing pressure**. Low volatility manager fees, for instance, have compressed by 25% since 2010 (*Investment Management Fees: New Savings, New Challenges,* bfinance, 2017). Conversely, despite the effervescent rise of passive investing and an increasingly cost-conscious clientele, the fees for broader global active equity mandates have only fallen by a marginal amount. The median quoted fee for active global equity searches declined by only 8% between the pre-09 period and 2015-17, moving from 61bps to 57bps, as shown in the chart below. (Readers should note that these figures are drawn from quoted fees and that the average negotiated discount for equity searches has been 12%.)

Although some interesting and innovative fee structures have been developed that enable better economics for investors, the much-touted broader trend towards performance fees has stalled as investors largely continue to prefer the simplicity of management fees and question – sometimes as a result of bitter experience – the extent to which performance structures really facilitate alignment. Equity performance fees have been in the press again lately, thanks to the much-publicised Fidelity pricing change, but it remains to be seen whether institutional investor appetite will be affected.

All in all, this represents remarkable resilience from a price perspective, given the circumstances. Providers efforts to present themselves as 'the real active managers,' whether spin or substance, have - by this financial measure at least - been successful.

> How helpful are these metrics – really – in selecting active equity managers that will outperform going forwards?
>
> **Justin Preston**

Quoted (pre-negotiation) fees for €100m Active Global Equity mandate



Source: bfinance. Data from 168, 163 and 189 managers.

ESG dimensions in the active/passive debate

By **Joey Alcock**

We were recently invited by FT's Pensions Expert to provide an article debating the potentially thorny question: *Is ESG Compatible with the Rise of Passive Management?* This brainteaser was born out of a plausible tension between two of this decade's most significant trends.

At first glance, the immediate answer might appear to be "yes," based on one simple development: the expanding universe of passive indices and semi-passive (smart beta) products with an ESG dimension. They range from tilts based on ESG ratings - which can now be sourced from various suppliers - to specific themes such as decarbonisation, which has proven particularly popular among European pension funds.

Yet somehow the question, and this initial answer, seemed to miss the point entirely. The real debate is not **whether** ESG, in any sense, can be incorporated in the context of a purely heuristic or rules-based investment style. The question, instead, is **what type** of ESG integration is desired.

In practice, we are seeing increasingly specific and complex requirements from pension funds, endowments and SWFs. Some emphasise engagement; some prioritise climate change. A few are keen on negative screens, which can be applied to passive or active styles; a larger proportion are looking for ESG to be embedded in decision-making or even in the DNA and culture of the fund manager.

Depending on these differing priorities, investors should be aware of the potential limitations of "passive ESG." Firstly, **the availability and reliability of ESG-relevant data** remains a challenge for active and passive managers alike. This is particularly true outside of the major developed markets. Yet, where passive providers tend to be more (sometimes wholly) reliant on third party sources of ESG data, active managers can draw on their own research to express specific views, augment third-party information and – as we frequently see in practice – disagree with those ratings.

"Passive providers tend to be more - sometimes wholly - reliant on third party sources of ESG data"

Joey Alcock

ESG dimensions in the active/ passive debate continued

Indeed, we saw an interesting example of this in early October, after Castlefield released a report entitled "*Winners and Spinners*." One of those criticised, in a list which included both passive and active players, was the €588m Vanguard SRI European Stock fund. The firm's spokesperson responded to media enquiries with this statement: "*Vanguard selected FTSE as the index provider for this fund after evaluating FTSE's screening process and 'socially responsible' criteria, however, we are not directly involved in decisions to exclude/include specific companies from the fund on an SRI basis. This strict segregation of duties avoids conflict of interest.*"

Secondly, **prioritising engagement** may also be a challenge for passive managers. We have observed that, if and when passive managers undertake engagement, the overall exposure at a firm level to each stock can influence how the manager spends its engagement time budget. Since they tend to be substantial owners of the largest companies, passive managers may feel compelled to direct their attention accordingly, whereas active managers may exert influence at smaller companies where they invest (or divest/ short) with conviction.

Thirdly, **expectations or objectives for the portfolio may not always be entirely clear**. For the most part, passive ESG is being implemented with the intention of replicating – as closely as possible – benchmark-type risks and returns. Yet, at the same time, we see publications pointing towards outperformance, albeit over a short period of time, leading to claims about "ESG factors" and some blurring of the lines with the popular factor investing trend. What are board members and stakeholders anticipating? Benchmark-like risks and returns or considerable tracking error – which can of course cut both ways? Is the potential for underperformance clearly understood?

So perhaps, for all its merits, "ESG passive" might not be the panacea initially suggested. Yet, if one chooses not to go down this route, does it follow that ESG is incompatible with the shift to passive management?

Not necessarily. There is more than one way to slice a cake. Commitment to ESG does not necessarily – depending upon a pension fund's beliefs – mean that every single part in the portfolio must have an ESG dimension.

We see investors that have moved a portion of their equity to (non-ESG) passive or smart beta but express sustainability beliefs through ESG-oriented active equity managers. There is also a major trend towards integrating ESG considerations beyond listed equity, particularly in private markets, as illustrated in recent publications such as *ESG Under Scrutiny: Lessons from Manager Selection* (ESG Private Debt) and *DNA of a Manager Search: Infrastructure* (Renewable Energy Infrastructure).

As long as limitations and objectives are appreciated, a diverse range of ESG preferences can be expressed through a combination of passive and active strategies across the portfolio. There is no "one size fits all."

"The overall exposure at a firm level to each stock can influence how the manager spends its engagement time budget"

Highlights from *New Equity Perspectives*

"ESG ratings are usually restricted to benchmark stocks, while many EM managers invest a significant proportion off-benchmark … Managers with more concentrated, higher conviction, lower turnover portfolios will find it more straightforward to assess ESG than those with a more diversified approach."

"Virtually all active global equity managers vying for significant institutional mandates through bfinance have high (>70%) active share percentages and, it's worth noting, there is no statistical evidence in our research that those at the lower end of the active share spectrum are underperforming those at the upper end."

"For the most part, passive ESG is being implemented with the intention of replicating – as closely as possible – benchmark-type risks and returns. Yet, at the same time, we see publications pointing towards outperformance, leading to claims about 'ESG factors' and some blurring of the lines with the popular factor investing trends. What are board members and stakeholders anticipating?"

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