Why are Active Managers Underperforming this Year?

Fall 2016

Since the market low on February 11th of this year, the large cap U.S. indices have rallied approximately 20%. Many observable oddities mark this rally, particularly one which finds a significant portion of active managers, including Boston Advisors, underperforming stated benchmarks. As professional investors not generally used to delivering bad news to our clients, we have focused our research on better understanding this year's market dynamics. What we have found—an unsettling subtext of investor behavior under the generally calm surface of the market averages—is meaningful and impactful.

In 1997 – 1999, investors were euphoric that internet technology would change the world. Technology share valuation metrics ballooned as investors chased prices. Cisco Systems traded at more than 30 times sales; today it trades for just 15 times earnings. While the internet, as the cliché goes, "changed everything," the 2000 crash in stock prices mostly left investors broke.

In the mid-2000s, housing created another wave of price insensitive buyers, this time mostly in the fixed income ecosystem. When those that purchased houses without sufficient resources defaulted on their mortgages, the entire global economy was severely damaged.

In 2016, the technology and housing busts have led to and created a new and different set of unusually high prices, this time driven by the fear of losing money. Many investors, damaged by two market crashes in less than 20 years, are loath to invest in equities. Yet central bank Zero Interest Rate Policy (ZIRP) has forced them back into the stock market. This reluctant reentry has driven demand for "safe" sectors, those that offer stability (low volatility) and high dividend yield.

This clamor for safety is evident when we look at Exhibit 1. At its inception, the iShares Edge MSCI Minimum Volatility ETF had less than 100,000 shares. By the summer of 2016, the share count had climbed to 325 million. As the graph shows, the creation of new shares is particularly notable in 2016 as investors have chased investments that are supposedly stable, safe and low in volatility.

EXHIBIT 1: ISHARES EDGE MSCI MINIMUM VOLATILITY ETF
Shares Outstanding (in millions) 10/18/11*- 9/26/16

Source: Bloomberg; Ticker: MVOL
*10/18/11 is the inception date of the iShares Edge MSCI Minimum Volatility ETF

Behavior Analysis

Boston Advisors' quantitative research department created a model of this behavior with a statistical analysis of factor performance. The team began by building a generic model of the U.S. stock market plotted along two axes, as shown in Exhibit 2. On the horizontal axis, we plot the *valuation* spectrum of the market, which is an average of earnings yield, book value yield and return on equity. On the vertical axis we plot the market's *business momentum* spectrum, which incorporates earnings growth, stock price momentum and earnings estimate revisions. When defined in this manner, the equity universe falls into four quadrants. Conceptually, these four quadrants incorporate the entire U.S. market in a rather simple but useful matrix.

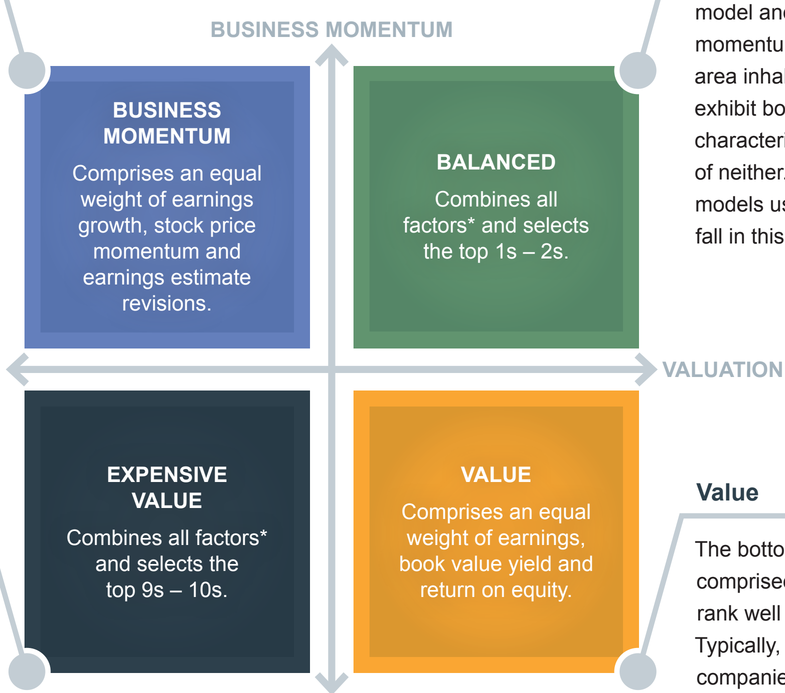
EXHIBIT 2: FOUR QUADRANTS OF THE U.S. STOCK MARKET (ALL CAP)

Business Momentum

The top left quadrant is comprised of companies that score well on the "business momentum" model. These would normally be companies that make up the portfolios of a typical growth manager. When investors demand growth, this quadrant should outperform the broader market averages and other management styles.

Balanced

The top right quadrant uses a combination of 50% of the value model and 50% of the business momentum model. Consider this area inhabited by companies that exhibit both growth and value characteristics, but the extremes of neither. The stock selection models used at Boston Advisors fall in this area.



Expensive Value (Ex-Val)

The bottom left quadrant is categorized, paradoxically, as the "expensive value" companies. This area includes the least attractive companies of the "Balanced" quadrant — those companies that are the most expensive but growing the least (or contracting).

Value

The bottom right quadrant is comprised of companies that rank well on the "value" model. Typically, these would be the companies that make up the portfolios of both deep and relative value managers. When value performs well, this quadrant would/should outperform the broader market averages.

*All factors include: Earnings Yield, Book Value Yield, Return on Equity, Stock Price Momentum, Earnings Growth and Earnings Estimate Revision

Application

To test our theories about the dynamic in the stock market this year, we took the top quintile of the companies in each quadrant (those that exhibit the most value characteristics in the value area, for example) and, using monthly rebalancing, plotted the performance of those stocks (equally weighted) over the last five years (Exhibit 3).

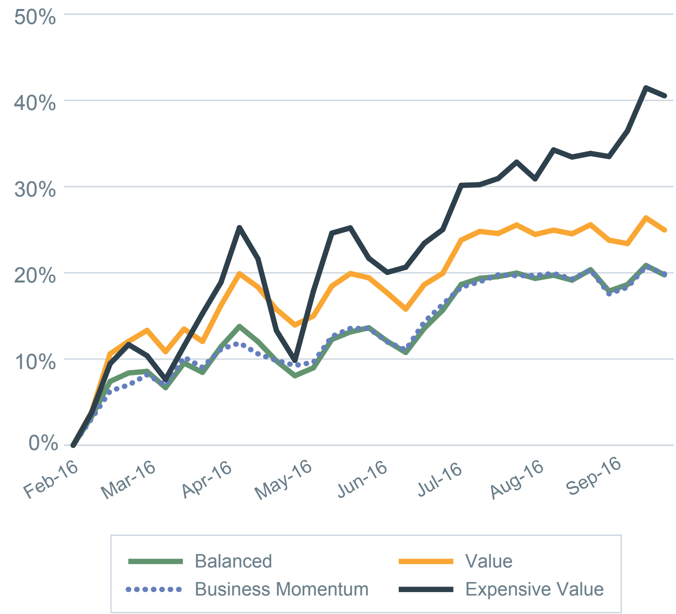
During this period, Business Momentum stocks performed well (up over 125%), Value stocks performed very well (up over 150%), and the Balanced model stocks performed best (up over 195%). Conversely, the Ex-Val companies lost approximately 5% over the period. This is not a surprise — expensive companies that are not growing generally don't make good investments.

What has surprised us, however, is the performance of these same four cohorts for most of 2016 (Exhibit 4). From the market bottom (Feb. 11th) through now (Sept. 23rd), the results for this analysis have been deeply perverse. The managers that invest in the "good" companies, those that show strong characteristics of growth, value and/or a combination, have struggled mightily. They have underperformed their historical averages and their benchmarks. And even more tellingly, Ex-Val companies are up roughly 40%.

EXHIBIT 3: FOUR QUADRANT PERFORMANCE IN LAST FIVE YEARS
8/29/11 – 9/23/16

Source: Bloomberg. Chart is meant for illustrative purposes only.
Past performance is not indicative of future results.

EXHIBIT 4: FOUR QUADRANT PERFORMANCE SINCE 2016 MARKET BOTTOM 2/12/16 – 9/23/16



Source: Bloomberg. Chart is meant for illustrative purposes only.
Past performance is not indicative of future results.

This effect is especially pronounced in the small cap landscape (not shown here), where Ex-Val has soared by over 50% while the other quadrants have risen between 20% and 25%. The investor behavior that has driven expensive, slow growing companies higher this year seems determined to continue.

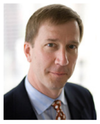
Ultimately this environment has created strong headwinds for most active managers, requiring firms to work with clients to remain patient while the market eventually responds to the traditional stimulus of valuation and growth. And it will, just like it did in 2000 and again in 2008 – 2009.

One thing will always remain true: "normal" market cycles typically endure just longer than the average investor's patience. While we certainly don't know the timing to unwind this market cycle, we have started to see some semblance of rationality returning to the market this quarter. Distortions can persist over extended periods of time, but eventually fundamentals, like the combination of good valuation and growth characteristics, will prevail. At Boston Advisors we invest with conviction and, despite temporary distortions in investor behavior, we remain firmly committed to our investment process.

About Boston Advisors

Established in 1982, Boston Advisors is a boutique investment management firm, managing assets for institutional and high-net-worth clients. We are an SEC-registered investment adviser with $4.4 billion in assets under management (as of 6/30/16) and 40 employees. The firm offers a range of investment capabilities, including equity, fixed-income, asset allocation, and socially responsible/faith-based asset management, as well as comprehensive private investment advisory services. Boston Advisors is known for its hybrid investment approach, combining sophisticated, proprietary quantitative modeling with a fundamental overlay to create custom portfolios with an emphasis on active risk management.

Boston Advisors Institutional Investment Team



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> Started with firm: 1997
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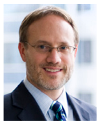

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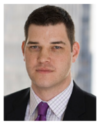

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