At the time of writing, the equity markets had generally posted solid overall year-to-date returns despite brief periods of volatility. It is challenging to be optimistic given the negative economics seemingly around the globe. However, we recognize that, in some areas, valuations of equities look attractive despite continuing fragile confidence in the equity markets.

In this issue of Perspectives on Equity Investments, we take a look at the increasing interest in income-oriented equity investments and the implications for manager research. We also consider whether the often-overlooked strategy of utilizing a “contrarian” approach to equity manager selection is worth reconsidering. Another article investigates whether combining different investment methodologies is a viable diversification strategy within US equity investing.

Moreover, this issue focuses on the concept of “active share” in the context of portfolio construction. A related Q&A explores active share more deeply as it pertains to our equity manager research efforts globally.

We hope you find this year’s second issue both informative and timely. Please contact us if you have any questions or comments.

Kind regards,

Deb Clarke
Global Business Leader,
Equity Boutique

Matt Reckamp
Editor
The concept of “contrarian” investing is widely and successfully used by value-oriented money managers in selecting securities. It is the very essence of buying low and selling high; of being attracted to those opportunities being shunned by the majority. Can it also be used for selecting money managers? Is it possible to build a successful contrarian manager selection strategy by hiring managers that underperformed their benchmarks in periods prior to the hire? This article summarizes the simulated results of such a strategy and the implications for the manager selection decision-making process.

THE PREMISE
To set the stage, past performance is often the single most important factor influencing decisions to hire or fire an investment manager despite empirical studies repeatedly showing that, on average, manager outperformance versus the benchmark in prior periods has little predictive power of manager success in subsequent periods. This is because returns appear to provide unbiased and measurable “evidence” of a manager’s skill. But do they really?

They could reflect skill, they could reflect luck, and additionally, they could simply be the result of the cyclicality of factors that drive market performance. As market sentiment vacillates between euphoria and fear, the factors that drive the performance of markets periodically rise in and fall out of favor.

More often than not, the level of exposure to a set of market factors is encoded in the DNA of an investment strategy. In such circumstances, a capable manager’s underperformance may be more indicative of the prevailing market sentiment rather than the deterioration of active management skills. Firing such a manager based on recent underperformance is often ill-timed and does not

“As market sentiment vacillates between euphoria and fear, the factors that drive the performance of markets periodically rise in and fall out of favor.”
allow the investor to capitalize on the manager’s stance when factors favored by the manager swing back. On the other hand, successful identification and hiring of a skilled manager in times when that manager’s style is out of favor can result in additional excess return.

THE SIMULATIONS
To test the empirical attractiveness of the contrarian manager selection strategy, we ran a series of simulations for each of the 12 traditional long-only universes listed below. These universes were chosen due to their long track records, breadth and relative homogeneity.

- US Large-Cap Value, Large-Cap Core, Large-Cap Growth
- US Mid-Cap Value, Mid-Cap Core, Mid-Cap Growth
- US Small-Cap Value, Small-Cap Core, Small-Cap Growth
- US Fixed Core Opportunistic
- Developed Market International, International Small Cap

For each of the universes above, we ran 1,000 simulations of gross-of-fee portfolio returns using quarterly manager returns from the Mercer Global Investment Manager Database™ (GIMD) for the 11-year period from 2000 through 2010. This period represents the longest dataset available to us without survivorship bias. For each simulation, we purchased one random investment strategy that met our evaluation criteria and held it until our monitoring criteria was violated. When the monitoring criteria triggered firing of the incumbent, we allowed three months to simulate the typical manager change period and then purchased another random investment strategy from the same universe based on the same evaluation criteria. Each quarter, the portfolio return was adjusted by the amount of the median management fee for the relevant universe applicable for a $50 million mandate. We also accounted for the two-way approximate transaction costs of replacing a manager.

We ran three distinct simulation scenarios:

1. “RANDOM-WALK” strategy – in each universe, a random manager was hired January 1, 2000, held a minimum period of two years and then fired as soon as either (i) the two-year information ratio (IR) fell into the bottom quartile or (ii) the two-year IR fell below the median for more than two quarters in a row

2. “MOMENTUM” strategy – in each universe, a random manager with a top-quartile two-year IR was hired as of January 1, 2000, held a minimum period of two years and then fired as soon as either (i) the two-year IR fell into the bottom quartile or (ii) the two-year IR fell below the median for more than two quarters in a row

“As market sentiment vacillates between euphoria and fear, the factors that drive the performance of markets periodically rise in and fall out of favor.”
3. “CONTRARIAN” strategy – in each universe, a random manager with a bottom-quartile two-year IR was hired as of January 1, 2000, held a minimum period of two years and then fired as soon as either (i) the two-year IR fell into the bottom quartile or (ii) the two-year IR fell below the median for more than two quarters in a row.

Utilizing alternative underperformance-identifying trigger metrics (for example, excess returns instead of IR) over the same 11-year period yielded similar results as those described below.

THE RESULTS
The summarized results of these simulations are shown in Figure 1 below. The chart shows the per annum median excess returns (net of median fees and approximated switching costs) among the three simulation scenarios. The contrarian strategy outperformed the momentum strategy in all universes (sometimes by a large margin) and the random-walk strategy in all universes except US small-cap core. Moreover, the random-walk strategy outperformed momentum in all universes.

Within our simulations, investment strategies were selected without regard to Mercer ratings. In fact, since our algorithm simply picked random managers that met our criteria, it did not differentiate between those managers with supposedly superior or inferior active management skills. Therefore, the bulk of the observed excess returns generated by the contrarian strategy cannot be attributed to skill.

It is also important to point out that the contrarian strategy outperformed the median investment strategy (reflecting no manager changes) within each universe during the 11-year period.
The annual excess return ranged from 0.3% in the Fixed Core Opportunistic universe to 3.5% for International Small-Cap and Mid-Cap Growth. As such, value was able to be created, on average, by following a contrarian manager selection strategy compared to taking no action. Following a momentum strategy actually detracted from a buy-hold approach in eight of the 12 universes.

Looking at the results in specific sub-periods yielded an interesting observation: A significant portion of the advantage of the contrarian strategy in the growth-oriented US equity universes came during the 2000–2001 technology bubble burst. During a period of distress within the growth universe’s dominant sector, the contrarian strategy shined. However, the unraveling of subprime mortgages in 2007–2008 had a negative effect on the contrarian strategy within value universes. As such, during a comparable period of distress within the value universe’s dominant sector, the contrarian strategy struggled.

**THE POTENTIAL IMPLICATIONS**

Understanding that many factors go into the selection of an investment manager, even the simplest contrarian strategy (at least over this 11-year period, across multiple universes and triggered by various underperformance metrics) appears to enhance investment manager selection over time. As expected, a contrarian strategy is well-suited for periods of uncertainty when factors favored by the markets are not consistent from one period to the next and market sentiment is volatile. A disciplined investor with a longer investment horizon and willingness to not only tolerate short-term portfolio underperformance but welcome it when looking for a replacement manager is expected to reap benefits from the contrarian manager selection strategy. Moreover, the successful identification of managers with superior investment insight can add value above the results presented herein.

“Understanding that many factors go into the selection of an investment manager, even the simplest contrarian strategy appears to enhance investment manager selection over time.”

**ABOUT THE AUTHOR**

Matt plays multiple roles as a Principal at Mercer. He currently splits his time between manager research for US equity strategies, client related work, and raising the profile of the Equities Boutique inside and outside Mercer.
INTRODUCTION
A good portion of our global manager research efforts are focused on identifying equity investment strategies with superior idea-generation capabilities resulting from either an information advantage or unique insights. Another important potential source of excess returns is portfolio construction. At a very high level, our interest in an investment manager’s portfolio construction is in assessing how effectively it converts its collection of ideas into consistent outperformance. In doing so, we consider metrics such as a portfolio’s level of concentration, index-centricity, explicit and implicit risk exposures, and position sizing, to name a few. For this paper, we are going to discuss what impact “active share,” or lack thereof, can have on portfolio construction, and ultimately portfolio returns.

WHAT IS ACTIVE SHARE?
Active share is a measure of the degree to which a portfolio deviates from the benchmark. Unlike a purely passive strategy that attempts to replicate its underlying benchmark, portfolio managers that employ an active-share mindset intentionally attempt to have different exposures than the appropriate benchmark. The concept of active share was coined by Annti Petajisto and Martijn Cremers in a 2006 study, entitled “How Active is Your Fund Manager? A New Measure That Predicts Performance.” In this seminal paper, the authors offered a framework for analytically evaluating the effect a manager’s portfolio construction decisions have on potential returns.

UNDERSTANDING ACTIVE SHARE
To understand active share it might be helpful to contrast it with a more common measure of how closely a portfolio follows an index – tracking error. Ex-post tracking error is the standard deviation of the return differential between the portfolio and the benchmark.
Consequently, it is calculated using historical returns over a very specific period. Active share, on the other hand, is calculated based on weighted holdings (not returns) as of a specific point in time (not over time). While tracking error statistics can be influenced (both up and down) by the changing magnitude of market returns over time, active share tends to be more stable from one period to the next.

Active share and tracking error are certainly positively correlated: high tracking error typically corresponds to high active share. But, looking at tracking error alone can lead to some false conclusions. High active-share managers may have a low tracking error and vice versa. With this in mind, we agree with Petajisto and Cremers, who believe investors are best served by looking at active share and tracking error in concert with one another. Figure 1 offers an illustration to help think about the effect a manager’s portfolio construction decisions have on its active share and tracking error.

![Figure 1: Active Share Versus Tracking Error](image)


According to Petajisto and Cremers, at the extremes, a portfolio manager can be a “stock picker” or a “factor bettor.” Stock pickers (high active share) are more likely to own stocks that are not represented in the index, or they own stocks that are in the index but at a position weight that materially differs from the benchmark. In contrast, factor bettors (low active share/high tracking error) tend to focus on having specific factor exposures (for example, style, size, sector, and country) that deviate from the benchmark while having individual position weights that are more in line with the index. Examples of a factor bettor might include a manager with a top-down approach or a quantitative strategy driven by desired factor exposures.
UNDERSTANDING THE IMPACT ON PORTFOLIO RETURNS

Portfolio managers with high active share have shown a degree of outperformance persistence. Using data from the CRSP mutual fund database, Petajisto examined the returns of more than 1,100 equity mutual funds during the period 1990–2009. The data (see Figure 2) showed that the best relative results came from managers that displayed a high degree of active share and low tracking error; specifically the group defined as “diversified stock pickers.” After adjusting for fees, factor bettors and closet indexers showed the worst performance. All told, the average active manager (net of fees) lost 0.4% relative to the index, which lends credence to the notion that active managers, in the aggregate, underperform the market.

![FIGURE 2](image)

Annualized Excess Returns, 1990–2009

<table>
<thead>
<tr>
<th>BECHMARK ADJUSTED</th>
<th>GROSS RETURN</th>
<th>NET RETURN</th>
</tr>
</thead>
<tbody>
<tr>
<td>Diversified stock pickers</td>
<td>2.6%</td>
<td>1.3%</td>
</tr>
<tr>
<td>Concentrated stock pickers</td>
<td>1.6%</td>
<td>-0.3%</td>
</tr>
<tr>
<td>Factor bets</td>
<td>0.1%</td>
<td>-1.3%</td>
</tr>
<tr>
<td>Modestly active</td>
<td>0.8%</td>
<td>-0.5%</td>
</tr>
<tr>
<td>Closet indexers</td>
<td>0.4%</td>
<td>-0.9%</td>
</tr>
<tr>
<td>ALL</td>
<td>1.0%</td>
<td>-0.4%</td>
</tr>
</tbody>
</table>


We believe there is also merit in having a strategic allocation to concentrated stock pickers. From 1990 to 2009, this category experienced the second-best return stream. Nevertheless, concentrated stock pickers suffered mightily during the financial crisis of 2008 (see Figure 3). Despite a dramatic comeback in 2009, when concentrated stock pickers beat their benchmark by an impressive 9.4%, the category was down 2.6% during the two-year period. As a result, we believe clients that have the flexibility to tactically reallocate capital to this category following a period of performance difficulty could see further benefits. Predictably, closet index strategies lost ground during and coming out of the crisis.
Benchmark Adjusted Net Return

<table>
<thead>
<tr>
<th></th>
<th>2008–2009</th>
<th>2009</th>
</tr>
</thead>
<tbody>
<tr>
<td>Diversified stock pickers</td>
<td>1.0%</td>
<td>6.1%</td>
</tr>
<tr>
<td>Concentrated stock pickers</td>
<td>-2.6%</td>
<td>9.4%</td>
</tr>
<tr>
<td>Factor bets</td>
<td>-1.7%</td>
<td>2.2%</td>
</tr>
<tr>
<td>Modestly active</td>
<td>-0.3%</td>
<td>1.1%</td>
</tr>
<tr>
<td>Closet indexers</td>
<td>-0.8%</td>
<td>-0.7%</td>
</tr>
<tr>
<td>ALL</td>
<td>-0.5%</td>
<td>2.1%</td>
</tr>
</tbody>
</table>


Manager Selection: Separating Luck from Skill

We believe it is important to remember that the existence of positive index-relative excess returns does not necessarily indicate that a portfolio manager is skilled. It is just as likely that the portfolio manager was simply fortunate. At the same time, high active share does not reflect skill, nor does it ensure excess returns. However, not incorporating active share into the evaluation process makes identifying an equity strategy that can deliver excess returns even more daunting. For example, if one assumes that 60% of a portfolio manager’s strategy is explicitly or implicitly passively invested (that is, an active share of 40%), the manager would need to earn a hefty 3.1% in excess returns on the remaining portfolio in order to cover a 1.25% expense fee. The following table (Figure 4) expands this analysis to include multiple active share and expense levels.
While we think it is important to have an appreciation for the effect active share can have on portfolio returns, we think it is also important to remember that academic research conducted over the past 30 years has yielded mixed results on the persistence of a manager’s returns. In our view, the limited evidence of performance persistence does not, however, rule out the possibility of successful active management. It simply suggests that truly skillful managers are hard to find. It also suggests that looking at a manager’s prior performance success is not necessarily a sound strategy in identifying prospective managers. High levels of active share, on the other hand, seem to have some correlation to excess returns.

CONCLUSION
In our view, portfolio construction considerations are an important and sometimes overlooked element in equity manager identification and selection. Active share is a dependable tool for evaluating one aspect of portfolio construction. We believe clients would be well served to consider assembling a collection of high active-share equity strategies that are also considered skillful, as evidenced by being highly rated by Mercer’s global equity manager researchers. For clients simply seeking equity beta, a lower-fee passive strategy is likely the best option. Based on the work of Petajisto and Cremers, however, we think investors are well served by avoiding those portfolios described as closet indexers. These managers have structural limitations associated with the portfolio construction process that hinder their ability to generate net-of-fee excess returns.

ABOUT THE AUTHOR
Sean is a Senior Associate in our Chicago office working in the research division of Mercer’s Investments business. Sean has responsibility for primary research on various US equity strategies for numerous domestic investment managers.
Over the last few years we have seen a significant increase in the number of global, yield-oriented equity strategies available on Mercer’s Global Investment Manager Database (GIMD™). To illustrate this, there are currently 55\(^1\) such strategies on GIMD – 37 have been added since 2008, with 12 of those having been added during the first six months of 2012.

There are a number of plausible reasons for this increased interest in dividend yield:

1. The current level of dividend yields is perceived as high, particularly relative to bond yields.
2. Yield strategies have performed well in recent years.
3. Yield strategies are seen as a proxy for “quality” and may be expected to offer some defensive characteristics
4. The increase may, in part, reflect a more general acceptance of global equity strategies.
5. Some equity managers are simply responding to a structural increase in demand for yield from an aging population with limited income options.

As stated earlier, there is a perception that dividend yields are high relative to history and/or compared to other assets (most notably bonds). The latter is certainly true. At year-end 2011, the MSCI World Index was yielding 2.9% while 10-year US Treasury Bonds were yielding 2.1% (now more like 1.7%). At the start of the 2000s, the

\(^{1}\) Out of 804 GIMD strategies in the Global – Core, Global – Value, and Global – Growth universes, 55 include the word “yield”, “dividend” or “income” in the strategy name (excluding sub-advised and multi-manager strategies).
comparable yields were 1.3% (equities) and 6.4% (bonds). This is highlighted in the chart below. However, relative to history, the current dividend yield on the MSCI World Index is no higher than the index’s historical average (1969–2011). Further, if we look at the 1970s, or go back even further, say to the start of the 20th century, dividend yields were regularly above 5%.

While current dividend yields may not actually be that high in an historical context, it is hard to dispute that a yield approach has performed well over time. There are numerous studies that support this (see Dimson E, Marsh P. and Staunton M. Triumph of the Optimists: 101 Years of Global Investment Returns, 2002 and updated 2010). Even using a naïve yield approach, such as the history of the MSCI World High Dividend Yield Index, the results have been impressive. The high-yield index outperformed the MSCI World Index by 3% per annum from its June 1995 inception through year-end 2011. Perhaps more importantly, in the near term, the MSCI World High Dividend Yield Index outperformed the MSCI World Index by 9.8% in 2011, generating a positive return, while the MSCI World Index fell 4.8%.

Our approach to researching global yield-oriented equity strategies has been to review them in line with our broad global equity universes (core, value and growth) – the benchmark typically chosen. That is to say, our rating reflects our view of each strategy’s prospects of outperforming the broad equity benchmark (for example, MSCI

FIGURE 1

MSCI World Dividend Yield
Benchmark Bond 10-year: US Redemption Yield
Average dividend yield

While current dividend yields may not actually be that high in an historical context, it is hard to dispute that a yield approach has performed well over time.

MSCI High Dividend Yield Index is a market cap-weighted subset of the parent index, including securities with a dividend yield of at least 30% higher than the parent index, a “reasonable payout,” and “a non-negative five-year dividend per share growth rate."
World, MSCI ACWI) in the context of the entire peer group. The global equity universe is very broad and competitive, with over 800 strategies on GIMD, and we have thus far not rated any explicitly yield-focused strategies above B+.

There are a number of considerations worthy of mentioning in our ongoing review of yield strategies.

**FIRST**, while yield strategies have performed well, so have other measures of “value,” such as “price to book” or “price to earnings” (frequently outperforming yield). Equally, while yield strategies have provided some defensive characteristics, there are other “quality” biased equity strategies that tend to provide more reliable protection.

**SECOND**, while dividends are clearly an important component of an investor’s total return (typically between 20% and 50%), they are only one component. Theoretically, the total expected return from equity investing can derived by the following formula:

\[ \text{Total return} = \text{current dividend} + \text{future dividend growth} +/\text{change in valuation} \]

Ignoring the other components, such as future growth and change in valuation, would appear foolish. The appropriate focus should be on total return, including each of its components.

**THIRD**, with regard to the yield strategies Mercer rates highly (that is, B+) there is a clear bias towards strategies that have at least some focus on the sustainability of dividend growth as opposed to outright high yield. Multiple metric managers, which we find appealing, are utilized to help avoid dividend-related value traps. We like managers that require a minimum level of historical dividend growth, positive dividend growth expectations, adequate income coverage of dividends or high levels of free cash flow yield. Managers also consider the focus of company management on delivering shareholder value as a means to avoid yield traps.

**FOURTH**, we have also tended to focus on strategies that have a degree of flexibility in the level of dividend required from each potential investment, thereby broadening the opportunity set. While some strategies have a strict minimum dividend yield requirement at a stock level (say 3.5% or 1.5 times the MSCI World Index dividend yield), other approaches may only have a portfolio level yield requirement, or an even looser “stable and growing dividend” portfolio guideline. As a general rule, we prefer strategies with fewer constraints, which may, for example, be able to invest in more dynamic (less mature) companies where a high dividend yield is not yet considered desirable.

Where a yield oriented equity strategy has the MSCI World Index as its benchmark, we will continue to assess its merits relative to the broader global equity universe. Where a strategy has a different benchmark, we will assess it against the most appropriate universe. There are a number of yield strategies in the global equity universe that Mercer rates B+ (nine as at 30 June 2012) and if clients have a specific need for income or a desire to focus on yield, we recommend they consider those strategies.
Investors have long used certain metrics to identify diversification opportunities within US equity mandates. The traditional US equity style box is based on two of the most common metrics – size (market capitalization) and style (growth or value). More recently, investors have also been appropriately considering quality as a third dimension to the style box schematic. However, to date, we have not heard much in terms of a potential fourth dimension, namely investment methodology. For the purposes of our discussion, we are simply alluding to two broadly differentiated investment methodologies: quantitative and fundamental.

Quantitative investment strategies vary, but are typically driven by a mix of fundamental and momentum factors (that is, quantitative information) such as P/E multiples, earnings revisions and price momentum. This tends to result in more diversified portfolios constructed using a customized optimization algorithm (objective rules) based on past performance correlations. Quantitative portfolios tend to have active factor bets. In contrast, fundamental investment methodologies tend to be driven by in-depth, company-specific investment research and human judgment. Because of the time and effort involved, fundamental investment managers generally limit portfolios to best ideas and are more willing to take active stock bets.

With that in mind, there are two primary questions to be addressed: Are diversification efforts within US equity investment mandates worthwhile? And does a manager’s investment methodology (quantitative or fundamental) warrant consideration when identifying diversification metrics? Based on our analysis, diversification benefits can clearly be garnered along the size, style and quality dimensions. The evidence is less compelling regarding the role of investment methodology as a primary diversifier. However, when utilizing multiple managers within a single category (for example, large-cap growth), there does seem to be some benefit in combining quantitative and fundamentally oriented strategies.

Let’s take a closer look. To capture the dimensions of size, style and quality, we have available a variety of relevant US equity indexes ripe for comparison. For the sake of consistency, we utilized three index pairs offered by Russell Investments to isolate each of the first three dimensions.

Size – Russell 1000 vs. Russell 2000\(^1\)

Style – Russell 3000 Growth vs. Russell 3000 Value\(^2\)

Quality – Russell 3000 Dynamic vs. Russell 3000 Defensive\(^3\)

For capturing the fourth dimension (investment methodology) we created two representative composites, one consisting of 16 large-cap core quantitative investment strategies and one consisting of 16 large-cap core fundamental investment strategies as there were no acceptable index proxies readily available.

**EXCESS RETURN CORRELATIONS**

With our constituents in mind, we looked at the historical monthly excess return correlations (index return less the Russell 3000 Index return) for each index pair to see if diversification opportunities were evident along each dimension. This analysis eliminates US equity market beta from the equation, which tends to be the prevailing driver of returns. The excess return correlation results are shown in Table 1.

<table>
<thead>
<tr>
<th>Average 12-month excess return correlations</th>
<th>Ending between 2002–2011</th>
</tr>
</thead>
<tbody>
<tr>
<td>R1000 vs. R2000</td>
<td>-0.46</td>
</tr>
<tr>
<td>R3000 Growth vs. R3000 Value</td>
<td>-1.00</td>
</tr>
<tr>
<td>R3000 Defensive vs. R3000 Dynamic</td>
<td>-1.00</td>
</tr>
<tr>
<td>Large-cap core quantitative vs. fundamental</td>
<td>0.36</td>
</tr>
</tbody>
</table>

The correlation of excess returns between the quantitative and fundamental composites is arguably the most interesting, as the absolute number (+0.36) suggests there is diversification potential. However, on a relative basis, investment methodology falls far short of the other diversification dimensions. For style and size, the “mirror image” structural design of the indexes (relative to the Russell 3000

\(^1\) These indexes represent large-cap and small-cap US stocks, respectively.

\(^2\) These indexes represent growth- and value-oriented US stocks, respectively.

\(^3\) These indexes represent lower- and higher-quality US stocks, respectively, of all sizes. These indexes equally split the Russell 3000 Index on accounting-based quality and performance-based volatility factors.
Index) automatically results in perfectly negative excess return correlations. Notwithstanding, a client utilizing size and style diversification may desire multiple investments in one category. So the question becomes whether there is any benefit to diversifying between quantitative and fundamental managers within a category such as US large-cap growth. We think there is.

Table 2 highlights the correlation of excess returns from broad lists of quantitative and fundamentally driven large-cap growth investment strategies over multiple rolling three-year periods from 1981 through March 2012. The average correlation was approximately twice as high between investment strategies utilizing a common methodology compared to a combination of quantitative and fundamental.

Table 2

<table>
<thead>
<tr>
<th>Average three-year excess return correlations</th>
<th>Quantitative vs. quantitative</th>
<th>Fundamental vs. fundamental</th>
<th>Quantitative vs. fundamental</th>
</tr>
</thead>
<tbody>
<tr>
<td>Large-cap growth</td>
<td>0.19</td>
<td>0.16</td>
<td>0.09</td>
</tr>
</tbody>
</table>

BEYOND PERFORMANCE

In addition to correlation statistics, we focused on other factors that might prove beneficial in identifying potential diversification opportunities across our four dimensions.

With regard to size, large-cap stocks generally have more of a global reach, broader Wall Street research coverage and are generally more established than small-cap stocks. For these reasons, it is generally agreed that diversifying US equity exposure on the basis of size is reasonably sound. The following fundamental characteristics (Table 3), through March 2012, support the notion that size is a meaningful metric in subdividing the US equity market.

Table 3

<table>
<thead>
<tr>
<th>10-year averages</th>
<th>Average market cap</th>
<th>ROE five-year average</th>
<th>Beta vs. R3000</th>
<th>EPS variability</th>
</tr>
</thead>
<tbody>
<tr>
<td>Russell 1000</td>
<td>$80 billion</td>
<td>20%</td>
<td>0.94</td>
<td>49.8</td>
</tr>
<tr>
<td>Russell 2000</td>
<td>$1.0 billion</td>
<td>11%</td>
<td>1.19</td>
<td>84.1</td>
</tr>
</tbody>
</table>

The growth and value style benchmarks maintain meaningfully different sector allocations. Because sectors have different levels of cyclicality, their relative performance can be heavily influenced by changing economic conditions. Sector performance can also be
affected by industry-specific headwinds or tailwinds. Also, as you might expect, the two style indexes have very different earnings growth, valuation and dividend characteristics. As evidenced by the numbers, style can be an effective diversification tool. (See Tables 4 and 5).

<table>
<thead>
<tr>
<th>10-year averages</th>
<th>Financials allocation</th>
<th>Technology allocation</th>
<th>Health care allocation</th>
<th>Utilities allocation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Russell 3000 Growth</td>
<td>9%</td>
<td>24%</td>
<td>19%</td>
<td>1%</td>
</tr>
<tr>
<td>Russell 3000 Value</td>
<td>31%</td>
<td>5%</td>
<td>7%</td>
<td>13%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>10-year averages</th>
<th>P/E</th>
<th>EPS growth five-year</th>
<th>Dividend payout five-year</th>
<th>Dividend yield</th>
</tr>
</thead>
<tbody>
<tr>
<td>Russell 3000 Growth</td>
<td>22.7x</td>
<td>15.8%</td>
<td>21%</td>
<td>1.2%</td>
</tr>
<tr>
<td>Russell 3000 Value</td>
<td>17.8x</td>
<td>8.0%</td>
<td>36%</td>
<td>2.5%</td>
</tr>
</tbody>
</table>

The distinguishing characteristics of the quality indexes make a compelling argument that quality can be a meaningful measure of distinction. Certain economic sectors are considered more defensive and others are more dynamic (see Table 6). Based on materially different sector exposures and the resulting index characteristics (Table 7), it is easy to understand how quality can be a discerning diversification metric, particularly during periods of volatility extremes.

<table>
<thead>
<tr>
<th>Five-year averages</th>
<th>Consumer staples allocation</th>
<th>Health care allocation</th>
<th>Financials allocation</th>
<th>Materials allocation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Russell 3000 Defensive</td>
<td>12%</td>
<td>16%</td>
<td>17%</td>
<td>3%</td>
</tr>
<tr>
<td>Russell 3000 Dynamic</td>
<td>2%</td>
<td>10%</td>
<td>24%</td>
<td>6%</td>
</tr>
</tbody>
</table>
Notable differences related to characteristics and construction also exist between our quantitative and fundamental composites. The most telling differences pertain to the degree of “index hugging.” Table 8 supports the assertion that quantitative strategies are typically more index-aware than fundamentally based strategies. These differences are important to note and may provide ample justification for considering investment methodology when selecting complementary US equity managers. Strategies that are more actively managed (that is, lower index coverage) are better equipped to overcome management fees.

One last point: the quantitative composite had a definite value orientation as indicated by the positive average value score while the fundamental composite did not. This may be a result of the propensity of quantitative managers to rely more on historical and current factors, something more common in value strategies.
CONCLUSION
Given the historical data, it is apparent that portfolio diversification on the basis of size, style and quality has been and is likely to continue to be a worthwhile endeavor for US equity investors. This is evidenced by the correlation of excess returns born from inherently different exposures. In addition, investment methodology could be considered as a secondary diversifier as benefits might be less acute given some overlapping exposures (despite the fact that portfolios can be constructed and managed in very dissimilar ways). Investors should consider the role of investment methodology when constructing a US equity portfolio; it could add an interesting dimension and increase overall diversification.

“Given the historical data, it is apparent that portfolio diversification on the basis of size, style and quality has been and is likely to continue to be a worthwhile endeavor for US equity investors.”

ABOUT THE AUTHOR
Kerrisha is a consultant in the Los Angeles office. Her responsibilities include advising defined contribution and defined benefit plans on investment policy, investment structure, asset allocation, manager selection, and manager performance.
Q: Sean Chatburn’s piece (“Get Active!”) in this issue of Perspectives on Equity Investments provides a nice summary of active share. What level of active share (for example, 60%, 75%, 90%) is typically necessary to reflect a highly actively managed portfolio?

A: There is no universal active share number above which we consider a strategy truly active. The threshold is very much dependent on the breadth of the underlying index being used for comparison. The broader the index, the higher the active share becomes for the typical portfolio in a given universe. The narrower the index – or said another way, the more concentrated the index – the lower the typical active share will be for that asset class. For this reason, active share tends to receive greater attention among large-cap strategies where the index is more concentrated and larger index names have more influence on returns. However, active share measures above 80% are a good place to start for identifying more active strategies. Unconstrained and concentrated portfolios will often have active share numbers of greater than 90%.

Q: Do you get the sense that investment managers are aware of active share and do they construct portfolios with active share in mind?

A: Even though the idea has been around for a few years, investment managers are just now becoming more accustomed to talking about active share as it pertains to how they manage portfolios. As you might expect, those investment strategies that are more active tend to present active share exposures/histories more than those that are more index-centric. They naturally like to talk about things that paint them in a good light. Ironically, the percentage of assets in high active share strategies has been on the decline for many years. One contributing reason for this decline is the growing popularity of index strategies. Also, closet indexers, or what might be referred to as “beta cheaters,” have also become more prevalent over the last 25 years. These are strategies with active share typically below 60%.

Q: Is active share related to the coverage metric used in style research portfolio reports?

A: It is indeed. You can think of our coverage ratio as the reciprocal of active share. For example, an active share of 70% is equivalent to a coverage ratio of 30% (100% - 70%). Both calculations are based on a snapshot of a portfolio’s weighted positions. Interestingly, even though active share (and consequently, coverage) is a moment-in-time metric, over time the numbers tend to stay uniquely consistent.

Q: Can you tell us more about how active share is utilized within Mercer’s equity research boutique?

A: Clearly active share is a metric related to portfolio construction – one of the four areas we focus on when assessing a given investment
strategy along with idea generation, implementation and business management. When assessing a manager’s portfolio construction, we are attempting to determine how well investment ideas are reflected in the portfolio. Active share gives us an objective measure of all differentiating positions within the portfolio that can add or detract value, in a relative sense, compared to the index. Active share also helps us determine if a client’s active management fee budget is being spent wisely. From an implementation perspective, a declining active share can also be an indicator, among other things, that a strategy is approaching its practical asset capacity regardless of stated limits. Finally, active share is one factor that goes into our assigning a (T) designation to an active strategy’s overall rating.

Q: You are referring to the high tracking error (T) designation. With that in mind, what else do you consider in assigning a (T) to a given strategy?

A: Assigning a (T) to a strategy is more subjective than you might think and is the result of several factors taken together. First, let me say that a (T) reflects our forward-looking assessment that a strategy will likely have a high tracking error to its primary benchmark in the future. In other words, it will likely perform differently than the index. Things like active share, historical tracking error and historical correlation of performance with the index, along with a quantitatively derived projected tracking error, index-relative portfolio constraints, a portfolio’s concentration or a manager’s propensity to expand its opportunity set outside the parameters of the benchmark, can all influence the (T) assignment.

Q: In your opinion, is there a correlation between higher active share portfolios and excess return as suggested by Petajisto and Cremers in their 2006 paper introducing active share?

A: We think so, but simply being differently positioned than the index does not necessarily translate into excess returns. Superior investment insights, judgment and talent are still the drivers of excess returns. Having said that, a high active share can free a skillful manager from some of the constraints that hinder performance. We’ve seen solid aggregate performance from our (T)-designated equity strategies and they generally correspond to higher active share portfolios.

ABOUT DEB CLARKE
Deb is the Global Leader of Mercer’s Equity Boutique, a unit within Mercer’s investments business. Based in London, she manages a group of over 40 specialists around the world who research a broad range of equity strategies. She specializes in researching global and global emerging market equity managers. She is a member of Mercer’s International and Asia Pacific Rating Review Committees as well as being a member of the Mainstream Asset Investment Committee. Deb works with a broad range of clients, advising on monitoring and selecting managers.
ABOUT MERCER’S EQUITY BOUTIQUE

Mercer’s Equity Boutique is responsible for research and advice in all aspects of equity investment, including:

- Due diligence on managers and strategies
- Structure of equity allocations
- Research on equity investment trends and opportunities
- Advice on portfolio structuring
- Performance reporting
- Due diligence and assistance with fee and mandate negotiation
- Ongoing monitoring of investment managers and client portfolios, including regular updates on performance

IMPORTANT NOTICES

References to Mercer shall be construed to include Mercer LLC and/or its associated companies. This contains confidential and proprietary information of Mercer and is intended for the exclusive use of the parties to whom it was provided by Mercer. Its content may not be modified, sold or otherwise provided, in whole or in part, to any other person or entity without Mercer’s prior written permission.

The findings, ratings and/or opinions expressed herein are the intellectual property of Mercer and are subject to change without notice. They are not intended to convey any guarantees as to the future performance of the investment products, asset classes or capital markets discussed. Past performance does not guarantee future results. Mercer’s ratings do not constitute individualized investment advice.

This does not contain investment advice relating to your particular circumstances. No investment decision should be made based on this information without first obtaining appropriate professional advice and considering your circumstances.

Information contained herein has been obtained from a range of third-party sources. While the information is believed to be reliable, Mercer has not sought to verify it independently. As such, Mercer makes no representations or warranties as to the accuracy of the information presented and takes no responsibility or liability (including for indirect, consequential or incidental damages) for any error, omission or inaccuracy in the data supplied by any third party.

This does not constitute an offer or a solicitation of an offer to buy or sell securities, commodities and/or any other financial instruments or products or constitute a solicitation on behalf of any of the investment managers, their affiliates, products or strategies that Mercer may evaluate or recommend.

For the most recent approved ratings of an investment strategy, and a fuller explanation of their meanings, contact your Mercer representative.

Mercer’s universes are intended to provide collective samples of strategies that best allow for robust peer group comparisons over a chosen timeframe. Mercer does not assert that the peer groups are wholly representative of and applicable to all strategies available to investors.

CONTACTS

ANDY BARBER (London)
+44 207 178 7109
andy.barber@mercer.com

BRIAN CLARK (Chicago)
+1 312 917 0578
brian.clark@mercer.com

DEB CLARKE (London)
+44 207 178 6936
deb.clarke@mercer.com

MARIANNE FEELEY (Sydney)
+61 2 8864 6909
marianne.feeley@mercer.com

TAKASHI HIRAMI (Tokyo)
+81 3 5354 1687
takashi.hirami@mercer.com

NERIDA LAW (Hong Kong)
+852 2116 3415
nerida.law@mercer.com

HOA QUACH (Chicago)
+1 312 917 9200
hoa.quach@mercer.com

MATT RECKAMP (St. Louis)
+1 314 746 1686
matt.reckamp@mercer.com

DAVID SCOBIE (Auckland)
+64 9 984 3511
david.scobie@mercer.com

RHODA SHAPIRO (Connecticut)
+1 203 229 6432
rhoda.shapiro@mercer.com

SHARON WILSON (Toronto)
+416 868 7657
sharon.wilson@mercer.com

www.mercer.com/research-boutiques
Argentina  |  Mexico
Australia  |  Netherlands
Austria  |  New Zealand
Belgium  |  Norway
Brazil  |  Peru
Canada  |  Philippines
Chile  |  Poland
China  |  Portugal
Colombia  |  Saudi Arabia
Czech Republic  |  Singapore
Denmark  |  South Korea
Finland  |  Spain
France  |  Sweden
Germany  |  Switzerland
Hong Kong  |  Taiwan
India  |  Thailand
Indonesia  |  Turkey
Ireland  |  United Arab Emirates
Italy  |  United Kingdom
Japan  |  United States
Malaysia  |  Venezuela

For further information, please contact your local Mercer office or visit our website at: www.mercer.com