“Reports of My Death Have Been Greatly Exaggerated”

“Going passive” is something we hear a lot about these days. It’s easy to understand why; buying an index fund seems to remove much of the guesswork from investing. With so many active managers to choose from—nearly all of whom claim superiority—how will investors know if they’ve selected the right one? Far easier to just buy “the market,” right? And don’t mutual funds collectively underperform their benchmarks after fees anyway? Why pay higher active fees for all this uncertainty and potential disappointment when you could instead just buy an index fund and lock in the market’s (fee-adjusted) return?

This train of thought has propelled the growth of the passive fund industry. The press has also helped; headlines like “The Decline and Fall of Fund Managers” (Wall Street Journal, 8/22/14), “Farewell to the Fund Manager?” (Financial Times, 10/10/14) and “The End of Mutual Funds Is Coming” (Fortune, 1/24/12) leave little room for interpretation. We haven’t seen such journalistic conviction about the demise of a market mainstay since Businessweek pronounced the “Death of Equities” in 1979 (the S&P 500 has since risen 19-fold). Even Warren Buffett, who amassed a fortune through active investing and entrusts Berkshire’s vaunted equity portfolio to two hedge fund managers, has recently recommended buying an index tracker.

Passive’s Problems Can Be Active’s Opportunities

As the passive segment of the market grows, we at Templeton believe the opportunities for active investors should only get better. While global equity markets as of December-end still offered great value in our opinion (especially compared to generally expensive, low-yielding fixed income assets), that value is becoming increasingly selective. After a prodigious rebound from 2009 lows, the beta rally may be behind us, and future
performance could become more alpha-driven and stock-specific. Indiscriminately buying the market in such an environment seems a dubious strategy to us.

Nor are the problems with passive funds merely situational. We find a number of structural limitations to these strategies that could result in value destruction over time. Consider the most basic premise of investing: buy low and sell high. Yet, passive funds tend to do just the opposite. Many of these products are market capitalization-weighted. In order to stay in line with benchmark allocations, they buy more of the stocks that get bigger while selling the stocks that shrink. By doing so, they are perpetually rotating away from cheaper stocks that have underperformed and into more expensive stocks with likely limited upside. (The “smart beta” funds that rebalance based on historical volatility do a similar thing.) Investors buying an index fund are exacerbating supply and demand imbalances by perpetuating momentum. Because these funds take no view of business fundamentals or valuation, they bear significant and unnecessary investment risks, in our view. For example, investors buying a global index fund in 1989 would have had the bulk of their investment (44%) in Japan at the absolute worst time to buy Japanese stocks.³ A decade later, they would have had nearly 25% of their investment in technology companies that were grossly overvalued.⁴

This focus on yesterday’s winners means that capital gets allocated dependent on size, not expected returns or growth rates. We think allocating capital in this manner perpetuates overvaluation, erodes competition and impoverishes free market capitalism. And, of course, not everyone can “go passive.” Without active managers practicing due diligence and facilitating price discovery, there is no market for an index tracker to track. Ultimately, this behavior may be self-curtiling, as the inefficiencies created by passive’s growing market share increase opportunities for active managers to allocate capital where it is expected to be most productive.

Finally, passive products guarantee underperformance versus the market after fees. For us, this is a non-starter. We will not achieve the goal of maximizing real return potential over time if we are compounding underperformance into perpetuity. You could buy pork belly futures or old baseball cards or vintage cars and at least theoretically have a chance of beating the market; but not an index fund. Locking in underperformance seems a tall price to pay for saving a few basis points in fees. It’s hard to maximize wealth creation in the long term by being penny-wise and pound-foolish.

Debunking Myths: The Value of Active Management

Very little of this information has made its way into the passive/active debate. Instead, the main talking point in support of passive funds is that “active managers on average fail to beat the benchmark after fees.” But, this is less a critique of active management than it is the recognition of a simple mathematical reality. To paraphrase Nobel laureate William Sharpe in The Arithmetic of Active Management, the cumulative sum of all investments equals the market return, which nets out to underperformance after fees. Yet, somehow this simple adding-up constraint has been misappropriated as a rhetorical pillar of the campaign against active management.

Keep in mind also that the “active management industry” includes managers who aren’t really all that active. In a seminal 2009 study, Yale professors Martijn Cremers and Antti Petajisto devised a measure called “Active Share” to gauge “activeness” in managers. Active Share simply measures how different a portfolio is from its benchmark. A pure index fund would mirror its benchmark and have an Active Share of zero. A fund that held none of the securities found in its benchmark would have an Active Share of 100. Templeton Growth Fund, with an Active Share of 86 as of December 31, 2014, would have been classified in the study’s most active quintile. What was surprising about Cremers’ and Petajisto’s findings wasn’t how few managers beat the benchmark, but rather how few actually seemed to be trying. The professors found that up to one-third of US mutual funds had low enough Active Share to be considered “closet indexers.” These are portfolios that hug their benchmarks in an effort to protect relative performance in a volatile and competitive marketplace. The primary risk in looking different than the benchmark is that performance will deviate markedly from the benchmark. Of course, deviating from the benchmark is the only constraint has been misappropriated as a rhetorical pillar of the campaign against active management.

Chart 1: Percent of Assets in Funds with High Active Share 1980–2009

![Chart 1: Percent of Assets in Funds with High Active Share 1980–2009](http://www.petajisto.net/data.html)

This is remarkable in light of the study’s primary conclusion: that truly active funds (defined as funds with Active Share of 80 or greater) do outperform their benchmarks on average even after fees and expenses. Prof. Cremers has since gone on to update the study with the finding that long holding periods are nearly as important as high Active Share to securing investment outperformance. Yet, the current vogue, as evidenced by the popular press and industry fund flows, seems to be away from long-term managers specializing in active security selection. Again, this flies in the face of academic research. To quote MIT professors Mark Kritzman and Sebastian Page’s 2003 study, The Hierarchy of Investment Choice: “Security selection is the most important investment choice, and skill as a security selector has the greatest value.”

Our message is simple: Active managers with distinctive, contrarian styles and long-term investment horizons can prove beneficial. This approach is not only supported by academic research; it is firmly rooted in empirical evidence. Take Templeton Growth Fund, for example, which features high active share and an average five-year holding period as of December 31, 2014. A hypothetical $10,000 investment in the fund at inception would be worth more than $11 million as of December 31, 2014, after all fees and expenses. A hypothetical investment in the “market,” as measured by the MSCI World Index, would be worth just over $2 million. We regard that $9 million left on the table as the opportunity cost of potentially “going passive.” In investing, as with all things in life, to be successful you at least have to try. This is remarkable in light of the study’s primary conclusion: that truly active funds (defined as funds with Active Share of 80 or greater) do outperform their benchmarks on average even after fees and expenses. Prof. Cremers has since gone on to update the study with the finding that long holding periods are nearly as important as high Active Share to securing investment outperformance. Yet, the current vogue, as evidenced by the popular press and industry fund flows, seems to be away from long-term managers specializing in active security selection. Again, this flies in the face of academic research. To quote MIT professors Mark Kritzman and Sebastian Page’s 2003 study, The Hierarchy of Investment Choice: “Security selection is the most important investment choice, and skill as a security selector has the greatest value.”

Our message is simple: Active managers with distinctive, contrarian styles and long-term investment horizons can prove beneficial. This approach is not only supported by academic research; it is firmly rooted in empirical evidence. Take Templeton Growth Fund, for example, which features high active share and an average five-year holding period as of December 31, 2014. A hypothetical $10,000 investment in the fund at inception would be worth more than $11 million as of December 31, 2014, after all fees and expenses. A hypothetical investment in the “market,” as measured by the MSCI World Index, would be worth just over $2 million. We regard that $9 million left on the table as the opportunity cost of potentially “going passive.” In investing, as with all things in life, to be successful you at least have to try.
WHAT ARE THE RISKS?
All investments involve risks, including possible loss of principal. Special risks are associated with foreign investing, including currency fluctuations, economic instability and political developments; investments in emerging markets involve heightened risks related to the same factors. In addition, smaller-company stocks have historically experienced more price volatility than larger-company stocks, especially over the short term. To the extent the fund focuses on particular countries, regions, industries, sectors or types of investment from time to time, it may be subject to greater risks of adverse developments in such areas of focus than a fund that invests in a wider variety of countries, regions, industries, sectors or investments. The fund’s risk considerations are discussed in the prospectus.

IMPORTANT LEGAL INFORMATION
Class A shares are offered at net asset value (NAV) to certain eligible investors, such as qualifying employee benefit plans and institutional investors exercising exclusive or shared discretionary investment authority for funds held in fiduciary, agency, advisory, custodial or similar capacity. Purchases made outside of the qualified class will be subject to the applicable sales charge.

This commentary reflects the analysis and opinions of the authors as of January 9, 2015, and may differ from the opinions of other portfolio managers, investment teams or platforms at Franklin Templeton Investments.

Because market and economic conditions are subject to rapid change, the analysis and opinions provided are valid only as of January 9, 2015, and may change without notice. The commentary does not provide a complete analysis of every material fact regarding any country, market, strategy, industry, asset class or security. An assessment of a particular country, market, security, investment, asset class or strategy may change without notice and is not intended as an investment recommendation nor does it constitute investment advice. Statements about holdings are subject to change. Statements of fact are from sources considered reliable, but no representation or warranty is made as to their completeness or accuracy.

Your clients should carefully consider a fund’s investment goals, risks, charges and expenses before investing. To obtain a summary prospectus and/or prospectus, which contains this and other information, please call Franklin Templeton Sales and Marketing Services at (800) 223-2141 or visit franklintempleton.com. Your clients should carefully read the prospectus before they invest or send money.

CFA® and Chartered Financial Analyst® are trademarks owned by CFA Institute.

1. Paraphrase of a quote attributed to Mark Twain in response to a 1897 New York Herald article reporting that the famous American writer was “grievously ill and possibly dying.”
2. Source: Bloomberg. The cumulative total return of the S&P 500 for the 35-year period ended 11/30/14 was 1,891%.
5. MSCI makes no warranties and shall have no liability with respect to any MSCI data reproduced herein. No further redistribution or use is permitted. This report is not prepared or endorsed by MSCI.
6. Source: © 2015 Morningstar. All Rights Reserved. The information contained herein; (1) is proprietary to Morningstar and/or its content providers; (2) may not be copied or distributed; and (3) is not warranted to be accurate, complete or timely. Neither Morningstar nor its content providers are responsible for any damages or losses arising from any use of this information. The indexes are unmanaged and include reinvestment of any income or distributions. One cannot invest directly in an index, nor is an index representative of the fund’s portfolio. Past performance does not guarantee future results.

See www.franklintempletondatasources.com for additional data provider information.