



Westwood®

Mission [Possible]

Changing the Probability
of Winning for Active Investors

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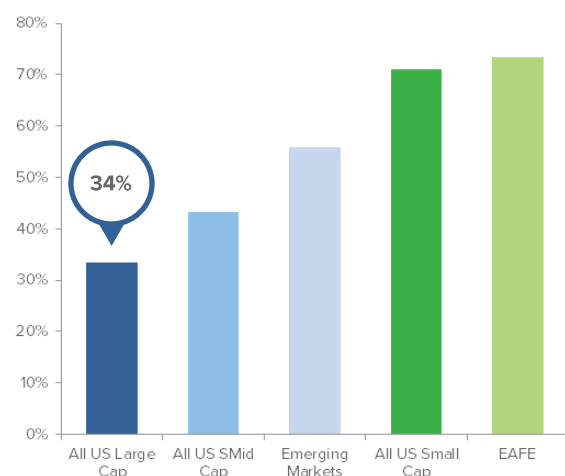
Solving the Fee Issue

As a high-performing equity market environment lifted most stocks over the last decade, the value proposition for active management in efficient asset classes such as U.S. Large Cap has been scrutinized by both institutional and retail investors alike.

Low active share, otherwise known as “closet indexing,” high turnover and lofty management fees all contributed to a trend of marginal performance results for active products relative to benchmarks. In response, many investors have chosen to reduce their allocations to active managers and increase passive holdings, particularly in efficient asset classes.

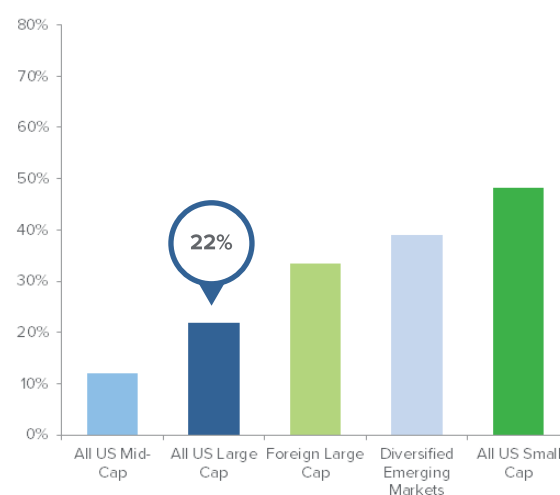
According to eVestment, just 27% and 34% of institutional Large Cap strategies have outperformed their benchmarks over a five- and 10-year period, respectively.³ Performance net of fees for retail investors was even worse for mutual funds, which only saw 19% and 22% outperformance for the same five- and 10-year periods,⁴ according to Morningstar Direct. As a result, mutual fund investors in these strategies paid a staggering \$100 billion in expenses to underperforming asset managers over the last 10 calendar years.⁵

Figure 1: % of Institutional Strategies That Have Outperformed Benchmark
Trailing 10 Yrs, Net of Fees



Source: eVestment¹

Figure 2: % of Mutual Funds That Have Outperformed Benchmark
Trailing 10 Yrs, Net of Fees



Source: Morningstar Direct²

The severe loss of confidence in active managers' ability to generate alpha, "net of fees" and the current asymmetric disadvantage to asset owners is evident as indexing-type product popularity ballooned to \$9.6T worldwide in 2018.⁶

During this period of dominance by passive products, the relationship between asset owners and investment managers has transformed, increasing fee pressures to improve alignment over existing fee structures. While overall fees have come down over the last decade, the industry has done very little to truly level the playing field for investors and solve the real problem — aligning fees to the value of active management and improving the probability of a favorable outcome depending on manager skill and the efficiency of the asset class.

Asset owners realize that high-priced products do not correlate to high success. As noted in a recent Wall Street Journal article, the most expensive active funds "are losing capital" according to Kevin McDevitt, a research analyst at Morningstar, while cheaper active funds "are doing better in terms of flows."⁷

But the tides for active managers may be changing. As we look to the future, the demand for alpha, particularly in efficient asset classes, may be finally turning a positive corner as annual capital market assumptions for asset allocators have dropped into the mid-single digits. Vanguard's chief investment officer, Greg Davis, revealed that he dramatically reduced the firm's median annualized 10-year outlook for U.S. equities to around 5% in a CNBC interview on Feb. 10, 2019.⁸ On a more pessimistic note, asset management firm GMO expects negative real returns for U.S. equities over the next seven years.⁹ Even more bullish estimates fall well short of the expected high single- or double-digit returns investors typically model in their projections to achieve their annual return goals.

Thus, over the intermediate term, the probability of low-cost beta delivering sufficient total returns could approach parity with the probability of selecting skilled active managers that can generate consistent alpha to justify their fees. This alone does little to change the demand curve for active managers in the short term, specifically in efficient asset classes where the oversupply of capacity and product abounds.

We believe the industry is primed for a major disruption that will better reflect the value-added returns of active management by solving the fee problem, altering the probability of winning for investors, and in turn radically changing asset allocation decisions. Following in the footsteps of the late Jack Bogle, we feel investors should be able to invest their assets in products that can deliver beta at a low cost but have the potential to generate alpha while aligning active fees to improve the probability of outperformance and favorable outcomes.

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Understanding the Problem with Fixed Fees in Efficient Asset Classes

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Fees should reflect the market rate for beta, the alpha potential of the asset class, unique manager/product attributes and the overall probability of a favorable outcome.

To solve the fee issue and the related implications of current fee constructs, we feel it's best to focus on the fundamental problems with fixed fee structures in efficient asset classes.

U.S. Large Cap is arguably the most efficient equity asset class available given its strong liquidity profile, broad ownership and research coverage, and high pair-wise correlation. Therefore, only the highest skilled active managers have been able to beat the benchmark over long periods of time on a risk-adjusted basis.

As we consider the probability of a favorable outcome in U.S. Large Cap, the performance spread between making a top quartile active decision vs. a bottom quartile decision needs to be considered in the context of the fee structure. As such, fees should reflect the market rate for beta, the alpha potential of the asset class, unique manager/product attributes and the overall probability of a favorable outcome. We believe the largest misalignment between client advantage and active manager compensation occurs most often in U.S. Large Cap.

Large Cap

34%

Only **34%** of U.S. Institutional Large Cap strategies outperformed net of fees over the last 10-year period ended Dec. 31, 2018. Investors' odds increased materially to **50%** when we evaluated the same data set using gross of fees performance.¹⁰

1.25%

The average level of outperformance net of fees when analyzing excess returns was a modest **1.25%**.¹¹

vs. Small Cap

71%

For comparison, **71%** of U.S. Institutional Small Cap strategies outperformed net of fees over the last 10-year period ended Dec. 31, 2018.¹²

1.97%

The average level of outperformance net of fees when analyzing excess returns for U.S. Institutional Small Cap strategies was significantly higher at **1.97%** with a much greater magnitude reflecting both the inefficiency of the asset class and higher alpha potential of the asset class.¹³

By the numbers, investors who paid a high fixed fee for U.S. Large Cap during the last decade were at a statistical disadvantage for alpha generation relative to most other core asset classes. Normalized against the benchmark, the data suggests many investors were essentially paying for parity or underperformance and thus had a higher chance of losing than winning (alpha), after fees — hence the great migration to passive. Asset owners allocate to an active product for the “chance” to beat the benchmark and potentially capture better risk-adjusted returns. But without the proper fee symmetry between the asset manager and asset owner, the relative value proposition during periods of outperformance may not be enough to offset periods of underperformance when you consider a high fixed fee in the context of the asset class — further adversely skewing the probability of winning for active investors.

By evaluating the importance of active share on performance, we found further performance deterioration in strategies that had “low active share” (i.e., closet indexers). When we evaluated strategies with active share of less than 70%, we found on average only 33% of strategies beat their benchmark over three-, five- and 10-year periods ended Dec. 31, 2018.¹⁶

Therefore, applying sound reasoning, investors could potentially improve the probability of winning by aligning with a sensible fee structure that offers symmetry with a favorable outcome, combined with a high active share strategy, understanding that these are the two corollaries that truly impact the odds for investors. Unfortunately, seeking high active share alone cannot be used to predict alpha potential, as noted by Henderson Global Investors in their recent commentary, *Understanding Active Share*, but rather a necessary precursor to determine a *manager’s ability* to generate alpha as low active share should equate to elevated correlation with the benchmark.¹⁷

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It's hard to outperform the market when you are the market.

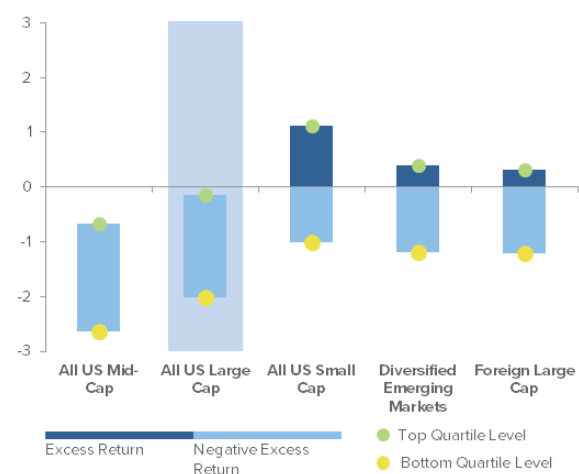
Jack Bogle

Figure 3: Institutional Strategies
10-Yr Annualized Excess Returns (%)
Top & Bottom Quartile Levels, Net of Fees



Source: eVestment¹⁴

Figure 4: Mutual Funds
10-Yr Annualized Excess Returns (%)
Top & Bottom Quartile Levels, Net of Fees



Source: Morningstar Direct¹⁵

Key Variables Necessary to Solve the Fee Problem and Misalignment with Investors:

1

Fees should reflect the market rate for beta, competitive dynamics and complexity of the asset class (i.e., capacity).

2

Fees should reflect the alpha potential of the asset class to ensure the asset owner has the proper fee symmetry to outperform over the long term.

3

Performance fees can serve as an effective tool particularly in asset classes where investors are at a statistical disadvantage (net of fees) to align the interests of the asset owner and asset manager. The asset owner should always retain an asymmetric advantage in the relationship retaining the majority of the value-added performance.

4

The combination of a low-index-like fee with a risk-adjusted performance component is the key ingredient to linearly align manager compensation with the “true value” of active management. A proper fee structure should penalize asset managers from taking excessive risks to unfairly earn fees while risking investor capital.

5

Simplicity, transparency and flexibility should always be emphasized in any framework while accommodating either annual or intermediate term rolling measurement periods at the discretion of the asset owner.

As of Dec. 31, 2018, only 56% of Institutional U.S. Large Cap strategies are considered high active share (70% or greater) potentially skewing the probabilities of winning for active investors in an efficient asset class.¹⁸ The lack of historical alpha observed in Large Cap active strategies, especially over the last decade, can be partially attributed to the large number of closet indexers who simply don't manage with enough conviction and variance to increase their odds of beating the benchmark — in turn, the lack of innovation and reluctance to break from benchmark cadence skews total managers' performance and general confidence in active managers' ability to deliver excess returns.

Over the last year or so, the industry has responded by experimenting with performance fees in the form of fulcrum fees offered by an extremely limited number of asset managers. Traditional fulcrum fees still garner a fair amount of criticism given their current structure, which includes a higher base fee than passive indexing or exchange traded funds (ETFs), and introduce unintended consequences that are less than ideal for investors.

While a massive step in the right direction, traditional fulcrum fees may still overcharge for cheap beta and can incent asset managers to take potentially excessive risks to the detriment of the client, therefore still failing to completely deliver on “solving the fee problem.” We affirm that traditional fulcrum fees and other fee structures may not be best aligned for a traditional efficient asset class like U.S. Large Cap where beta is priced like a commodity and the true value of active management needs to be measured in relative risk-adjusted terms.

By many accounts, the innovation by Peter Kraus, Founder of Aperture Investors and others who have developed new performance fees structures, have taken a big step toward creating greater calibration of alignment between the asset owner and active manager. While certainly industry disruptors, deserving of respect for what has been accomplished, we are prepared to build on their efforts to truly level the playing field for investors and introduce a disruptive fee structure that attempts to solve for true alignment, low cost, linearity and risk management.

Translation: Solving the fee problem *in an efficient asset class* means that a “skilled” manager would need to charge an “ETF-like” fixed rate for cheap beta, combined with a linear fee that is directly linked with the true, risk-adjusted value of active management that compensates the asset manager only when it is “earned.”

All else equal, investors would potentially have better odds of winning after fees using a diversified, high active share product with little or no cost for beta exposure, while paying sensible risk-adjusted fees only when a favorable, measured outcome is achieved.

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Borrowed from the hedge fund world, fulcrum fees, or performance fees based on a manager's relative performance versus the benchmark, have recently been cropping up in the active space.



Westwood® Sensible Fees™

A new initiative for Westwood is focused on solving investor challenges with active management fees, in an effort to level the playing field for investors.

Westwood (WW) has developed a new, innovative and simple fee framework available to eligible investors on our high-conviction **LargeCap Select** strategy. This framework, called **Westwood Sensible Fees™**, embraces the core principles of evaluating pure manager skill, addressing the low cost of indexing and protecting investors using risk-based fees — all with the goal of changing the probability of winning in an efficient asset class and reversing the historical precedent set in the industry by giving the asset owner the asymmetric advantage.

Our risk-adjusted performance fees are offered using two different options to be selected at the discretion of the investor. Both fee structures offer a passive-like base fee plus a fee linked directly to risk-adjusted performance over the long term with all fees capped regardless of the upside captured by investors. **WW Sensible Fees™** integrate built-in guardrails for investors that negate unnecessary or uncompensated risk-taking in pursuit of performance fees.

Information Ratio-Based Fees (IR)

WW IR Sensible Fees™

Zero-Based Fees (α)

WW Zero-Based Sensible Fees™

WW IR Sensible Fees™

An industry first, **WW IR Sensible Fees™** solve the fee problem by creating a simple structure with a pure zero or transparent low base fee for beta exposure plus a linear fee, directly linked to risk-adjusted outperformance *only* when it is earned, by using information ratio (IR). IR is a measurement of excess return and the active risk taken relative to a specific benchmark. A positive IR indicates that positive excess returns were achieved over the measurement period while also taken into account the level of active risk used to beat the benchmark.

$$[\text{Base Fee} + (\text{IR} \times 100)]$$

Where:

$$\text{IR} = \frac{\text{Excess Return}}{\text{Tracking Error}}$$

WW IR Sensible Fees™ Key Benefits:

Combines a risk-adjusted fee to measure the **true value of active management** with a pure-zero or low-index-like base fee for beta

Integrates **built-in guardrails** for investors that deter asset managers from taking unnecessary or uncompensated risks to earn performance fees

Aligns fees to both the **efficiency of our investment decisions** and **risk-adjusted returns**

Ensures the **asset owner only pays a low nominal fee** for beta, when the manager matches or underperforms the benchmark

Utilizes a **maximum fee cap**

How It Works:

WW Sensible Fees™ with IR risk-adjusted performance fees implement a simple framework that aims to provide the asset owner an asymmetric advantage in both the short and long term. The pure-zero or low-index-like fee is determined based on the size of the mandate or platform relationship. For example, on average, for investment mandates greater than \$100M, the annual base fee for beta would be set at 5 basis points.

The performance fee calculation, based solely on IR, is then calculated annually in arrears over either a trailing one-year or three-year period at the discretion of the asset owner. **WW IR Sensible Fees™** also have built-in annualized fee caps to limit manager compensation, but since a high IR is so difficult to achieve, only an outsized performance experience with limited tracking risk would ever approach the cap. It's important to reiterate that in any mathematical scenario where the IR is positive, the investor will hold the asymmetric advantage as the performance component of the total fee will always be less than or equal to 30% of the excess returns generated.

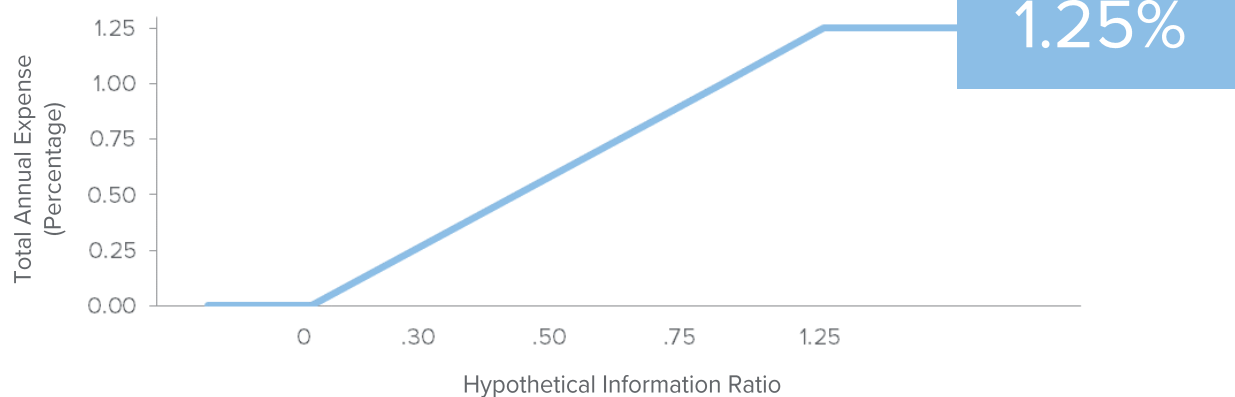
With WW Sensible Fees™, investors hold the asymmetric advantage:

Both fee structures offer either a zero or low-index-like base fee and align manager compensation on risk-adjusted performance only if and when they are earned.

The investor will always retain the majority of the outperformance generated.

Sensible Fee

Assuming a Zero-Base Flat Fee



Low-index-like fee when Westwood matches or underperforms the benchmark

Investors hold the asymmetric advantage as the performance component of the total fee will always be less than or equal to 30% of the excess return generated

Max fee capped at 1.25%.

For example, 5% of excess return with tracking error of 4% would equate to an IR of 1.25 and hit the fee cap

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We affirm IR as the best basis for linearly aligning the incremental value-added return for investing capital and active risk on behalf of the asset owner.

“

Historically, using WW IR Sensible Fees™ would have helped asset owners avoid overpaying for median manager performance.

Why It Works:

The **Fundamental Law of Active Management** by Grinold and Kahn simplified the productivity of an asset manager by measuring both the manager’s skill level, and how often that skill is put to use via IR. By definition, the IR rewards breadth, accuracy and stability, incentivizing the manager to stay active and within directives.¹⁹

The IR was designed to purely assess the excess return (value added) over the benchmark, per unit of risk. A fee structure linked to IR is inherently *unattractive to managers* as it not only measures excess returns, but also attempts to quantify compensated active risk vs. the index, taking scrutiny to the highest level. We affirm IR as the best basis for linearly aligning the incremental value-added return for investing capital and active risk on behalf of the asset owner.

Using our proprietary fee calculation, we translate fair compensation for the true value of active returns per unit of risk into basis points for efficient asset classes. **WW IR Sensible Fees™** also ensure a “fair share of alpha,” as the asset owner receives a majority of excess returns, and include a cap on total fees. These factors essentially provide the asset owner with built-in guardrails, eliminating payment for unearned fees and preventing manager rewards for uncompensated risk. During periods of underperformance, the investor only pays a zero or low-index-like fee depending on the level of assets invested.

But attaining IR is an incredibly difficult feat that most managers use as an efficiency metric, not as a rule to align fees. For historical reference, an IR of 0.38 would place a strategy in the top quartile of performance for the 10-year period in the U.S. Large Cap Value universe.²⁰ Therefore, as it relates to changing the probability of a favorable performance outcome with aligned fees, an IR of 0.38 would have translated to annualized excess returns of 1.66% with tracking error 4.37% vs. the index of over a 10-year period. Based on **WW IR Sensible Fees™**, investors would have paid 38 basis points in active fees (assuming a zero-based fee) securing top quartile performance within a modest level of active risk relative to the benchmark. When observing the top quartile performing U.S. Large Cap Core strategies over a five-year period, an IR of 0.17 would have translated to a modest 0.53% in annualized excess returns with a tracking error of 3.11% seeing the asset owner pay a mere 17 basis points in management fees and retaining 68% of excess returns (assuming a zero-base fee). Both examples, illustrate the asset owner always maintains the asymmetric advantage and only pays the asset manager a fair share for the true value of active management.

Over the last five- and 10-year periods, the median IR across the entire U.S. Large Cap Universe was an unflattering -0.06 and 0.00, respectively, which translated to a zero-to-negative excess return scenario relative to the benchmark. Therefore, **WW IR Sensible Fees™** would have helped asset owners avoid overpaying for median manager performance. In this median performance scenario, where the excess returns are negative, the asset owner would only pay a zero or a nominal base fee for beta.

It's important to reiterate that in any mathematical scenario where the IR is positive, the investor will hold the asymmetric advantage as the performance component of the total fee will always be less than or equal to 30% of the excess returns generated. In a negative IR scenario, the investor's total fee would be a zero or low-index-like base fee depending on their level of assets invested.

This ensures 1-to-1 alignment of interests between the asset manager and the asset owner, who pays a fair share of active fees, on a risk-adjusted basis, only when it aligns with a favorable outcome and is "earned."

In essence, IR scrutiny is an efficient way to align fees to both the level of outperformance and risk management as it relates to active risk relative to a benchmark. Westwood has introduced **WW IR Sensible Fees™** as part of a new initiative on our high conviction LargeCap Select strategy. We are confident in linking our fee structure directly to IR in an attempt to change the probability of winning for investors in an efficient asset class.

Figure 5: Institutional Large Cap Strategies
Information Ratio and Excess Returns Summary
Trailing as of 12/31/2018

Strategies in eVestment Large Cap Universes – Historical Rankings for IR and Excess Returns

	IR		Excess Annualized Returns	
	5 Yr	10 Yr	5 Yr	10 Yr
Large Cap Value				
High	1.41	1.11	5.31	10.80
25th Percentile	0.44	0.38	1.42	1.66
Median	0.07	0.19	0.27	0.77
75th Percentile	-0.20	-0.03	-0.74	-0.08
Low	-1.21	-0.59	-9.99	-5.46
Large Cap Growth				
High	1.03	0.88	4.16	10.00
25th Percentile	0.07	0.09	0.30	0.37
Median	-0.19	-0.11	-0.73	-0.35
75th Percentile	-0.53	-0.39	-1.91	-1.54
Low	-2.34	-1.41	-8.65	-5.62
Large Cap Core				
High	0.97	1.03	5.01	6.53
25th Percentile	0.17	0.11	0.53	0.40
Median	-0.08	-0.14	-0.24	-0.40
75th Percentile	-0.37	-0.32	-1.08	-1.01
Low	-1.41	-1.15	-4.48	-8.10
Large Cap Total				
High	1.41	1.11	5.31	10.80
25th Percentile	0.24	0.24	0.74	0.95
Median	-0.06	0.00	-0.19	0.01
75th Percentile	-0.37	-0.24	-1.29	-0.88
Low	-2.34	-1.41	-9.99	-8.10

Source: eVestment²⁰

WW Zero-Based Sensible Fees™

For the most frugal investors who need alpha to reach their return goals, we offer **WW Zero-Based Sensible Fees™**. We believe this solves the fee problem by creating a simple structure with a zero-base fee that is cheaper than most index and ETF products plus a linear fee, directly linked to risk-adjusted outperformance only when pure alpha is earned.

$$0 \text{ Base Fee} + [\% \text{ of } \alpha]$$

WW Zero-Based Sensible Fees™ Key Benefits:

Integrates **built-in guardrails** for investors that deter asset managers from taking unnecessary or uncompensated market risks in lieu of pure stock selection to earn fees

Combines an alpha-based fee directly linked to the **true value of active management** with a pure-zero fee for beta generation

Delivers the **majority of value-added return** to the investor

Utilizes a **maximum fee cap**

Guarantees that the asset owner **pays nothing** when the manager matches or underperforms the benchmark

This simple performance fee structure eliminates beta costs altogether while giving the asset owner a majority share of pure alpha generation. The asset owner avoids paying unearned fees for marginal or excessive market risk — and pays nothing when the manager meets or underperforms the benchmark. A fee structure linked to alpha is inherently *unattractive to managers* as it not only measures excess returns, but also attempts to adjust for excessive or uncompensated market risk. This protects investors from ever paying unearned fees unrelated to true value add or manager skill.

For index or ETF investors considering an active allocation decision in an efficient asset class, this structure dramatically reduces the decision stress with its zero-base fee offering lower fees than competing ETFs and index solutions unless alpha is earned.

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This simple performance fee structure eliminates beta costs altogether while giving the asset owner a majority share of pure alpha generation.

How It Works:

WW Zero-Based Sensible Fees™ utilize a simple alpha-based pricing framework that aims to provide the asset owner an asymmetric advantage in both the short and long term. Expect a base fee of zero plus a percentage of alpha which is determined based on the size of the mandate. The percentage of alpha retained by the asset owner ranges from 60%-80% in every scenario. Therefore, the asset owner in all scenarios maintains asymmetric advantage by retaining the majority of the pure alpha generated while paying a zero-base fee for beta exposure. The performance fee is calculated annually in arrears over either a one- or three-year trailing period, at the discretion of the asset owner.

In summary, the alpha-based performance fee goes beyond leveling the playing field with competing index and ETF products from a cost perspective and ensures fees will only be paid when a favorable outcome is achieved.

WW Zero-Based Sensible Fees™

Invested Amount	Base Fee (bps)	Fee (% of Alpha)
Hypothetical Asset Level 1	0 basis points	20%
Hypothetical Asset Level 2	0 basis points	25%
Hypothetical Asset Level 3	0 basis points	30%
Hypothetical Asset Level 4	0 basis points	40%

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An attempt to level the playing field for investors and change the probability of winning in an efficient asset class.

Why It Works:

Alpha provides an overall measurement of a manager's skill. Alpha is computed by using **Portfolio Return - [Risk Free Rate + Portfolio Beta * (Market Return - Risk Free Rate)]**.²¹ In this sense, alpha, like IR, helps determine skill in producing excess returns, but with less restriction on tracking risk relative to the benchmark. As the purest and most common measure of risk-adjusted fund performance relative to the benchmark, alpha is a specified target for most fund managers.

In essence, **WW Zero-Based Sensible Fees™** are an efficient way to eliminate beta fees altogether and align manager compensation with outperformance. This is potentially very attractive to index or ETF investors who seek alpha but are working within a constrained fee budget. Westwood has introduced **WW Zero-Based Sensible Fees™** as part of a new initiative on our high-conviction LargeCap Select strategy. We are confident in linking our fee structure directly to alpha in an attempt to level the playing field for investors and change the probability of winning in an efficient asset class.

The Renaissance in Active Management

We believe a marked shift back to active products must be led by a disruption in the current fee landscape to better align with the value proposition.

Fee reform, combined with strong demand for alpha to offset lower expected returns for stocks and bonds over the next 10 years, will be the catalyst to reignite the industry. Active managers have historically held the advantage with the “promise” of delivering alpha; moving forward, the investor will hold the advantage particularly in efficient asset classes like U.S. Large Cap. Mussie Kidane, head of fund and manager selection at Pictet Wealth Management, sees disruptive pricing and fee structures as the key for active asset managers, and that the “hymn ‘value for money’ has never been louder than in the present low return environment.”²²

The optimal fee structure will be one that isolates the manager’s ability to deliver true skill within a specific and conservative risk framework, while at the same time aligning the needs of both asset owner and manager.

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What is Active Share?

Active share is a measure of how much a portfolio's holdings differ from the benchmark constituents. It is calculated by taking the sum of the absolute values of the differences between the weight of each holding in a portfolio and its benchmark and then dividing by two. Mathematically this is shown as:

$$\text{Active Share} = \frac{1}{2} \sum_{i=1}^N \left| W_{\text{portfolio}, i} - W_{\text{index}, i} \right|$$

A simple worked example can be shown by imagining an index with only one stock. If a portfolio holds 50% of this stock and 50% of an off-benchmark stock, the portfolio would have an active share of 50%. Using absolute values means underweight and overweight differences are treated the same, with all differences converted to a positive number.

$$AS = \frac{1}{2} [| 50\% - 100\% | + | 50\% - 0\% |] = \frac{1}{2} [50\% + 50\%] = 50\%$$

- A pure index tracker therefore has an active share close to 0%
- A portfolio that is completely off-benchmark has an active share of 100%

Source: Henderson Global Investors

The few managers who are confident in their skill must offer a well-aligned fee structure that “holds their feet to the fire” to create demand and compete with passive products. Inherently, through natural selection, an industry adoption of an IR-based fee structure like **WW IR Sensible Fees™** would help eliminate low-skill managers, specifically in asset classes with an oversupply of products, unlimited capacity and high efficiency. Over the long term, this process of elimination will benefit investors and the industry overall.

Moving forward, we believe that fee structures may signify just as much, if not more, insight on management style, confidence and breadth than past ratings and even historical returns.

This theory is also supported by Aon Hewitt’s ongoing research, which has repeatedly found value in fees rewarding appropriate, risk-controlled performance, and that high-conviction managers have delivered the most alpha historically. High-conviction and high active share typically go hand-in-hand. Research by Martijn Cremers and Antti Petajisto found that high active share funds were also more likely to “significantly outperform” their benchmarks.²³ Though not a measure of skill, high active share helps identify a manager’s unique convictions (and minimize closet indexing risk). Since high-conviction and high active share both can contribute to positive IR and alpha while decreasing probability of index-like performance with high management fees, we believe **WW Sensible Fees™** can be a more effective way to convey manager confidence.

Asset Classes Will Determine the Largest Need for Fee Reform if Active Is to Make a Strong Comeback

Typically, less efficient asset classes are statistically easier alpha generators due to a wider selection field, lower correlation between targets and a higher incidence of information disconnect. High-efficiency categories such as U.S. Large Cap generally offer fewer alpha opportunities as they tend to attract higher numbers of similar investment opinions with less behavioral variance (high correlation).

To deliver alpha in efficient asset classes, all elements, including high-conviction, high active share, appropriate turnover, manager skill and, perhaps most importantly, the proper fee structure must all contribute synergistically.

Rethinking alpha opportunities in efficient asset classes like U.S. Large Cap, which represent a sizable allocation in the portfolio, makes sense for high active share managers offering fair fee structures that only compensate the manager for the true value of active management on a risk-adjusted basis.

The Real Cost of Passive

In its 2018 Long-Term Capital Market Assumptions Report, J.P. Morgan Chase noted, “more modest [future] returns in capital markets,” and emphasized “diversification, active allocation and manager selection in alternatives will be essential tools for managing cyclical risks in anticipation of secular growth trends that might finally be bottoming out.”²⁴

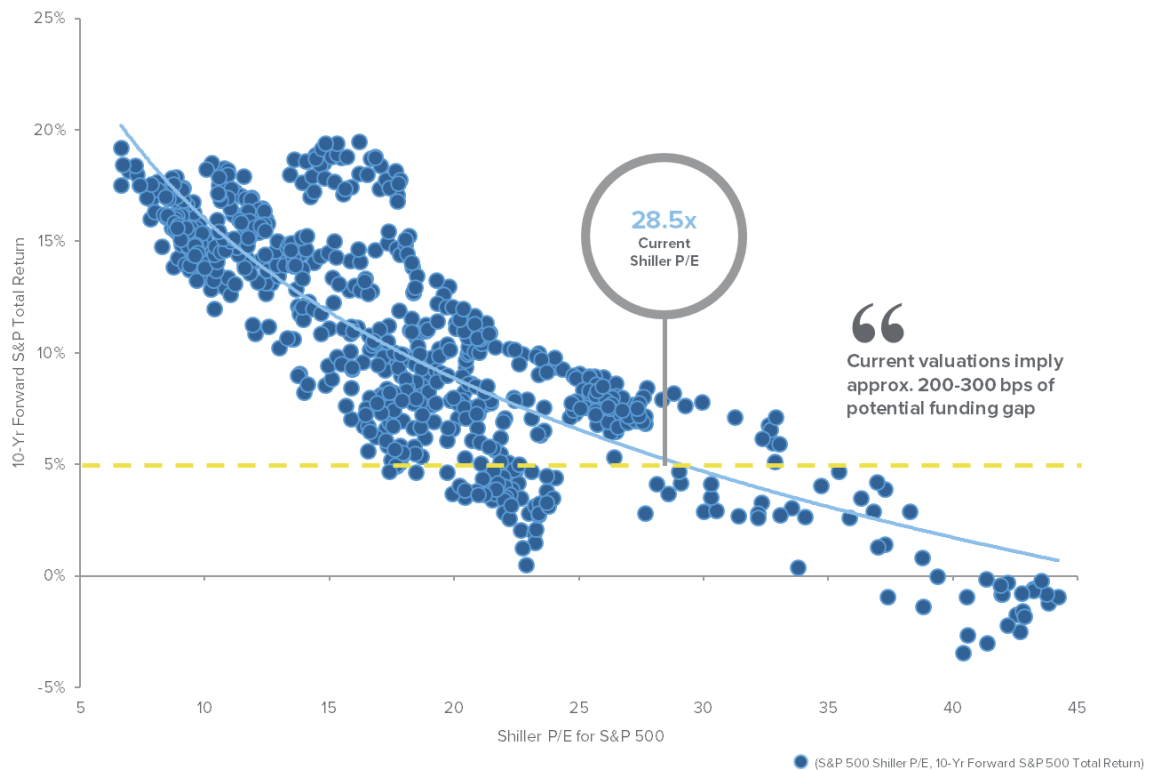
We foresee 60/40 portfolios with heavy passive allocations potentially struggling to meet plan objectives going forward as seven-year capital market assumptions for a blended allocation seem to fall around +3% to +5%, with more bearish projections from industry-respected GMO expecting -5.2% real returns for U.S. Large Cap equities during the same period.²⁵

The respected and venerable industry valuation guide, the **Shiller P/E Ratio**, also supports sub-par performance looking forward into the next decade. The current P/E of 28.5x suggests 10-year forward total returns (dividends included) of approximately 5% on an annualized basis — far below the average of the last 10- or 35-year periods and even less than median returns going all the way back to World War II. Price to earnings ratio is based on average inflation-adjusted earnings from the previous 10 years, known as the Cyclically Adjusted P/E Ratio (CAPE Ratio), Shiller P/E Ratio or P/E 10.

The Challenge | The Need for Alpha May be Greater in Future Periods

Alpha may appear more attractive going forward at current valuation levels in a low return environment.

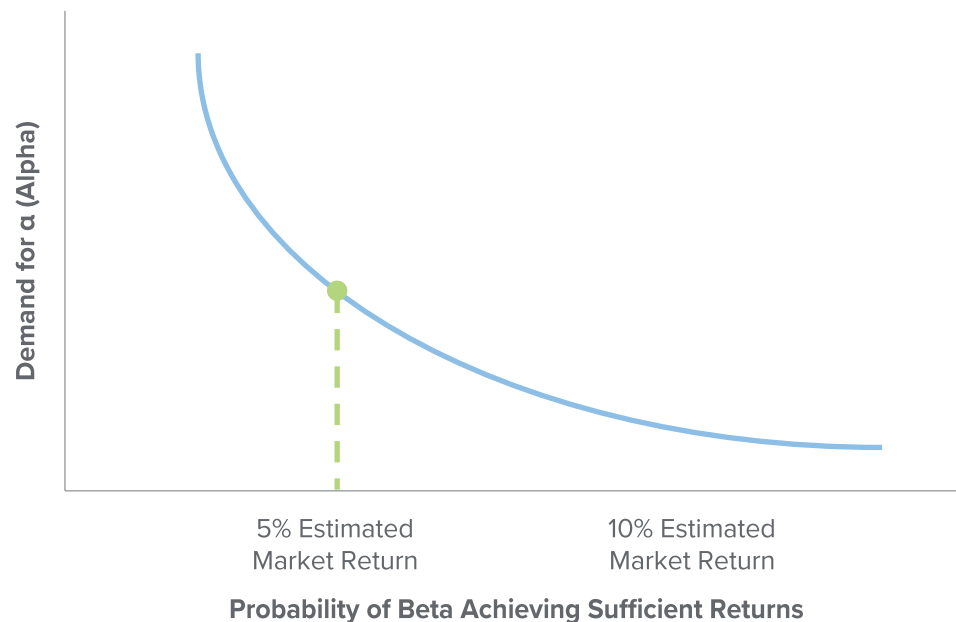
Shiller P/E for S&P 500 vs. 10-Yr Forward S&P 500 Total Return Since 1950



Source: Strategas²⁶

We believe the actual real cost of passive won't be simply the low fees charged, but the potential performance goal shortfalls in the future. With capital market assumptions for equities and fixed income in the mid-to-low single digits, alpha generation and/or participation will likely rise on the priority list — perhaps equaling the importance of fee structure.

Investor Indifference Curve



In summary, investors will be indifferent when the probability of winning in active management is closer to parity with the probability of beta achieving an insufficient level of return. In a low return market environment, we believe the renaissance in active management will accelerate for managers who can compete on skill and align their fees as such.

We believe our **WW Sensible Fees™** are a major leap forward in reforming active management fees and altering the probability of winning for active investors. **WW Sensible Fees™** change the conversation and ensure that managers are compensated for value-added returns, adjusted for risk, only when earned.

As markets shift into a more normalized regime, the demand for active management will accelerate, and Westwood will be there for investors to lead the next revolution in the active management industry.

Sources

¹Figure 1: Institutional strategy data compiled from eVestment as of 12/31/2018 using the following universes: US Large Cap Core (vs the Russell 1000 Index), US Large Cap Value (vs the Russell 1000 Value Index), US Large Cap Growth (vs the Russell 1000 Growth Index), US SMidCap Core (vs the Russell 2500 Index), US SMid Cap Value (vs the Russell 2500 Value Index), US SMid Cap Growth (vs the Russell 2500 Growth Index), All Emerging Market Equity (vs MSCI EM – ND Index) and All EAFE Equity (vs MSCI EAFE – ND Index). Outperformance percentages based on net of fees performance. The “All US Large Cap,” “All US SMidCap” and “All US Small Cap” segments combine all reported strategies within their underlying core, growth and value style universes.

²Figure 2: Mutual fund data compiled from Morningstar Direct as of 12/31/2018 using the following mutual fund categories: US Large Cap Blend (vs the Russell 1000 Index), US Large Cap Value (vs the Russell 1000 Value Index), US Large Cap Growth (vs the Russell 1000 Growth Index), US Mid-Cap Blend (vs the Russell MidCap Index), US Mid-Cap Value (vs the Russell MidCap Value Index), US Mid-Cap Growth (vs the Russell MidCap Growth Index), Diversified Emerging Markets (vs MSCI EM – ND Index) and Foreign Large Cap Blend (vs MSCI EAFE – ND Index). Outperformance percentages based on net of fees performance. The “All US Large Cap,” “All US Mid-Cap” and “All US Small Cap” segments combine all reported strategies within their underlying blend, growth and value style categories.

³Data compiled from eVestment as of 12/31/2018 using the following Universes: US Large Cap Core (vs the Russell 1000 Index), US Large Cap Value (vs the Russell 1000 Value Index) and US Large Cap Growth (vs the Russell 1000 Growth Index). Outperformance percentages based on net of fees performance. The US Large Cap institutional universe combines all reported strategies within the underlying core, growth and value style universes.

⁴Data compiled from Morningstar Direct as of 12/31/2018 using the following Categories: US Large Cap Blend (vs the Russell 1000 Index), US Large Cap Value (vs the Russell 1000 Value Index) and US Large Cap Growth (vs the Russell 1000 Growth Index). Outperformance percentages based on net of fees performance. The US Large Cap mutual fund universe combines all reported strategies within their underlying blend, growth and value style categories.

⁵Mutual fund data compiled from Morningstar Direct as of 12/31/2018 using the following mutual fund categories: US Large Cap Blend (vs the Russell 1000 Index), US Large Cap Value (vs the Russell 1000 Value Index) and US Large Cap Growth (vs the Russell 1000 Growth Index). Performance evaluation based on net of fees performance during each calendar year from 2009 – 2018. Total fees for each fund calculated using the Annual Report Net Expense Ratio and Net Assets as of each calendar year end. Funds in the data set are based on current constituents as of February 2019 and using historical data.

⁶Li, Y. (2019, January 17). Investors pulled a record \$143 billion out of active funds during December's plunge. Retrieved March 5, 2019, from <https://www.cnbc.com/2019/01/17/investors-pulled-a-record-143-billion-out-of-active-funds-during-decembers-plunge.html>.

⁷Baer, J., & Sun, M. (2018, July 13). The Investor Fever for Passive Funds Is Cooling in 2018. Retrieved March 5, 2019, from <https://www.wsj.com/articles/the-investor-fever-for-passive-funds-is-cooling-in-2018-1531486800>.

⁸Belvedere, M. J. (2019, February 11). Vanguard dramatically cuts its expected rate of return for the stock market over the next decade. Retrieved March 5, 2019, from <https://www.cnbc.com/2019/02/11/vanguard-cut-expected-return-for-stock-market-over-the-next-decade.html>.

⁹GMO. (2018). 7-Year Asset Class Real Return Forecasts (As of September 30, 2018). Retrieved March 5, 2019, from <https://www.advisorperspectives.com/commentaries/2018/10/23/gmos-7-year-asset-class-forecasts-still-favor-emerging-markets-over-u-s-stocks>.

¹⁰Data compiled from eVestment as of 12/31/2018 using the following Universes: US Large Cap Core (vs the Russell 1000 Index), US Large Cap Value (vs the Russell 1000 Value Index) and US Large Cap Growth (vs the Russell 1000 Growth Index). Outperformance percentages based on net of fees performance. The U.S. Large Cap universe combines all reported strategies within the underlying core, growth and value style universes.

¹¹Data compiled from eVestment as of 12/31/2018 using the following Universes: US Large Cap Core (vs the Russell 1000 Index), US Large Cap Value (vs the Russell 1000 Value Index) and US Large Cap Growth (vs the Russell 1000 Growth Index). Outperformance percentages based on net of fees performance. The US Large Cap universe combines all reported strategies within the underlying core, growth and value style universes. The total average level of outperformance is weighted by number of reported strategies.

¹²Data compiled from eVestment as of 12/31/2018 using the following Universes: US Small Cap Core (vs the Russell 2000 Index), US Small Cap Value (vs the Russell 2000 Value Index) and US Small Cap Growth (vs the Russell 2000 Growth Index). Outperformance percentages based on net of fees performance. The U.S. Small Cap universe combines all reported strategies within the underlying core, growth and value style universes.

¹³Data compiled from eVestment as of 12/31/2018 using the following Universes: US Small Cap Core (vs the Russell 2000 Index), US Small Cap Value (vs the Russell 2000 Value Index) and US Small Cap Growth (vs the Russell 2000 Growth Index). Outperformance percentages based on net of fees performance. The US Small Cap universe combines all reported strategies within the underlying core, growth and value style universes. The total average level of outperformance is weighted by number of reported strategies.

¹⁴Figure 3: Institutional strategy data compiled from eVestment as of 12/31/2018 using the following Universes: US Large Cap Core (vs the Russell 1000 Index), US Large Cap Value (vs the Russell 1000 Value Index), US Large Cap Growth (vs the Russell 1000 Growth Index), US SMidCap Core (vs the Russell 2500 Index), US SMid Cap Value (vs the Russell 2500 Value Index), US SMid Cap Growth (vs the Russell 2500 Growth Index), All Emerging Market Equity (vs MSCI EM – ND Index) and All EAFE Equity (vs MSCI EAFE – ND Index). Outperformance percentages based on net of fees performance. The “All US Large Cap,” “All US SMidCap” and “All US Small Cap” segments combine all reported strategies within their underlying core, growth and value style universes.

¹⁵Figure 4: Mutual fund data compiled from Morningstar Direct as of 12/31/2018 using the following mutual fund categories: US Large Cap Blend (vs the Russell 1000 Index), US Large Cap Value (vs the Russell 1000 Value Index), US Large Cap Growth (vs the Russell 1000 Growth Index), US Mid-Cap Blend (vs the Russell MidCap Index), US Mid-Cap Value (vs the Russell MidCap Value Index), US Mid-Cap Growth (vs the Russell MidCap Growth Index), Diversified Emerging Markets (vs MSCI EM – ND Index) and Foreign Large Cap Blend (vs MSCI EAFE – ND Index). Outperformance percentages based on net of fees performance. The “All US Large Cap,” “All US Mid-Cap” and “All US Small Cap” segments combine all reported strategies within their underlying blend, growth and value style categories.

¹⁶Data compiled from eVestment as of 12/31/2018 using the following Universes: US Large Cap Core (vs the Russell 1000 Index), US Large Cap Value (vs the Russell 1000 Value Index) and US Large Cap Growth (vs the Russell 1000 Growth Index). Outperformance percentages based on net of fees performance for reporting strategies. Not all strategies report active share and therefore is not fully reported. Average outperformance represented by taking the average of the total percentages for the three periods referenced (three years, five years and 10 years).

¹⁷Henderson Global Investors. (2016, October 20). Understanding active share – six points to watch. Retrieved March 5, 2019, from <https://www.henderson.com/henderson/document/42560>.

¹⁸Data compiled from eVestment as of 12/31/2018 using the following Universes: US Large Cap Core (vs the Russell 1000 Index), US Large Cap Value (vs the Russell 1000 Value Index) and US Large Cap Growth (vs the Russell 1000 Growth Index). Not all strategies report active share and therefore is not fully reported. Reporting strategies with an active share of 70% or above were considered high active share.

¹⁹Kahn, R. N. (1997). Seven Quantitative Insights into Active Management Part 3: The Fundamental Law of Active Management. *BARRA Newsletter*, Winter 1997.

²⁰Figure 5: Data compiled from eVestment as of 12/31/2018 using the following Universes: US Large Cap Core (vs the Russell 1000 Index), US Large Cap Value (vs the Russell 1000 Value Index) and US Large Cap Growth (vs the Russell 1000 Growth Index). Information Ratio and Excess Return data based on gross of fees performance.

²¹Pareto, C. (2009, February 26). A Deeper Look At Alpha. Retrieved March 13, 2019, from <https://www.investopedia.com/articles/financial-theory/08/deeper-look-at-alpha.asp>.

²²Sloley, C. (2019, February 5). Pictet’s Kidane: “The ‘value for money’ hymn has never been louder.” Retrieved March 5, 2019, from https://citywireselector.com/news/pictet-s-kidane-the-value-for-money-hymn-has-never-been-louder/a1197801?ref=citywire_global_latest_news_list.

²³Cremers, M., & Petajisto, A. (2006, August 7). How Active Is Your Fund Manager? A New Measure That Predicts Performance.

²⁴J.P. Morgan, 2018 Long-Term Capital Market Assumptions.

²⁵GMO. 7-Year Asset Class Real Return Forecasts (as of Sept. 30, 2018). Retrieved March 5, 2019, from <https://www.advisorperspectives.com/commentaries/2018/10/23/gmos-7-year-asset-class-forecasts-still-favor-emerging-markets-over-u-s-stocks>.

²⁶Strategas Research Partners, as of 12/31/2018. Shiller P/E ratio is based on average inflation-adjusted earnings from the previous 10 years.



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The hypothetical fee scenarios are intended to provide educational examples of how these fee structures would work in practice and are not meant to imply specific investment returns or results.

Investment in securities involves substantial risk and has the potential for partial or complete loss of funds invested. Past performance is not indicative of future results.

A performance-based fee generally introduces the following risks: (i) Performance-based fee arrangements may cause Westwood to make investments that are more risky or speculative than otherwise; (ii) Westwood may receive increased compensation (compared to a fixed fee) based on unrealized appreciation as well as realized gains on assets in the client's account, (iii) clients may pay a performance fee even if an account declines in value, and (iv) no compensation or refund is paid if Westwood underperforms the benchmark. Sensible Fees are only available to those investors which are "qualified clients," as defined in Rule 205-3 of the Investment Advisers Act of 1940.