IS IT TIME FOR

ACTIVE MANAGERS TO SHINE?

BASED ON A WEBINAR WITH GREENWICH ASSOCIATES

CANALYST

One of the most important skills for an institutional investor is the ability to differentiate between a secular and a cyclical trend. In the past decade, it's often been hard to tell the difference between those two types of trends whether in the stock market or the market for active management. Here, we will take a look at how the current position in both secular and cyclical trends have set the stage for a promising period for active managers and outline some of the strategies and tools they should consider.

While active managers on the buyside have been wrestling with these challenges, one of their main sources of research, the sellside, has been going through an equally demanding set of circumstances.

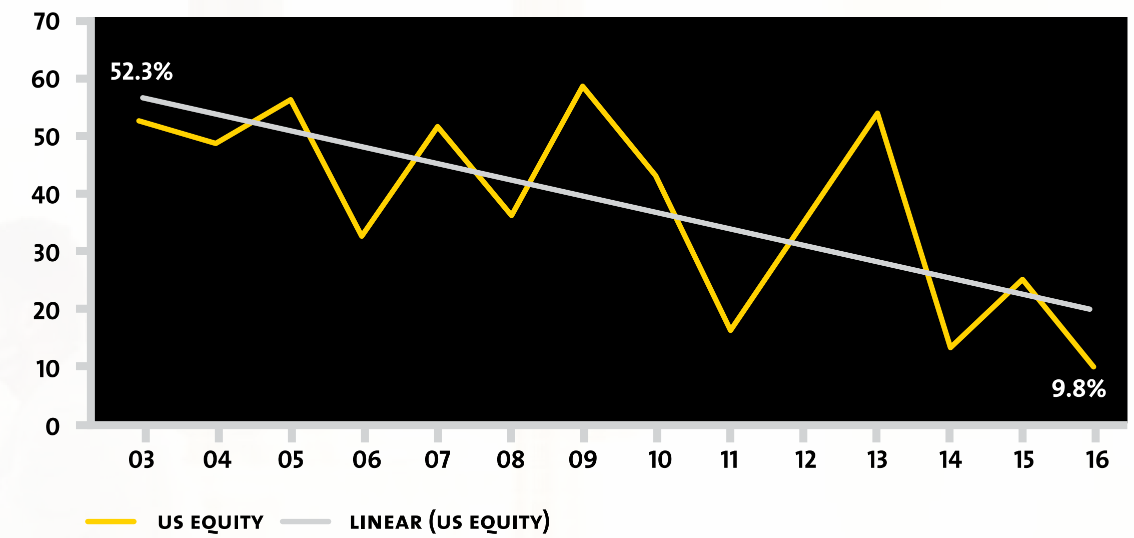
A CHALLENGING DECADE

In a world obsessed with alternative strategies, recommending individual stock picking sadly qualifies as a contrarian idea unto itself. The sentiment that this is an outdated approach is echoed by the following tongue-in-cheek quote by a popular financial columnist:

"Who buys individual stocks? It has become an old-timey hobby for the modestly wealthy and eccentric, like model railroading." – Matt Levine, Bloomberg Money Stuff

The attitude towards this view is fairly logical, given the deterioration in alpha captured by hedge funds over the last 15 years. The percent of actively managed funds outperforming the S&P Composite 1500 has dropped from 52.3% in 2003 to 9.8% in 2016.[i]

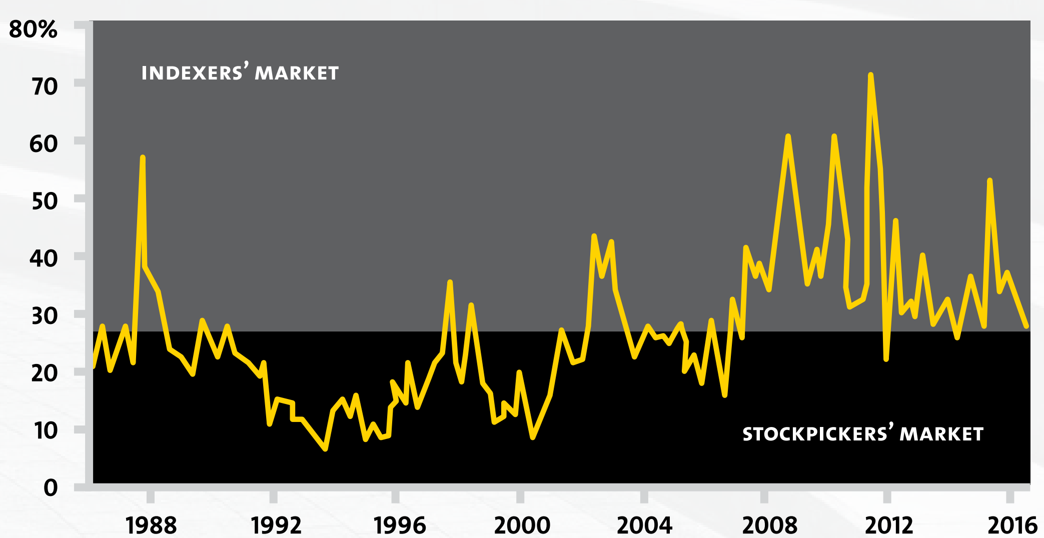
PERCENT OF ACTIVELY MANAGED FUNDS OUTPERFORMING S&P COMPOSITE 1500



Source: S&P Dow Jones Indices LLC

While many reasons have been put forward for why this occurred, the "abnormal markets" explanation appears to fit the chart best. From 2008 until recently, the average pairwise correlation of stocks was well above the long-term average. This phenomenon was exacerbated by the central bank policy pinning rates near zero, rendering most tactical asset allocation models temporarily worthless vs. the non-stop injection of liquidity.

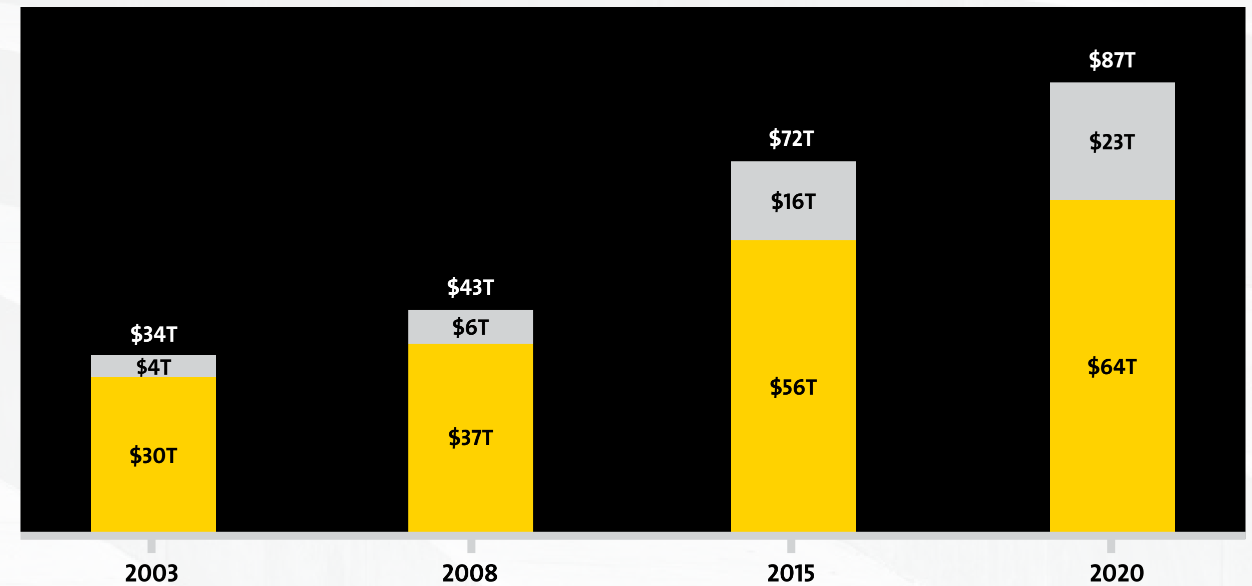
AVERAGE PAIR-WISE CORRELATION OF ALL S&P 500 STOCK COMBINATIONS



Source: BofA Merril Lynch US Equity & US Quant Strategy

Any discussion of active stock picking over the past decade can't ignore the passive elephant in the room. As the popularity of indexing surged, inflows to actively managed funds have dwindled. Global AUM for passive investments has grown at a CAGR of 15% 2008 to 2015, while global AUM for active investments has grown at 6% during that same period.[ii]

GLOBAL AUM—ACTIVE VS PASSIVE



Source: Greenwich Associates 2016 BCG Global Asset Management

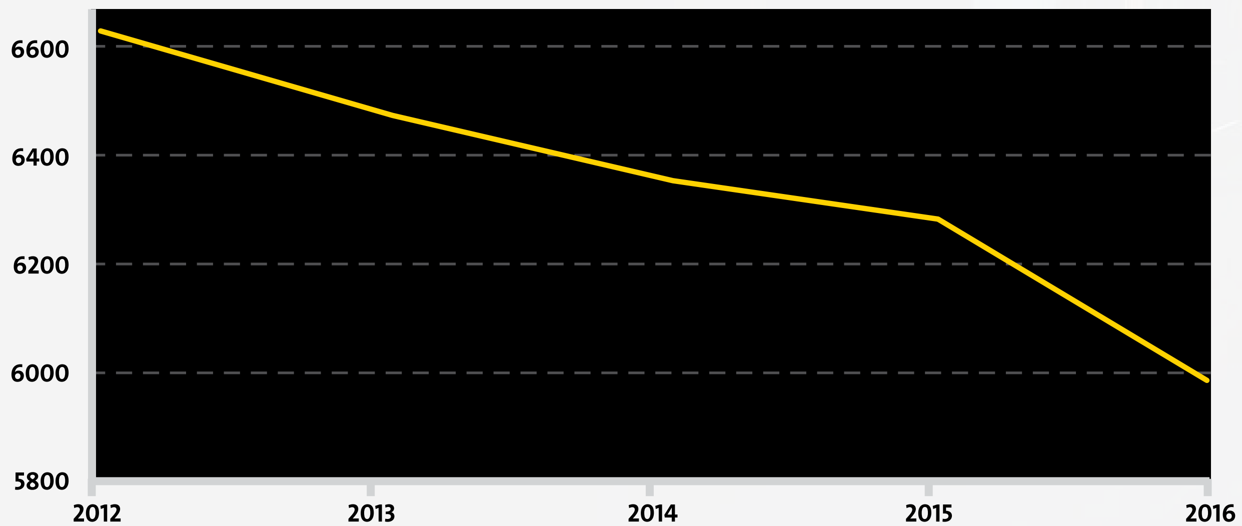
The US market was particularly indicative of this shift to passive. Of the total US AUM, passive investments made up 16% (US$1.2 TN) vs active investments of 84% (US$6.5 TN) in 2006. By 2016, US AUM in passive investments totalled 34% (US$5.1 TN) vs active investments of 66% (US$10 TN).[iii]

Another hurdle for the stock pickers is that asset allocators are increasingly providing inflows to quantitative strategies as an alternative to traditional active strategies. In 2017, research by UBS and Campden Research showed that although family offices were decreasing their allocations to hedge funds as an overall group, they were allocating a larger amount to quant funds.[iv]

While active managers on the buyside have been wrestling with these challenges, one of their main sources of research, the sellside, has been going through an equally demanding set of circumstances.

Downward pressure on sellside coverage was originally set in motion by the Global Analyst Research Settlement in 2003. The settlement addressed the conflict of interest to have analysts produce favorable research reports on investment banking clients, while also being compensated by them. Besides instituting a number of firewalls between research and banking, the order mandated that research departments' funding would have to come from commissions on trading, and not from underwriting.

RESEARCH HEADCOUNT: NUMBER OF ANALYSTS AT THE 12 BIGGEST BANKS AND INVESTMENT BANKS



Source: Coalition, Financial Times

The impact on the sellside has been compounded by decreasing equity trading volumes, a long period of lower volatility, the uptake of Commission Sharing Agreements, a decline in the number of publicly traded companies and IPOs, and a shift towards passive investing. All of this has resulted in a reduction in the number of analysts working at the largest banks.

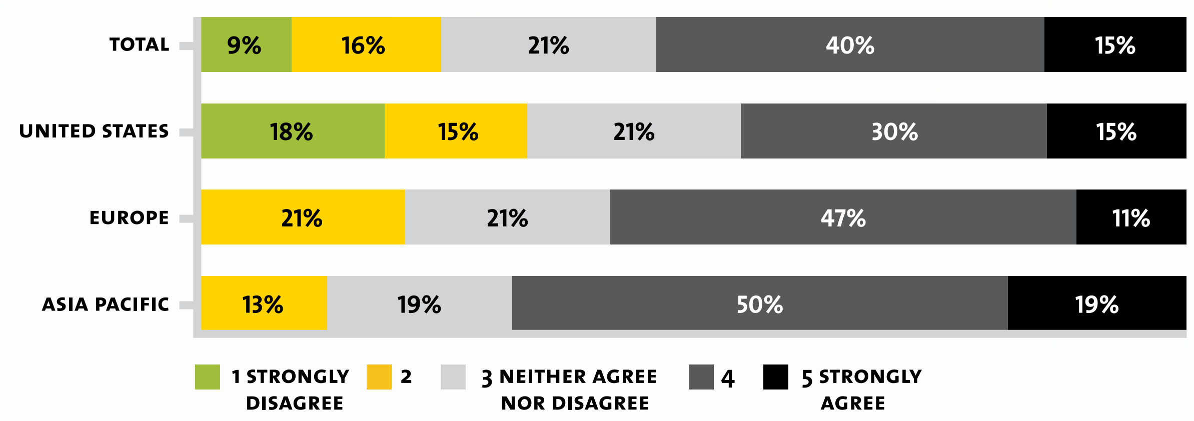
Not surprisingly that has had the knock-on effect of reducing the number of equities that are covered by the sellside. The number of companies in the Russell 2000 with no sellside coverage jumped 30% in the three years prior to 2017.[v]

MiFID II is perhaps the most significant challenge facing the sellside and appears to guarantee that the reduction in sellside coverage is a secular trend. The regulation requires asset managers to pay for research directly or to pass the cost on to their customers instead of the cost of research being bundled in with trading commissions. The January 2018 EU implementation of MiFID II has had a domino effect around the world. Global asset managers and investment banks are concerned about the complexity of procuring and distributing research using entirely different systems in different regions. Many firms are trying to migrate towards systems that are fully complaint—with or more similar—to MiFID II in regions outside of the EU. In a recent Greenwich survey of 57 US-based respondents, 43% were planning changes to their research evaluation process and the number was an even higher 61% amongst 42 European-based respondents.[vi]

TIME TO SHINE

The stage has been set for active managers to enter a period of strong performance. In a recent Greenwich survey, 55% of respondents agreed or strongly agreed that there were more opportunities for active managers to outperform in the current environment vs 25% who disagreed or strongly disagreed.[vii]

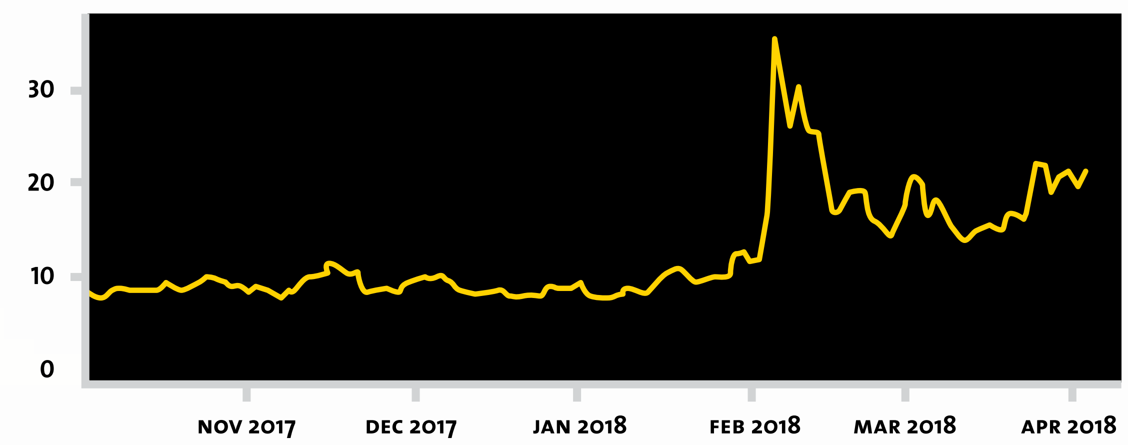
MORE OPPORTUNITIES FOR ACTIVE MANAGERS TO OUTPERFORM IN CURRENT ECONOMIC ENVIRONMENT



Note: On a scale of 1 to 5, where 1 is "strongly disagree and 5 is "strongly agree"; will the current economic environment create more opportunities for Active Managers to outperform. Based on 68 responses.
Source: Greenwich Associates 2017 Active and Passive Investing Study

The external economic factors are most likely to be cyclical in a way that may benefit active managers. Ignoring the rare doomsday prediction, the general consensus is that the last decade of accommodative monetary policy is a cyclical trend that has already started to revert towards the mean. This is happening at a time when US economic policy and international trade policy are also swinging in a different direction after an extended period of relative consistency. These external changes are leading to periods of increased volatility and bringing the pairwise correlation of stocks back to levels where active management has the upper hand.

VIX INDEX CHART



Source: CBOE Global Markets October 4, 2017 to market close on April 3, 2018

In the pool of alpha theory, there are a limited number of opportunities for outsized returns that need to be divided up amongst participants. According to data from Hedge Fund Research, the number of hedge fund closures outnumbered new funds in 2017 and 2016, with 2016 experiencing the largest number of fund closures since 2008.[viii] Active managers may soon find that opportunities that require in-depth analysis are less crowded today than they were before the Great Financial Crisis.

Many of the most promising opportunities may lie in small to midcap equities. The lack of sellside coverage is a blessing in disguise for those who are willing to put in the work to investigate these companies through their own analysis. In addition to the lack of coverage, analysts and portfolio managers are being forced to spend more and more time on each company's reporting, as nuanced non-GAAP figures become more prevalent. In March of 2016, James V. Schnurr, Chief Accountant of the SEC noted that: "The SEC staff has observed a significant and, in some respects, troubling increase over the past few years in the use of, and nature of adjustments within, non-GAAP measures by companies as well prominence that the analysts and media have accorded such measures when reporting on the results of the companies they cover."[ix]

Efficient Market Hypothesis purists may scoff at the idea that an investor could use publicly available information to discover alpha, when information is immediately available to all participants. However, a research paper published in March of 2018, titled “Do Hedge Funds Profit From Public Information?” showed that “funds accessing filings in a month exhibit 1.5% higher annualized abnormal returns than non-users. Above-median users earn even higher returns. The effect is not due to fund-type differences.”[x] As the analysis of the public information becomes more complex due to the proliferation of non-GAAP measures and shrinking coverage from investment banks, it is reasonable to expect public information to continue to offer value. The existence of these findings also puts to bed the idea that the robots have already discovered how to consume all the alpha before mortal analysts have a chance.

Finally, the growing portion of global AUM that is invested passively creates the conditions for small and midcap names that are not included in a major index to be mispriced. In December of 2017, James Rife, Head of Equities at Canalyst highlighted several examples showing how the public market had failed to accurately value a smallcap name prior to it being taken out at a significant premium.[xi]

Ticker	Company	Sector	Date Announced	Pre-Takeout Market Cap	Post-Takeout Market Cap	Premium
HGN	Halogen Software	Info Tech	1/12/2017	166	260	56.6%
LMP	Lumenpulse	Info Tech	4/26/2017	290	530	82.8%
CAM	Canam	Materials	4/27/2017	280	550	96.4%
TMB	Tembec	Materials	5/25/2017	295	520	76.3%
PIH	Pacific Insight	Consumer	8/2/2017	73	127	74.0%
PLS	Polaris Materials	Materials	8/28/2017	90	300	233.3%
NYX	NYX Gaming	Consumer	9/19/2017	120	260	116.7%
AF	Alarmforce	Consumer	11/6/2017	105	180	71.4%
PUR	Pure Technologies	Industrials	12/11/2017	250	495	98.0%

When performing “research arb” to identify mispriced names, great patience and conviction may be required while waiting for the rest of the investment world to catch up. It’s possible that other investors will come to your realization gradually or that management may push up the undervalued stock over time through buybacks. However, the scenario may look more like the punctuated equilibrium model of evolution than gradualism. The investor who has identified and purchased the mispriced equity may need to wait for a take-out, inclusion in an index, or initiation of analyst coverage in order for the stock to move towards a fair price. Research on 549 “neglected” stocks that publicly traded at least one year without any research coverage showed an average +4.9% return at the initiation announcement.[xiii]

Cost Pressures

Sellside Drops Coverage of Small and Midcap

→

Passive Benchmarks Grow in Importance

Value Gap Between Large & Smallcap Increases

→

Arb the Gap

Identify Quality Smallcap Names as a Fundamental Strategy

HOW?

The idea is simple enough, but how can an active manager execute on this type of a strategy? In a Greenwich Associates webinar in 2018, Daniel Lloyd, Founder of Sui Generis and Portfolio Manager at Forge First boiled it down to: "Having quick access to a model that is not being modelled by a particular broker, we think, is a big driver for us in terms of our ability to generate alpha. We're often turning over a lot of rocks and looking for undiscovered names, particularly from the long side." Any analyst or portfolio manager who has ever built a model in a rush understands that is easier said than done. With the reduction in sellside coverage, investors are left with a tricky gap to fill if they want to be able to turn over enough rocks to find the hidden gems.

One option is to skip building a full model and rely on raw historical data instead. However, there is a reason that financial models serve a central role in the investment process for active managers. The difference between data and a fully functioning model is like the difference between telling a Scout they need to cross two rivers, climb 3000 feet and hike 10 miles vs providing them with a topographic route map. Data alone will always fail to fully tell the story of how a company works and what is most important for performance. Companies are constantly evolving, and a working financial model allows an investor to determine what a company is most sensitive to at that current point in time. This is even truer among small and midcap names that are more likely to operate businesses with unique operating statistics and fewer direct comparables.

Technology providers now offer a solution to this problem and Canalyst is a pioneer in the category. Institutional investors have never had an ideal solution for their modeling needs. Data vendors uniformly cover a very broad universe of equities but often need to force company data into templates or rely too heavily on computers and outsourcing for data entry. At the other end of the spectrum, hand-built models (whether sourced from the sellside or built in-house) capture individual company details and drivers but are next to impossible to compare. Sellside models are unavailable on many small and midcap stocks and in-house models take time to build and update. Canalyst offers the best of both worlds: A forward-looking database that covers every North American equity of interest to active managers and accurately models how companies operate, as opposed to just providing historical financial data.

Canalyst's in-house equity research team, based in Vancouver, builds and updates financial models from company filings. The models include all the important data from the companies, including data from the MD&A and Investor Presentations. Each model is laid out in a consistent format but is designed to reflect unique factors that drive the performance of that particular equity. All Canalyst modeling work is done manually by skilled equity analysts using double-blind data entry, backed up by a sector specialist and a proprietary technology platform that flags potential errors and ensures that the data is essentially perfect. Every value in the Canalyst database has been verified by three equity analysts and multiple sets of quantitative checks before landing on the client-facing platform. The use of this type of a model database can allow an institutional investor to turn over a lot of rocks without compromising on the quality of a model they use to make their investment decisions. Investors also get the added benefit of not sending any signals to the market since they can perform their research without needing to request any items from their broker.

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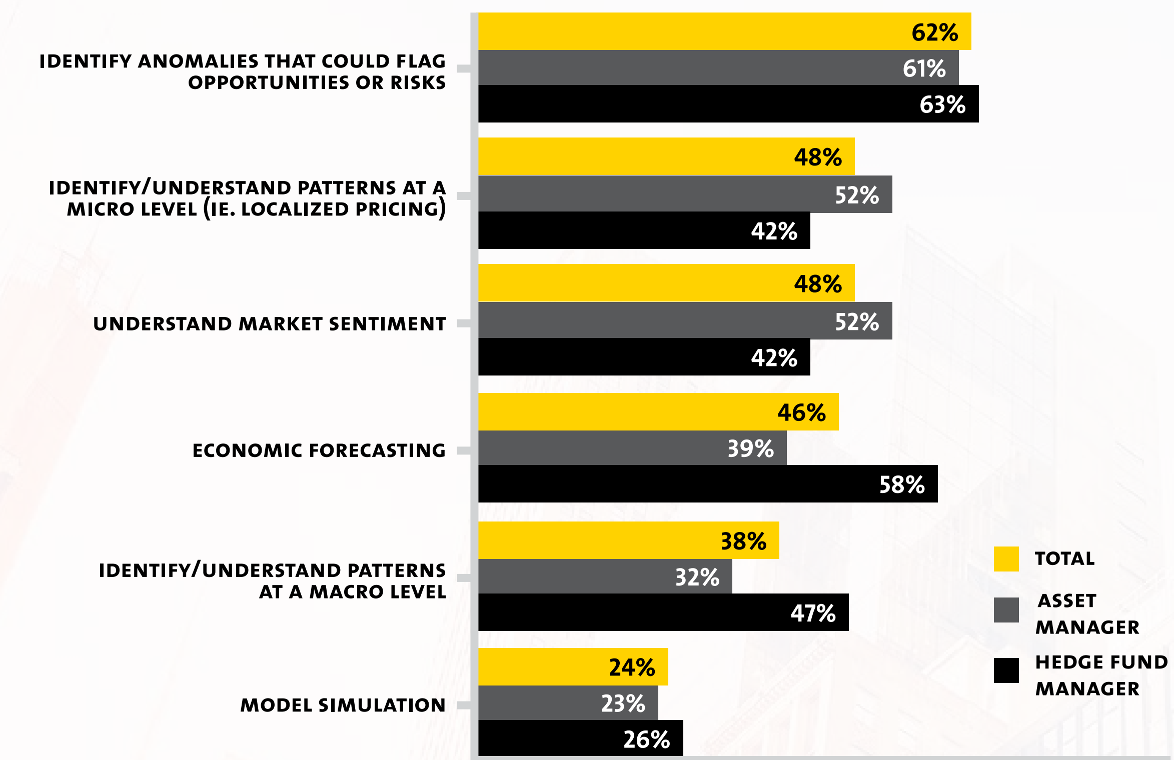
GOING BEYOND

Funds that leverage a comprehensive model database to make their existing processes more efficient, soon discover that it can enable them to also introduce new processes.

Founder and Portfolio Manager of GenCap Portfolio Management, Stephen Bradley, Jr. says: “The database has everything—I have yet to look for a company I haven’t found.” As a result of instant access to any model that they are looking for, GenCap has been able to change the way they approach the idea generation process. When interested in a company, they will log in and download the model, and then see how it reacts to their assumptions. It’s extremely dependable for the firm during earnings. Canalyst’s in-house equity research team focuses on updating the models after a release so that GenCap can focus on analysis. While still keeping an eye on their holdings, this is one way they have been able to follow new companies quarter after quarter.

HOW DO YOU USE ALTERNATIVE DATA?



Note: Based on 50 responses including 31 asset managers and 19 hedge funds.
Source: Greenwich Associates 2017 Alternative Data Usage Study

Another added benefit of using a model database is that the consistency across the models makes it easier for the investor to start to layer on alternative data. Although alternative data has primarily been thought of as an input for algorithms in quant funds, traditional stock pickers are increasingly turning to these datasets to help inform their own views and to begin to introduce quantamental practices into their investment processes. In a recent Greenwich survey, over 60 of hedge fund managers use alternative data to identify anomalies that could flag opportunities or risks.[xiv]

For active managers, the combination of a number of secular and cyclical trends suggest that optimism is warranted. After an extended period of high pairwise stock correlation, external cyclical forces are likely to create an improved environment for picking stocks. At the same time, secular changes to the sellside research model have left significant sections of the market in dark corners with an increased chance that equities are mispriced. Investors that wish to make the most of this unique opportunity now also have access to new technologies that can be used to increase their productivity and stave off the next generation of threats.

ENDNOTES

i Figure 1: Percent Of Actively Managed Funds Outperforming S&P 1500
ii Figure 3: Global AUM – Active Vs Passive
iii Morningstar Direct
iv Detrixhe, John. “Wealthy Families Are Cooling on Hedge Funds except in One Area.” Quartz, 12 Sept. 2017, qz.com/1074272/family-offices-reduced-their-allocations-to-hedge-funds-for-a-second-year/
v Randall, David. “Funds Target ‘Unknown’ Stocks as Wall Street Cuts Analyst Jobs.” Reuters, 7 Aug. 2017, 10:00 AM, www.reuters.com/article/us-usa-funds-research-idUSKBN1AN221
vi “Is It Time For Active Managers To Shine?” Greenwich Associates, 6 Mar. 2018
vii Ibid
viii Vlastelica, Ryan. “Hedge Fund Closures Still Outnumbered Launches in Second Quarter.” MarketWatch, 18 Sept. 2017, 2:09 PM, www.marketwatch.com/story/hedge-fund-closures-still-outnumbered-launches-in-second-quarter-2017-09-18
ix Schnurr, James V. “Remarks before the 12th Annual Life Sciences Accounting and Reporting Congress.” 22 Mar. 2016, Philadelphia, PA
x Crane, Alan D., et al. “Do Hedge Funds Profit From Public Information?” SSRN, 16 Mar. 2018, papers.ssrn.com/sol3/papers.cfm?abstract_id=3127825
xi Rife, James. “Smallcap Value Investing.” Canalyst Newsletter: Smallcap Value Investing & NASDAQ:KTEC, 22 Dec. 2017
xii Demiroglu, Cem, and Michael Ryngaert. “The First Analyst Coverage of Neglected Stocks.” Financial Management, vol. 39, no. 2, 22 June 2010, pp. 555–584., www.jstor.org/stable/40732449
xiii “Is It Time For Active Managers To Shine?” Greenwich Associates, 6 Mar. 2018
xiv Ibid

ROBUST FINANCIAL MODELS

OUR BREADTH X YOUR DEPTH = ALPHA

Canalyst is built to leverage buyside professionals' time. We've built a database of up-to-date fundamental models on nearly every public equity in North America, so our clients can focus on the key drivers of their business: finding better investment ideas, generating better returns, and bringing in more assets.

Canalyst provides immediate access to unlocked Excel-based financial models for download via a secure online portal. All models go through a stringent review process. They are built directly from company filings—always up-to-date with quarterly earnings and major corporate events.

Sector-focused analysts check each and every update that goes into the database. Our expert team completes three rounds of review. Multiple layers of quantitative checks are also built into the process.

Canalyst's coverage consists of 3600+ names, including every company trading in North America with more than $100MM in annual revenue. Canalyst does not provide buy or sell recommendations.

FOR ANALYSTS

React Quicker
Expand Your View
Maximize Your Value

PORTFOLIO MANAGERS

Leverage Your Edge
Reduce Sellside Reliance
Maximize Your Value

DIRECTORS OF RESEARCH

Leverage Your Team
Expand Your Scope
Reduce Sellside Reliance

FOUNDERS & CIOS

Leverage Your Strengths
Focus On Your Business
Reduce Sellside Reliance