



Swedroe: Active Manager Lags Despite Research

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Larry Swedroe

I recently received an email asking me to comment on a white paper, “[Return on Equity: A Compelling Case for Investors](#),” published by Jensen Investment Management.

The paper explains Jensen’s investment strategy: “At Jensen Investment Management, we believe that Return on Equity (ROE) is a very useful criterion for identifying companies that have the potential to provide attractive returns over long periods of time. Our experience and research suggest that our requirement of consistently high Return on Equity results in a universe of high-quality, profitable companies that are able to generate returns above their costs of capital in a variety of circumstances and economic environments. Further, we believe that this universe produces companies with sustainable competitive advantages, strong growth potential and stocks with a lower beta relative to broad market indices.”

In other words, ROE is a key element of the “secret sauce” that will allow Jensen to deliver alpha to investors, justifying the higher fees that coincide with active management.

The paper explains: “We start by annually selecting only those U.S. companies that have earned a Return on Equity of 15% or greater for the last ten consecutive years, as determined by Jensen’s Investment Committee. From there, we narrow down this universe of high Return on Equity companies through fundamental research based on their growth potential, financial strength, competitive advantages and their lines of business. Finally, we seek to identify the undervalued securities – those that are the ‘best deals’ of the companies that we follow.”

They conclude: “We seek to invest only in quality growth businesses that we can reasonably understand, whose outlooks are favorable and that can be acquired at sensible prices. Our investments remain unless business fundamentals deteriorate below our strict standards, we identify a more compelling opportunity or the stocks become overpriced based on our metrics.”

Supporting Research

It’s important to note that Jensen’s focus on profitability is supported by the academic research. For example, in July 2004, the paper “[Profitability, Investment and Average Returns](#),” by Eugene Fama and Kenneth French, found that more profitable firms have higher expected returns, as do firms with higher book-to-market ratios (value stocks).

The paper was published in the November 2006 issue of the Journal of Financial Economics. Their paper confirmed the findings of the 1996 paper by Robert A. Haugen and Nardin L. Baker, “[Commonality in the Determinants of Expected Stock Returns](#),” as well as those of the 2002 paper by Randolph Cohen, Paul Gompers and Tuomo Vuolteenaho, “[Who Underreacts to Cash-Flow News? Evidence from Trading Between Individuals and Institutions](#).” Both papers found that, controlling for book-to-market equity, average returns are positively related to profitability.

Robert Novy-Marx made an important contribution to the literature with his 2012 paper, “[The Other Side of Value: The Gross Profitability Premium](#).” Defining profitability as revenues minus cost of goods sold divided by assets, Novy-Marx found that profitable firms generate significantly higher returns than unprofitable ones despite having significantly higher valuation ratios, particularly when value is defined by book-to-market.

The most profitable firms earn average returns that are 3.7 percentage points per year higher than the least profitable firms. This idea has been extended to include a quality factor, which captures a broader set of quality characteristics. In particular, high-quality stocks that are profitable, stable, growing and have a high payout ratio outperform low-quality stocks with the opposite characteristics.

In other words, this information about the importance of profitability is well-known, and has been for some time. However, it’s also important to point out this research shows that the newer gross profitability measure does a better job of explaining the cross section of returns than does ROE.

Today profitability is considered to be one of the common factors that explains the cross section of expected returns. It is also one of the factors in the q-factor model proposed by Kewei Hou, Chen Xue and Lu Zhang in their 2014 paper, “[Digesting Anomalies](#).” And Fama and French have incorporated it into their [Five-Factor Asset Pricing Model](#).

As my co-author Andrew Berkin and I explain in our book “[The Incredible Shrinking Alpha: And What You Can Do to Escape Its Clutches](#),” the publication of academic research effectively converts what was once alpha (outperformance against an appropriate risk-adjusted benchmark) into beta, which is exposure to a common factor. Since alpha is a scarce resource, active managers who can deliver it can charge high fees. On the other hand, beta (loading on a common factor) is a commodity.

Thus, it should be cheap, which then raises the question, does Jensen, as an active manager, deliver alpha or only beta?

Its fees certainly seem reflective of their ability to deliver alpha. The newer and lower-cost version of the Jensen Quality Growth Fund (JENIX) has an expense ratio of 0.63%. The higher-cost version (JENSX) has an expense ratio of 0.87%. The lowest-cost version of the Jensen Quality Value Fund (JNVIX) has an expense ratio of 1.10%. The higher-cost version (JNVSX) has an expense ratio of 1.25%.

Investors clearly believe the Jensen funds will generate alpha, as the Quality Growth Fund had \$5.9 billion of assets under management as of March 31, 2017. However, the Quality Value Fund had only about \$33 million.

Can Jensen Deliver Alpha?

To answer the question about Jensen’s ability to generate alpha, I’ll compare the returns of the two funds to the comparable passively managed fund of Vanguard. (Note that my usual practice is to also compare the active funds to the comparable fund from Dimensional Fund Advisors (DFA). However, DFA does not have funds comparable to the Jensen funds.)

I’ll begin by looking at the performance of the higher-cost Jensen Quality Growth Fund (JENSX) as it has a longer history, allowing us to look at 15-year returns (JENIX’s returns would be 0.24% higher due to its lower cost). Morningstar classifies JENSX as a domestic large growth fund. Thus, I’ll compare its performance to that of the Vanguard Growth Index Institutional Fund (VIGIX).

The table below shows the performance of the 15-, 10- and 5-year periods ending March 31, 2017. One reason to show the three different periods is that the academic research on the quality factor (ROE is one metric used to determine quality and/or profitability) is relatively recent. And the evidence shows that post-publication premiums tend to be reduced (although in the cases of the size, value, momentum and profitability factors, they do not reach zero) as investors seek to exploit them.

Another reason is that successful active management often sows the seeds of its own destruction—cash inflows follow outperformance, increasing the hurdles to generating alpha.

Fund	Symbol	Expense Ratio (%)	15-year Annualized Return (%)	10-Year Annualized Return (%)	5-Year Annualized Return (%)
Jensen Quality Growth Fund	JENSX	0.87	6.66	8.37	12.81
Vanguard Growth Index Fund	VIGIX	0.05	7.31	9.03	12.93

As you can see, JENSX underperformed over the full 15-year period by 0.65 percentage points; it underperformed by 0.66 percentage points over the most recent 10-year period; and it underperformed by 0.08 percentage points over the most recent five-year period.

Note that the lower-cost Jensen Quality Value Fund (JNVIX) does not have a full 15-year history, but if it did, its lower costs would not have allowed it to outperform over the 15 years. It underperformed by 0.36 percentage points over the most recent 10-year period and outperformed by 0.17 percentage points over the most recent five-year period.

JNVIX is a relatively new fund. Over the five-year period ending March 31, 2017, it returned 10.95%. Morningstar considers it a midcap value fund. Instead of comparing it to one specific fund, I’ll look at the full midcap category, which includes active and passive funds. It underperformed the category’s average return of 11.95% by 1.0 percentage point, and had a Morningstar ranking of 77.

Factor Analysis

I will now look at the performance of JENSX using the analytical tools and data available at Portfolio Visualizer. Factor analysis provides important additional insights into fund performance, because Morningstar asset class categories are very broad, and actively managed funds often style drift.

Using the AQR Capital Management factors, the table below shows the results of the three-factor (beta, size and value), four-factor (adding momentum) and six-factor (adding quality and low beta) analyses for the Jensen Quality Growth Fund. The data covers the 15-year period March 2002 through February 2017. Each t-statistic is in parentheses.

Fund	Symbol	Three-Factor Annual Alpha (%)	Four-Factor Annual Alpha (%)	Six-Factor Annual Alpha (%)
Jensen Quality Growth	JENSX	0.3 (0.2)	0.5 (0.4)	-1.4 (-1.1)

The results show that while the fund did produce some alpha (0.3% and 0.5%) under the three- and four-factor models, it produced a large negative alpha of -1.4% (although it was not statistically significant) once we included the quality factor and the low-beta factor.

Thus, based on these factors, there really is no evidence of any stock selection skill—none of the statistics were significant at the 5% confidence level. The positive three- and four-factor alphas are more than fully explained by the fund's loading (0.4) on the quality factor—a loading that the three- and four-factor models don't capture.

Now, it's important to note that Jensen was gaining exposure to the quality factor before the research was published. Thus, they should still get credit for that exposure. But in more recent years, low-cost, passively managed funds have been developed that provide exposure to this factor. In other words, what was once alpha (for which investors pay high fees) has become beta (for which investors should not pay high fees).

Another Version

A factor analysis of the lower-cost version of the fund over the more recent 10- and five-year periods can also be analyzed. I'll begin with a look at the 10-year period March 2007 through February 2017.

Fund	Symbol	Three-Factor Annual Alpha (%)	Four-Factor Annual Alpha (%)	Six-Factor Annual Alpha (%)
Jensen Quality Growth	JENIX	1.8 (1.2)	1.8 (1.2)	-1.0 (-0.7)

Here we see similar results, with the positive alphas under the three- and four-factor models more than fully explained by the loading of 0.4 on quality. Note again that none of the alphas are statistically significant at the 5% confidence level.

The following table shows the results over the five-year period March 2012 through February 2017.

Fund	Symbol	Annual Alpha (%)	Annual Alpha (%)	Annual Alpha (%)
Jensen Quality Growth	JENIX	1.3 (0.7)	0.8 (0.4)	-1.4 (-0.8)

Here again, we have similar results, with the positive alphas under the three- and four-factor models more than fully explained by the loading of 0.3 on quality. In addition, the six-factor alpha was -1.4 percentage points, although not statistically significant at the 5% level.

I'll now turn to an analysis of the Jensen Quality Value Fund (JNVIX). The Fund's inception date was March 31, 2010. As you might guess from the tiny amount of assets under management, the fund's performance has been poor, no matter how we look at the data.

Morningstar classifies the fund as a midcap value fund. Therefore, I'll compare its performance to that of the Vanguard Mid-Cap Value ETF Fund (VOE). The following table covers the performance for the five-year period ending March 31, 2017.

Fund	Symbol	Expense Ratio (%)	5-Year Annualized Return (%)
Jensen Quality Value Fund	JNVIX	1.10	10.95
Vanguard Mid-Cap Value ETF	VOE	0.08	14.33

As you can see, the fund underperformed the comparable Vanguard fund by 3.38 percentage points, much more than the difference in the expense ratios. Clearly, the fund did not achieve its objective of adding value during this time period.

We can also perform the factor analysis on the fund. The following table shows the results over the five-year period March

2012 through February 2017.

Fund	Symbol	Three-Factor Annual Alpha (%)	Four-Factor Annual Alpha (%)	Six-Factor Annual Alpha (%)
Jensen Quality Value	JNVIX	-0.3 (-0.2)	1.0 (0.4)	-3.5 (-1.6)

Here again we see similar results, though in this case, the three-factor regression showed a small and statistically insignificant negative alpha. The positive alpha based on the four-factor regression is due to the approximately 0.3 loading on the quality and low beta factors. Once those are both accounted for, the six-factor alpha was highly negative, though not statistically significant at the 5% confidence level.

Summary

The bottom line is that, while Jensen was able to generate alpha prior to the uncovering of the quality and low-beta factors, JENSX underperformed a comparable passively managed fund over the last 10 and 15 years, though it has slightly outperformed over the most recent five-year period. On the other hand, JNVSX underperformed by a very wide margin. The evidence doesn't seem to support the claims of the white paper.

This is another example demonstrating what I believe is the winning strategy most likely to achieve your financial goals: deciding which investment factors you want exposure to and then choosing low-cost, passively managed funds that systematically provide that exposure, rather than relying on human judgment to make that decision.

Larry Swedroe is the director of research for The BAM Alliance, a community of more than 140 independent registered investment advisors throughout the country.