Does Active Management Deliver?

January 2010

Introduction

There has been a lot of discussion in the media recently about the value of active management. Investors are questioning, among other things, whether active managers can outperform their appropriate benchmarks. This article will review the performance of the Canadian Equity managers available in the BMO Nesbitt Burns Advance Program® (Advance Program) and the BMO Nesbitt Burns Architect Program® (Architect Program) with the goal of addressing the question of whether these active managers have outperformed their benchmark. Since the Canadian Equity managers as a group comprise the largest mandate in dollar terms in both the Advance and Architect Programs, a review of the performance of these managers may be of interest to many clients and their investment advisors.

The Managers and the Benchmark

This article will examine the performance of the 14 Canadian Equity managers available in our Advance and Architect Programs over the 10 year period ending December 31, 2008. This 10 year period was chosen because it covers more than one complete market cycle and includes both bull and bear markets.

The 14 Canadian Equity managers are listed alphabetically in Figure 1 along with their availability in the Advance and Architect Programs. All of the Canadian Equity managers have 10 years of quarterly data with the exceptions of Inhance, which has three years of data, and Sionna, which has five and a half years of data.

Figure 1: A table of our Canadian Equity managers and their program availability

Manager	Advance	Architect
Beutel Canadian Equity	yes	yes
Bissett Canadian Equity	yes	yes
Foyston Canadian Equity	yes	yes
Guardian Canadian Equity	yes	yes
Inhance Canadian Equity SRI	no	yes
Jarislowsky Canadian Equity	yes	yes
Jones Heward Canadian Equity	yes	yes
Jones Heward Canadian Stock Selection	no	yes
McLean Budden Canadian Equity	yes	yes
MFC Global Investments Canadian Equity	yes	yes
PCJ Canadian Equity	yes	yes
Scheer Rowlett Canadian Equity	yes	yes
Sionna Canadian Equity	no	yes
Standard Life Canadian Equity	yes	yes

The S&P/TSX Total Return Index, which includes the effects of dividends, will serve as the benchmark for our comparative analysis. For the sake of brevity, the S&P/TSX Total Return Index will henceforth be referred to as the S&P/TSX Index. Please note that the performance numbers quoted in this article are based on historical quarterly return data and are stated gross of fees, i.e. before fees. Also, please remember that past performance does not guarantee future performance.

Performance of our Managers Relative to the S&P/TSX Index

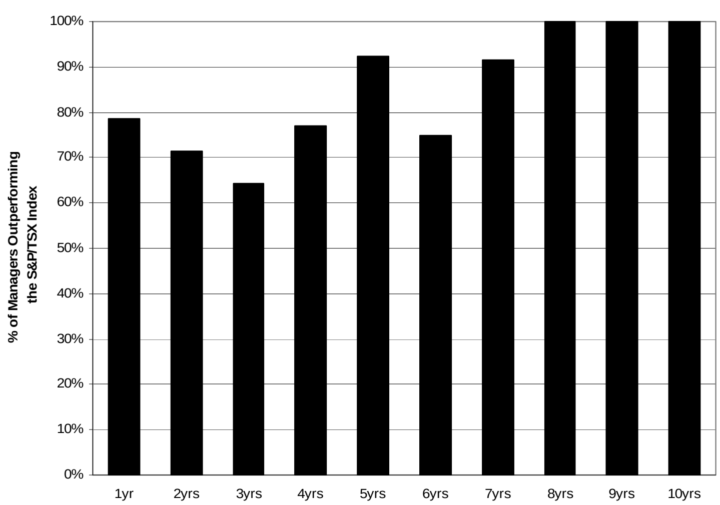
Figure 2 shows the annualized returns of our Canadian Equity managers for the 10 year period ending December 31, 2008. Cells that are shaded light grey indicate that the manager has outperformed the S&P/TSX Index. Cells that are shaded dark grey indicate that the manager has underperformed the S&P/TSX Index. White cells containing “N/A” indicate that the manager does not have enough performance history to calculate the specific annualized return. Note that the colour coding does not indicate the magnitude of the outperformance or underperformance – the colour coding only shows whether the manager has outperformed the benchmark. The last row of the table contains the annualized returns of the S&P/TSX Index over the same 10 year period so that the reader can assess the magnitude of the outperformance.

Figure 2: Annualized returns of Canadian Equity managers
for the 10 year period ending December 31, 2008

	Annualized Return									
Manager	**1yr**	**2yrs**	**3yrs**	**4yrs**	**5yrs**	**6yrs**	**7yrs**	**8yrs**	**9yrs**	**10yrs**
Beutel Canadian Equity	-22.1%	-8.6%	-0.6%	4.5%	6.5%	9.6%	7.1%	7.2%	8.8%	8.5%
Bissett Canadian Equity	-29.9%	-13.8%	-5.0%	2.7%	5.1%	7.5%	5.7%	5.6%	7.5%	7.6%
Foyston Canadian Equity	-30.2%	-13.8%	-5.4%	1.6%	4.3%	7.4%	7.4%	9.3%	11.1%	10.6%
Guardian Canadian Equity	-31.9%	-14.6%	-3.8%	1.7%	5.2%	8.9%	5.8%	4.9%	6.1%	7.2%
Inhance Canadian Equity SRI	-36.1%	-15.2%	-6.3%	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Jarislowsky Canadian Equity	-25.3%	-10.4%	-3.0%	3.1%	6.4%	8.6%	6.2%	5.8%	7.1%	9.1%
Jones Heward Canadian Equity	-20.1%	-6.2%	1.0%	6.2%	7.7%	9.8%	7.1%	6.2%	8.3%	10.3%
Jones Heward Canadian Stock Selection	-29.2%	-10.2%	-2.4%	3.8%	6.3%	9.1%	6.3%	5.8%	6.7%	9.1%
McLean Budden Canadian Equity	-35.5%	-15.6%	-5.9%	0.5%	2.7%	6.9%	3.6%	3.3%	4.9%	6.9%
MFC Global Investments Canadian Equity	-35.6%	-13.7%	-3.1%	3.4%	5.4%	8.7%	5.5%	3.5%	4.5%	9.2%
PCJ Canadian Equity	-29.8%	-12.8%	-3.6%	2.8%	5.1%	8.7%	5.0%	3.4%	5.8%	8.9%
Scheer Rowlett Canadian Equity	-32.0%	-14.9%	-4.8%	2.5%	5.0%	8.6%	6.2%	6.5%	8.1%	9.9%
Sionna Canadian Equity	-24.6%	-10.9%	-2.0%	4.8%	7.6%	N/A	N/A	N/A	N/A	N/A
Standard Life Canadian Equity	-32.2%	-12.7%	-3.4%	3.5%	5.5%	8.2%	5.0%	4.2%	6.1%	8.2%
S&P/TSX Index	-33.0%	-14.2%	-4.8%	1.7%	4.2%	7.6%	4.5%	2.2%	2.8%	5.3%

A quick look at Figure 2 reveals that the majority of our managers have outperformed the index on a relative basis. To better quantify the success of our Canadian Equity managers as a group, and by inference the efficacy of our manager selection process, we can calculate the percentage of Canadian Equity managers who beat the benchmark over a particular time interval. For example, on a one year basis, 79% (11/14) of the managers beat the benchmark. On a two year basis, 71% (10/14) of the managers beat the benchmark. Figure 3 shows these percentages in graphical form. For most time periods, 75% or more of the managers beat the benchmark with the percentage of outperforming managers tending to increase as the length of the time interval increases.

Figure 3: Performance of Canadian Equity managers
for several time periods ending December 31, 2008



Risk Adjusted Performance of our Managers Relative to the S&P/TSX Index

Although the return on an investment is often of paramount importance to investors, it is wise to also consider the risk taken on to achieve that return. Investing involves a tradeoff between return and risk, and as such it would be informative to assess the performance of the Canadian Equity managers on a risk adjusted basis.

One measure of risk adjusted return is the return-to-risk ratio. The return-to-risk ratio is equal to the manager's annualized return divided by the manager's annualized standard deviation. This metric helps to quantify the amount of return a manager generates per unit of risk taken. When comparing the risk adjusted performance of two similar managers, the manager with the higher return-to-risk ratio is preferable all else being equal.

The return-to-risk ratio can also be used to compare a manager against a benchmark. If the manager's return-to-risk ratio is greater than that of the benchmark, then the manager has outperformed the benchmark on a risk adjusted basis. Conversely, if the manager's return-to-risk ratio is less than that of the benchmark, then the manager has underperformed the benchmark on a risk adjusted basis.

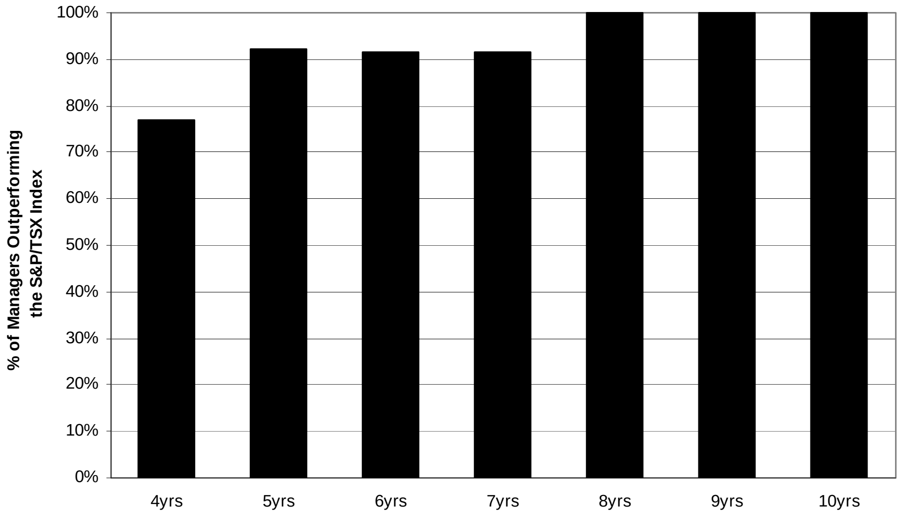
Figure 4 displays the return-to-risk ratios for the Canadian Equity managers and the S&P/TSX Index over a number of time intervals ending December 31, 2008. The colour coding in Figure 4 is the same as that used in Figure 3 except that in Figure 4 the comparison to the benchmark is made on a risk adjusted basis. For example, cells that are shaded light grey indicate that the manager has outperformed the S&P/TSX on a risk adjusted basis for the indicated time interval while cells that are shaded dark grey indicate that the manager has underperformed the S&P/TSX Index on a risk adjusted basis.

Figure 4: Return-to-risk ratios of Canadian Equity managers
for several time periods ending December 31, 2008

	Return-to-Risk Ratio						
Manager	**4yrs**	**5yrs**	**6yrs**	**7yrs**	**8yrs**	**9yrs**	**10yrs**
Beutel Canadian Equity	0.35	0.55	0.77	0.53	0.55	0.68	0.66
Bissett Canadian Equity	0.17	0.36	0.52	0.40	0.38	0.53	0.54
Foyston Canadian Equity	0.09	0.27	0.46	0.47	0.62	0.76	0.74
Guardian Canadian Equity	0.09	0.30	0.52	0.33	0.28	0.36	0.43
Inhance Canadian Equity SRI	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Jarislowsky Canadian Equity	0.21	0.47	0.65	0.46	0.43	0.55	0.68
Jones Heward Canadian Equity	0.52	0.71	0.89	0.61	0.51	0.66	0.80
Jones Heward Canadian Stock Selection	0.22	0.39	0.59	0.39	0.36	0.43	0.57
McLean Budden Canadian Equity	0.03	0.14	0.37	0.19	0.17	0.25	0.35
MFC Global Investments Canadian Equity	0.16	0.28	0.47	0.30	0.18	0.24	0.44
PCJ Canadian Equity	0.14	0.29	0.52	0.28	0.18	0.30	0.45
Scheer Rowlett Canadian Equity	0.13	0.28	0.49	0.35	0.37	0.48	0.60
Sionna Canadian Equity	0.30	0.51	N/A	N/A	N/A	N/A	N/A
Standard Life Canadian Equity	0.19	0.33	0.51	0.31	0.26	0.39	0.52
S&P/TSX Index	0.09	0.24	0.46	0.26	0.12	0.15	0.29

As shown in the table above, for most time intervals the majority of our Canadian Equity managers have outperformed the S&P/TSX Index on a risk adjusted basis. To better quantify the outperformance of the Canadian Equity managers as a group, we can calculate the percentage of Canadian Equity managers who beat the index on a risk adjusted basis for each time period in Figure 4. For example, on a four year basis, 77% (10/13) of the managers beat the benchmark on a risk adjusted basis. On a five year basis, 92% (12/13) of the managers beat the benchmark on a risk adjusted basis. Figure 5 displays these percentages in graphical form. For each time interval in Figure 5, at least 75% of the managers beat the benchmark on a risk adjusted basis. For most time periods, 90% or more of the managers beat the benchmark on a risk adjusted basis with the percentage of outperforming managers reaching 100% for eight year, nine year, and ten year periods.

Figure 5: Risk adjusted performance of Canadian Equity managers for several time periods ending December 31, 2008



Performance of our Managers Relative to Mercer's Peer Universe

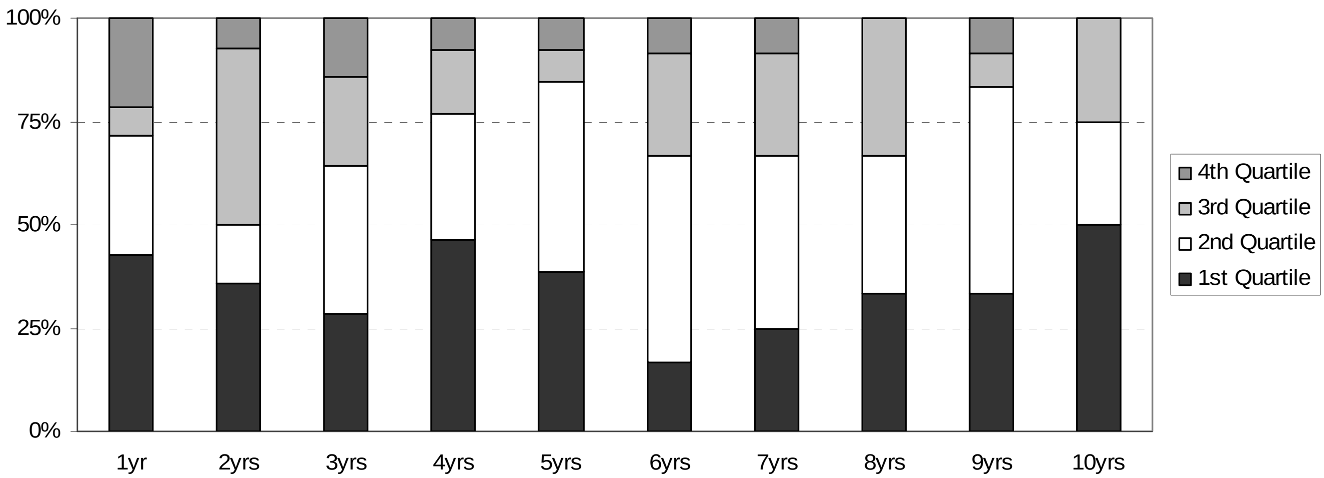
So far, this review has considered the performance of the Canadian Equity managers available in the Advance and Architect Programs relative to a benchmark, the S&P/TSX Index. Taking a cue from the world of institutional investing, it might be insightful to compare the performance of these managers to that of a peer group of managers. For the Canadian Equity managers, the Mercer Pooled Canadian Equities Universe will be used as the peer universe.

One way to quantify the performance of our Canadian Equity managers as a group relative to their peer universe is to calculate the percentage of our Canadian Equity managers who fall in each quartile and compare these percentages to those of the peer universe for a particular time period. To provide context for the comparative analysis that follows, recall from basic statistics that each quartile in the peer universe contains, by definition, 25% of the managers in the peer universe, i.e. 25% of the managers in the peer universe fall in the first quartile, 25% of the managers in the peer universe fall in the second quartile, and so on.

Figure 6 shows the quartile rankings of our 14 Canadian Equity managers in the form of a stacked bar graph for various time intervals ending December 31, 2008. For each stacked bar, the black, white, light grey, and dark grey sections represent the percentage of our Canadian Equity managers who placed in the first quartile, second quartile, third quartile, and fourth quartile respectively.

Inspection of Figure 6 reveals that the combined percentage of our Canadian Equity managers in the first and second quartiles is well over 50% for almost all time periods. Also, note that the percentage of managers in the fourth quartile is below 25% for all time periods and noticeably below 25% for nine of the ten time periods. These observations indicate that as a group our Canadian Equity managers have turned in a respectable performance relative to the managers in their peer universe.

Figure 6: Quartile rankings of our Canadian Equity managers wrt
the Mercer Pooled Canadian Equities Universe as of December 31, 2008



End Point Sensitivity

End point sensitivity is one shortcoming of most returns-based performance analysis. In a nutshell, end point sensitivity means that the return of a manager or index varies depending on the end points of the time interval used in calculating the return.

As an illustration of end point sensitivity, consider Figure 7. The table in Figure 7 contains the rolling three year annualized returns for PCJ Canadian Equity and the S&P/TSX Index for each quarter in the period 2006-2008. Inspection of the table in Figure 7 reveals that PCJ's three year annualized returns exhibit considerable variability from one quarter to the next quarter. As an extreme example of end point sensitivity, consider PCJ's three year returns for Q2 2008 and Q3 2008. The addition of just one new quarter of data coupled with the removal of the oldest quarter of data used in the calculation of the rolling three year return has caused the return to change from 18.1% to 6.3%. This is a huge change over just one quarter and clearly illustrates end point sensitivity. End point sensitivity also afflicts the S&P/TSX Index's returns as is readily apparent in Figure 7.

Figure 7: Rolling three year annualized returns
for PCJ Canadian Equity and the S&P/TSX Index

	Rolling 3yr Annualized Returns											
	Q1 2006	Q2 2006	Q3 2006	Q4 2006	Q1 2007	Q2 2007	Q3 2007	Q4 2007	Q1 2008	Q2 2008	Q3 2008	Q4 2008
PCJ Canadian Equity	27.1%	20.5%	19.1%	19.0%	18.3%	19.6%	19.9%	16.7%	14.4%	18.1%	6.3%	-3.6%
S&P/TSX Index	26.3%	20.7%	18.9%	18.6%	17.7%	20.1%	20.2%	16.9%	14.2%	16.2%	4.7%	-4.8%
Value Added	0.8%	-0.2%	0.3%	0.5%	0.6%	-0.5%	-0.3%	-0.3%	0.2%	1.9%	1.6%	1.2%

Holding Period Batting Average

Earlier in this article we investigated the percentage of our Canadian Equity managers who beat the S&P/TSX Index over various time intervals. Unfortunately, the analysis did not consider the effects of end point sensitivity. Let us continue with our discussion of Figure 7 with the goal of finding a way to reduce the effects of end point sensitivity on our analysis of manager outperformance.

The last row of the table in Figure 7 shows the value added by PCJ in each quarter. Inspection of the value added row reveals that PCJ has outperformed the benchmark in eight of the twelve three year periods and underperformed the benchmark in four of the twelve three year periods. Has PCJ outperformed the benchmark? Well, the answer is "It depends." It depends on which of the twelve three year intervals is chosen. If one chooses any of the eight periods of outperformance, then PCJ has outperformed the index. If one chooses any of the four periods of underperformance, then PCJ has underperformed the index. This is not an entirely satisfactory answer.

One way to reduce the effects of end point sensitivity in this example is to consider all twelve three year periods. In baseball, players are often evaluated using a "batting average" in which the number of "hits" is divided by the number of "at bats." We can use a similar concept, a "holding period batting average," to measure PCJ's frequency of outperformance on a three year basis. In the language of baseball, PCJ had eight "hits" in twelve "at bats." In the language of investment performance analysis, PCJ outperformed the S&P/TSX Index in eight of the twelve three year periods resulting in a three year holding period batting average of 67% (8/12).

The holding period batting average concept introduced in the example above reduces the effects of end point sensitivity and gives a better estimate of a manager's historical frequency of outperformance relative to the index. This approach can easily be applied to shorter or longer time intervals. Furthermore, it can be applied not only to individual managers but also to the Canadian Equity managers as a group.

Holding Period Performance of our Managers Relative to the S&P/TSX Index

Figure 8 shows the holding period batting averages of the Canadian Equity managers for the 10 year period ending December 31, 2008. Holding period batting averages for eight year, nine year, and ten year holding periods were not included in the table in Figure 8 because there was insufficient data to calculate meaningful averages. Cells in the table containing "N/A" indicate that the manager does not have enough performance history to calculate the appropriate holding period batting average.

Consider the holding period batting averages of Beutel Canadian Equity in Figure 8. Beutel's one year holding period batting average is 59% while its two year holding period batting average is 58%. How were these numbers calculated? Recall that the data used in this review is quarterly and spans the 10 year period from 1999-2008. Based on these 40 quarters of data, there are 37 one year holding periods and 33 two year holding periods in this 10 year period. It turns out that Beutel outperformed the S&P/TSX Index in 22 of the 37 one year holding periods in the 10 year period and so Beutel's one year holding period batting average is 59% (22/37). Similarly, it turns out that Beutel outperformed the index in 19 of the 33 two year holding periods in the 10 year period resulting in a two year holding period batting average of 58% (19/33).

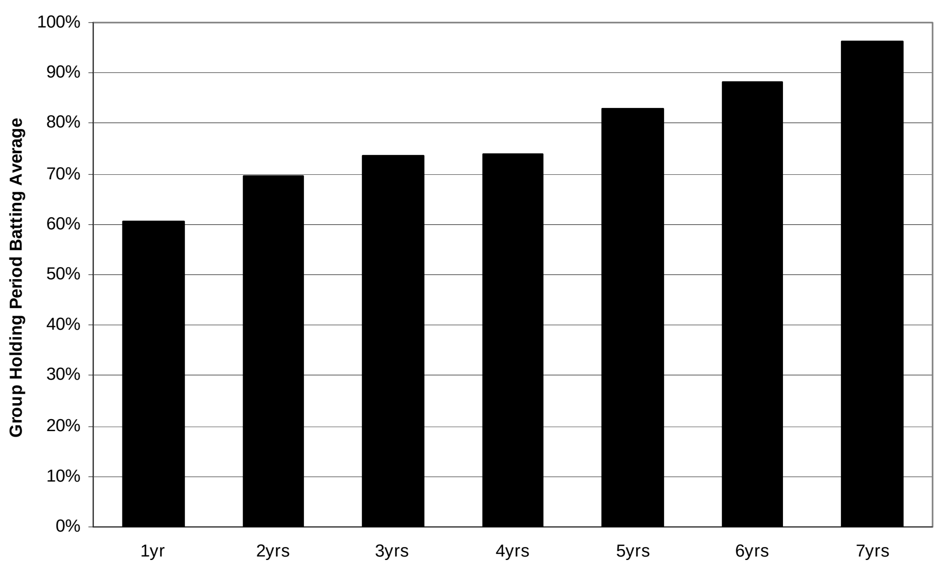
Figure 8: Holding period batting averages of Canadian Equity managers
for the 10 year period ending December 31, 2008

	Holding Period Batting Averages						
Manager	**1yr**	**2yrs**	**3yrs**	**4yrs**	**5yrs**	**6yrs**	**7yrs**
Beutel Canadian Equity	59%	58%	62%	60%	76%	82%	100%
Bissett Canadian Equity	57%	64%	69%	76%	76%	76%	92%
Foyston Canadian Equity	57%	64%	62%	68%	76%	82%	100%
Guardian Canadian Equity	59%	82%	83%	92%	100%	100%	100%
Inhance Canadian Equity SRI	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Jarislowsky Canadian Equity	51%	58%	66%	60%	71%	76%	85%
Jones Heward Canadian Equity	43%	42%	48%	52%	62%	71%	92%
Jones Heward Canadian Stock Selection	70%	82%	93%	84%	100%	100%	100%
McLean Budden Canadian Equity	43%	64%	52%	48%	57%	82%	85%
MFC Global Investments Canadian Equity	73%	85%	97%	96%	100%	100%	100%
PCJ Canadian Equity	76%	79%	83%	84%	95%	94%	100%
Scheer Rowlett Canadian Equity	68%	85%	97%	100%	100%	100%	100%
Sionna Canadian Equity	68%	67%	82%	N/A	N/A	N/A	N/A
Standard Life Canadian Equity	68%	76%	69%	68%	81%	94%	100%
Canadian Equity Managers	61%	70%	74%	74%	83%	88%	96%

Looking at the holding period batting averages of the individual managers in Figure 8, it is evident that some of the managers have tended to outperform the index more frequently than have other managers. Overall, for most of the managers, the holding period batting average has tended to increase as the length of the holding period increases. Furthermore, for two-thirds of the managers, the holding period batting average has converged to 100% for seven year holding periods.

The last row of the table in Figure 8 contains the holding period batting averages of the Canadian Equity managers as a group. Figure 9 shows these averages in graphical form. For each time interval in Figure 9, the holding period batting average of the Canadian Equity managers as a group is over 60%. For the majority of holding periods, the group holding period batting average is 70% or higher. And, as the length of the holding period increases, the group holding period batting average increases reaching 96% for seven year holding periods.

Figure 9: Group holding period batting averages
for the 10 year period ending December 31, 2008



Summary

This article reviewed the performance of the Canadian Equity managers available in the Advance and Architect Programs over the 10 year period ending December 31, 2008 with the goal of assessing whether these managers have been able to outperform their benchmark, the S&P/TSX Index.

Over the 10 year period under consideration in this review, our Canadian Equity managers as a group have delivered favourable performance relative to the S&P/TSX Index on an annualized return basis (Figures 2 and 3), on a risk adjusted basis (Figures 4 and 5), on a holding period basis (Figures 8 and 9), and relative to their peers in the Mercer Pooled Canadian Equities Universe (Figure 6).

More specifically, for most time periods under consideration in this review, 75% or more of the managers outperformed the index on an annualized basis and 90% or more of the managers beat the index on a risk adjusted basis. For most holding periods considered in this article, our Canadian Equity managers as a group have generated holding period batting averages of 70% or higher. In addition, the percentage of managers who have outperformed the index has generally tended to increase as the length of the time interval or holding period increases.

This history of favourable performance is indicative of the quality of the Canadian Equity managers available to clients in the Advance and Architect Programs and reflects well on the ability of BMO Nesbitt Burns to select and retain active managers who add value for clients. Access to value adding managers and the ongoing monitoring of these managers by BMO Nesbitt Burns are two key elements of the value proposition that the Advance and Architect Programs offer to clients.