Where Indexing Makes Less Sense:

The Case for Active Management in Non-Us Markets

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For much of 2017, the investment markets saw the continuation of an indexing trend as equity fund flows went predominantly to passive strategies.

WHY HAS INDEXING INCREASED IN POPULARITY?

Debates over the relative merits of active vs. passive strategies have raged for years. However, the impetus for many to switch from active to passive in recent years has been simple: Indexing has benefited equity investors in the US markets. For a number of reasons, active domestic funds have had a hard time keeping up with US indexes and—at least in the near term—investors in US equity funds have been rewarded for the decision to go passive. Conversely, although international equity funds have also seen a growing trend toward passive strategies, investors have not generally been rewarded for indexing their international holdings.

Percentage of Funds beating their benchmarks[1]		
	Large Blend Category vs S&P 500	Foreign Large Blend Category vs ACWI ex-US
	Active Underperforms	Active Outperforms
1 Year	42	40
3 Year	9	65
5 Year	19	74
10 Year	19	N/A

Source: Morningstar Direct

WHY HAS ACTIVE MANAGEMENT CONTINUED TO ADD VALUE IN NON-US MARKETS?

We believe there are several factors at play here. First, worldwide investing offers an expanded opportunity set—particularly with regard to emerging and developing countries—over investing in domestic markets alone. Consider that approximately 95% of the global population and approximately 75% of the world's economic activity (as represented by nominal global GDP) can be found in emerging and developing countries outside the United States. Given elevated growth rates in these non-US countries, active managers simply have more opportunity to find strong, high-quality growth investments. Furthermore, a sound strategy around variables such as currency, country and sector allocation can give the active manager greater opportunity to outperform a static index.

THE IMPORTANCE OF STOCK PICKING

With US and International markets increasingly correlated, we at Chautauqua Capital believe successful stock picking is the only route to outperformance. To capture the full benefit of stock selection skill, we believe portfolios should be invested for the long term, on a conviction-weighted basis, in a concentrated set of best idea investments.

To mitigate the risks within a concentrated portfolio, our team enforces rigorous quality criteria and employs a thoughtful approach to sector and geographic diversification while applying a forward-looking valuation discipline. For example, the team keeps weightings of the four major macro sectors—defensive (health care, consumer staples, utilities, telecom), economically sensitive (consumer discretionary, information technology, materials, industrials), energy, and financials—in line with the benchmark weight. This helps us to reduce volatility in the portfolio without sacrificing the benefit of our best ideas.

[1] As of 6/30/2017. S&P 500 represented with Vanguard 500 Index Fund (VFIAX) versus the Morningstar US OE Large Blend category and ACWI ex-US represented with iShares MSCI ACWI ex US ETF (ACWX) versus the US OE Foreign Large Blend category. Given an inception date of 2009 ACWX does not have 10 years' worth of data.

Chautauqua's rigorous, risk-conscious approach has enabled our international growth strategy to meet or outperform its benchmark over rolling time periods for more than a decade:

% of time the Chautauqua International Growth equity strategy MET or OUTPERFORMED the MSCI ACWI ex-US – ND Index [2] (Rolling Time Periods since 1/1/2006)	
	% of time met or outperformed benchmark
1 Year	70
3 Year	88
5 Year	100
7 Year	100
10 Year	100

Source: eVestment analytics

WHY EXCESS RETURN MATTERS MORE TODAY THAN EVER BEFORE

In an environment where the risk-free rate of return (as measured by the 10-year bond) yields 2.3%, investors are looking for higher returns in their portfolios—often incurring greater risk and less liquidity than traditional stocks and bonds. Since inception, the Chautauqua International Growth composite strategy has provided, net of fees, 279 basis points of annualized outperformance vs. the MSCI ACWI ex-US benchmark and 301 basis points vs. the MSCI EAFE index. Our goal is to provide 300 basis points of outperformance over a normalized investment cycle of 3-5 years. And in today's investment world, an extra 200-400 basis points of return can significantly improve the chances of meeting portfolio expectations.

	Cumulative Returns (%)		**Average Annual Total Returns (%)**				
	QTD	**YTD**	**1 Yr**	**3 Yr**	**5 Yr**	**10 Yr**	**Since Inception (01/01/2006)**
CCIG – Gross	5.66	17.04	16.87	3.81	9.15	4.85	7.62
CCIG – Net	5.57	16.82	16.38	3.39	8.72	4.59	7.38
MSCI ACWI ex-US	5.99	14.45	21.00	1.27	7.70	1.59	4.59
Excess Return (Net)	*-0.42*	*2.37*	*-4.62*	*2.12*	*1.02*	*3.00*	*2.79*
MSCI EAFE	6.37	14.22	20.83	1.61	9.18	1.50	4.37
Excess Return (Net)	*-0.8*	*2.6*	*-4.45*	*1.78*	*-0.46*	*3.09*	*3.01*

Source: PSN

To learn more about Chautauqua Capital Management's views on the international markets, our disciplined investment approach and our offerings for both institutional and individual investors, visit Chautauqua Capital Management.

[2] Performance numbers used are though each month-end period from the Chautauqua International Growth Equity composite since inception. Net returns shown are based on performance from January 1, 2006 to June 30, 2017. Past performance does not guarantee future results.

ABOUT THE AUTHOR

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David Lubchenco has returned to Chautauqua Capital Management after working the past three years as an executive vice president at Marsico Capital Management. David started with Chautauqua Capital in 2012 and has rejoined as a member of the investment team. Drawing upon 23 years of experience, he contributes on portfolio construction, market analysis and communications. Prior to Chautauqua Capital and Marsico Capital, David was the executive vice president of Scout Investments and worked in a management, product development and communications capacity. Before Scout Investments, David was a principal and managing director at Transamerica Investment Management, where he was involved in the development of a similar strategy to that of Chautauqua Capital. He earned a bachelor's degree in economics from The Colorado College and an MBA from the Daniels School of Business, The University of Denver.

IMPORTANT DISCLOSURES