MFS® White Paper

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Our Active Purpose: Building Long-Term Outcomes

Attributes of a successful active investment manager

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In brief

- After a roaring comeback from 2020 lows, valuations look stretched, and spreads look exceedingly tight given underlying secular challenges. We feel investors should consider focusing on risk management and mitigating downside risk in investment markets, a process inherent in active management.
- Active managers have historically performed better in difficult markets (Exhibit 1), and top-quartile active managers have historically added substantial excess return in down markets (Exhibit 2).
- Even top-quartile active managers routinely underperform. Investors should consider developing a tolerance for underperformance and using a long-term performance time period to assess skill.
- Identifying the attributes of a skilled active manager may be critical to driving long-term outcomes. In our view, high active share, long holding periods, thoughtful risk management and collaborative research teams that take what we call an Active 360° perspective can validate skill.

As investors looked past the pandemic to an eventual global economic recovery, markets roared back, posting astonishing gains. The S&P 500 Index has gained 77% over the year-plus since its March 2020 low. During the past 140 years, there have been only five episodes in which the US equity market has had a return of 75% or more, all of which occurred in the early 1930s coming out of the Great Depression, which was another period of extraordinary government economic intervention.[1] The past four quarters of US equity market returns were the greatest four quarters of return that we've seen in almost 90 years. The combination of an abnormally high US savings rate (thanks to pandemic-driven government transfer payments) and pent-up consumer demand (after more than a year of lockdowns) we feel should lead to an enormous pop in economic growth, but the economic rebound will most likely be a short-term event. At MFS, we remain focused on the long term, investing through the market cycle and looking to take advantage of volatility when opportunities arise.

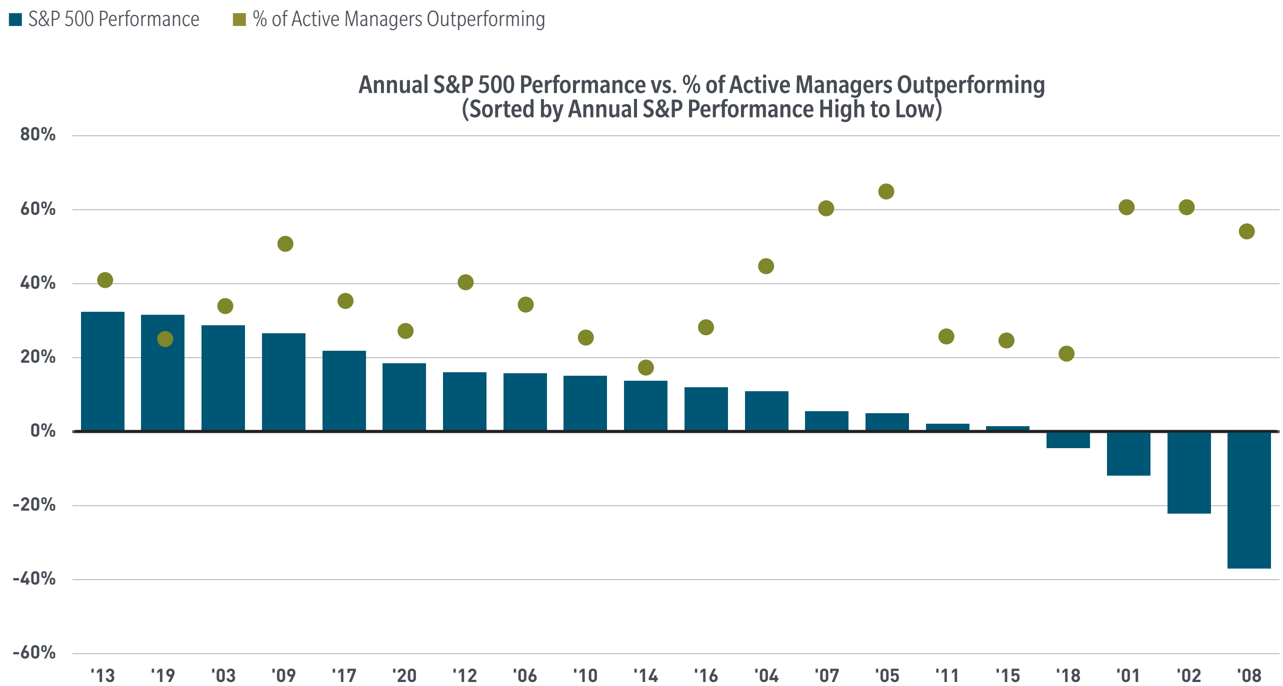
The importance of alpha

Prior to the pandemic, many in the market were concerned about high levels of debt, poor long-term demographics and the ability to generate the real growth needed to service debt levels. Today, we believe those secular challenges have become worse. Globally, debt is higher today than before the pandemic, and birth rates have declined dramatically during it. The world will most likely continue to struggle with debt sustainability and real growth. Looking forward, we believe capital market returns will be historically low over the next 10 years, substantially trailing their 10- and 15-year historical returns.[2] Finding alpha during a difficult market environment will become increasingly important for driving long-term results. The opportunity for alpha generation for active managers that invest over a complete market cycle could be powerful, especially those who view investments through multiple lenses, or take what we call an Active 360° perspective. Moreover, given the concentration of US equity indices and high valuations, we believe that investors should consider a focus on risk management and mitigating downside risk, as active managers do.

Active managers deliver in tough markets

Strength in stocks and bonds over the past decade has coincided with a large shift from active to passive management. The move suggests a desire on the part of some to reduce fees; for others, the move has reflected that many active managers have trailed their benchmarks. However, looking back at the 20-year period from 2001 to 2020, active managers generally performed better in tough markets (Exhibit 1). Put another way, active managers have proven their worth on the downside. We feel that given the current environment and likelihood of more volatility, the ability to preserve capital in rough markets will be key to driving excess returns over a full market cycle.

Exhibit 1: Active managers generally performed better in tough markets

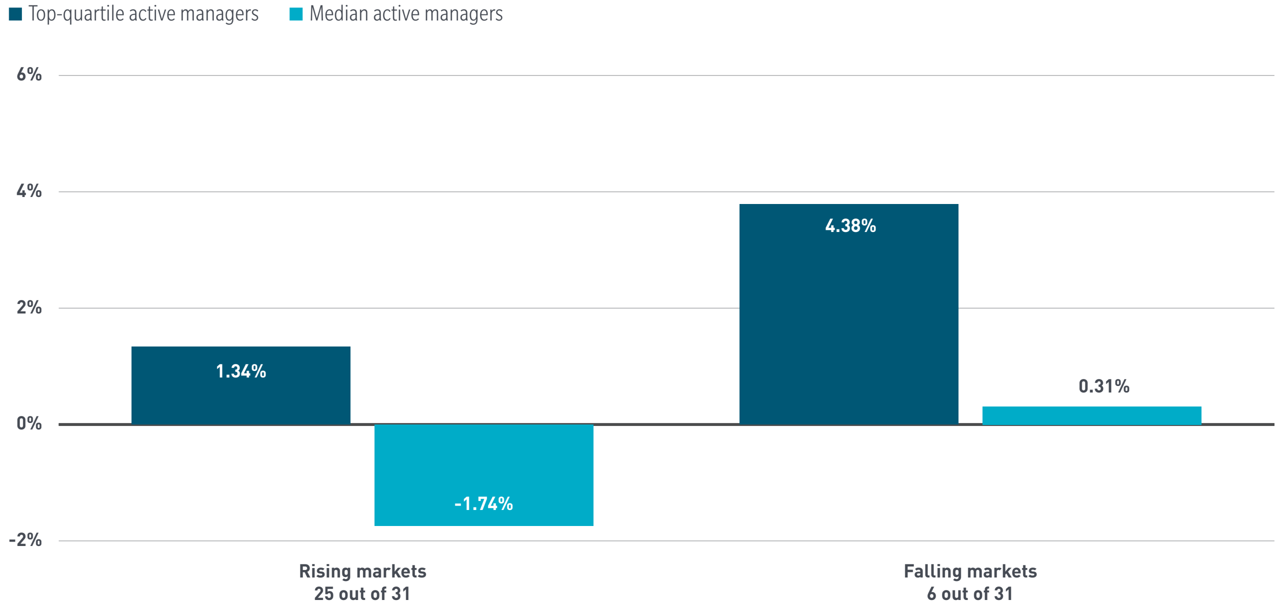


Source: Strategas Research Partners, December 2020. Analysis is based on US-based large-cap mutual funds from the Morningstar Large Blend Category, examining each calendar year (2001 to 2020) and identifying the percentage of managers that outperformed the S&P 500 TR Index during each year. Analysis includes all share classes and excludes index funds, net of fees. S&P 500 stock index measures the broad U.S. stock market. Index returns do not take into account investment related fees or expenses. It is not possible to invest directly in an index. Past performance is no guarantee of future results.

Active skill and risk management matters

More to the point, not all active managers are created equal. As Exhibit 2 shows, from 1991 to 2020, top-quartile active managers added value above the S&P 500 Index in all market environments. In rising markets, median managers have typically had trouble keeping up with skilled managers, while top-quartile active managers have added value in up markets, and more important in our view, shone in down markets. In poor markets, active risk management has been rewarded, a process that is less robust in passive portfolios. For example, active managers select securities rather than "owning the index" and can avoid companies or industries with low-quality, unsustainable earnings. Passive does not allow the same risk assessment. In other words, what you don't own is just as important as what you do.

Exhibit 2: Top-quartile managers outperformed in rising and falling markets



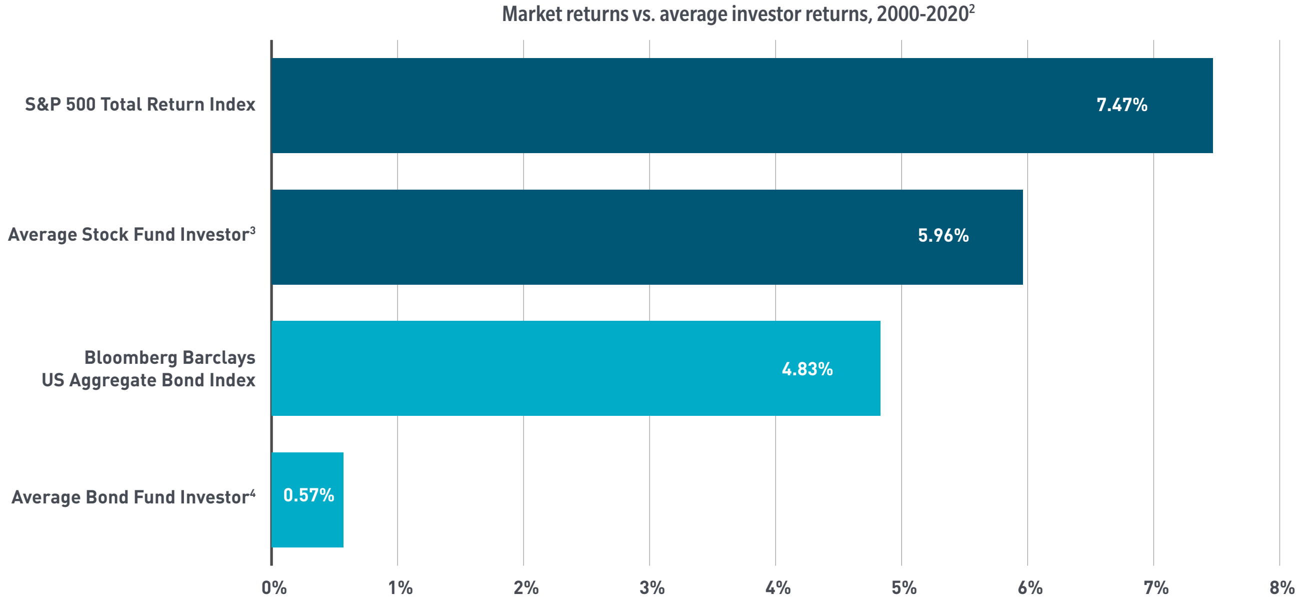
Source: Analysis using Morningstar data. Excess returns of top quartile (25th percentile) and median (50th percentile) active managers taken from the Morningstar Large Blend Category, 1991 to 2020. Rising and falling markets based on calendar year returns when the S&P 500 Index rose or fell (1991 to 2020). Excess returns, net of all fees (including 12b-1) but excluding sales charges, calculated against the S&P 500 TR Index. Analysis covers all share classes and excludes index funds. The falling markets are 1990, 2000, 2001, 2002, 2008 and 2018. Past performance is no guarantee of future results.

At MFS, rather than chasing short-term gains, we actively manage risk when the markets are inefficient and seek to add value by managing volatility and navigating changing market cycles more effectively. Because if you can lose less value in a down market, you can begin to grow it from that higher capital base. That is how you compound long-term returns and how we believe investors should be thinking about risk today.

Short-termism: Why has the average investor underperformed?

It is a fact that even skilled active managers underperform at times. This can be challenging for investors. Studies by DALBAR, Inc. have shown that investors' decisions to buy, sell and switch in and out of mutual funds have consistently resulted in substantial underperformance. As illustrated in Exhibit 3 below, when investors tried to protect their portfolios by market timing, they often limited gains and increased losses instead.

Exhibit 3: Timing the market rarely works: The average investor underperformed[1]



Source: Dalbar, 2021 QAIB Report, as of December 31, 2020. This example is for illustrative purposes only and is not intended to represent the future performance of any MFS® product. Although the data are gathered from sources believed to be reliable, MFS cannot guarantee the accuracy and/or completeness of the information. **Bloomberg Barclays U.S. Aggregate Bond Index** measures the US bond market. The **S&P 500** measures the US stock market. It is not possible to invest in an index. Past performance is no guarantee of future results.

[1]Average Investor refers to the universe of all mutual funds investors whose actions and financial results are restated to represent a single investor. This approach allows the entire universe of mutual funds investors to be used as the statistical sample, ensuring ultimate reliability.

[2]Average investor return performance: Methodology — QAIB calculates investor returns as the change in assets, after excluding sales, redemptions, and exchanges. This method of calculation captures realized and unrealized capital gains, dividends, interest, trading costs, sales charges, fees, expenses and any other costs. After calculating investor returns in dollar terms, two percentages are calculated: total investor rate for the period and annualized investor return rate. Total return rate is determined by calculating the investor return dollars as a percentage of the net assets, sales, redemptions and exchanges for the period. Annualized return rate is calculated as the uniform rate that can be compounded annually for the period under consideration to produce the investor return dollars.

[3]Average Stock Fund Investor comprises a universe of both domestic and world equity mutual funds. It includes growth, sector, alternative strategy, value, blend emerging markets, global equity, international equity and regional equity.

[4] Average Bond Fund Investor comprises a universe of fixed income mutual funds, which includes investment- grade, high-yield, government, municipal, multisector and global bond funds. It does not include money market funds.

All investments, including mutual funds, carry a certain amount of risk, including possible loss of principal amount invested.

We think that a misalignment of time horizons is one of the reasons why. Most skilled active managers look to generate consistent alpha over a full market cycle, which typically takes 7 to 10 years.[3] However, the industry has anchored around three- and five-year performance time periods to assess skill. In reality, a three-year time period is less than half of the historical time period of a full market cycle. Apparently, while a majority of institutional investors know this, few will tolerate negative alpha on a three-year basis,[4] yet when discussing objectives, few financial professionals or asset managers discuss the metrics for measuring skill and the time frame of a "full" market cycle. To us, however, it does make sense to discuss the use of longer-term-performance time periods when assessing skill.

The misalignment makes even less sense when you look at the time horizon associated with most investors' reason for investing — typically saving for retirement (Exhibit 4). The average asset-weighted holding period for a US equity manager is only 2.3 years. While this does align with a 1- to 3-year performance period, it does not align with investors' long-term goals. MFS' average asset-weighted holding period for US-registered funds is almost double the industry average and thus more closely aligned with investor goals. We have high confidence in our long-term performance, where fundamentals typically prevail. We feel market sentiment, rather than fundamentals, is more likely to drive what our performance will look like over the next quarter or year.

Investors may be better served by developing a tolerance for underperformance — what we call countercyclical courage — that may potentially lead to more value creation and a better outcome over time. When markets sell off, good active managers often use weakness as a rationale for buying when they have conviction in a company and the patience to ignore market noise and wait for a potential rebound. The COVID-related downturn is a prime example and demonstrates what separates above-average active managers from median managers. MFS investment teams understand their companies, their operations and their best- and worst-case scenarios. During a downturn, our teams can quickly assess what has changed and which companies are attractive long-term buying opportunities. To take advantage of a decline, your analysis — especially scenario modeling — needs to be in place. If you wait until volatility occurs to analyze companies, you will be too late.

Exhibit 4: Long-term horizon clashes with short-term investing

[1] MSCI, as of 12/14.
[2] Based on the MFS US Retail Equity Funds, as of 12/31/2020. Please see mfs.com for individual fund information. The MFS US-registered funds are generally available only to US residents with a valid US tax identification number (and to certain other qualified investors). Holding horizons vary by fund and are calculated differently than holding period. Holding horizons for MFS and the average equity manager are based on the inverse turnover calculation (100/1 year turnover). Turnover methodology: (Lesser of Purchase or Sales)/Average Market Value of the Date Range.
[3] Annual DALBAR Quantitative Analysis of Investor Behavior Study, 2021.
[4] Morningstar (US) Equity Categories, ex index funds and fund of funds, as of 12/31/2020.

Identifying skilled active managers

While it may sound simple, separating skill from luck is anything but. In our recent Compass Survey, only 30% of institutional investors indicated they could tell the difference between a skilled active manager and an average one.[5] We believe that skilled active managers — those who demonstrate conviction through high active share and long holding periods, manage risk thoughtfully and bring together different perspectives — can add value in all markets environments. MFS has always adhered to this philosophy and a single purpose: to create value by allocating capital responsibly for clients.

Active 360° approach

Our investment process is predicated on bringing teams of equity, fixed income and quantitative analysts together to share and respectfully challenge ideas. We call this our Active 360° approach and believe that analyzing investments from all angles leads to the best investment ideas for our clients. A core tenet of this approach is believing that long-term active management is synonymous with sustainability investing; in order for a company to generate durable earnings over time, it must be sustainable from both a financial and ESG perspective. So rather than approach sustainable investing as a separate practice or product, MFS has integrated material ESG factors into our research process; it is how we analyze investments from a 360° perspective. As an active manager, we believe this drives long-term returns and is a critical part of being good stewards of capital and investing responsibly.

Allocating capital responsibly also relies on a differentiated investment process and culture. At MFS, our process and culture are built on three distinct pillars: collective expertise, active risk management and long-term discipline.

Collective expertise

We believe that teams of diverse thinkers contributing different perspectives and actively debating them within a shared value system are more likely to understand and incorporate all financially material factors, enabling better investment outcomes. The goal of our investment teams is to uncover sustainable opportunities or identify pitfalls that other managers may have missed. Our investors engage directly with the companies we own to understand what could impact the sustainable value of those companies, and they exercise our voting power to influence issues that matter.

Active risk management

Our risk aware culture leads us to try to understand which risks — whether fundamental, secular, macroeconomic or ESG — are material to a company's long-term sustainability (not just noise) and how those risks may evolve over time. It is thinking through the risks that you see and trying to anticipate those you don't — *e.g.*, the coronavirus. We believe the pandemic will likely have long-lasting impacts on governments, consumers, companies and industries. In this uncertain environment, active risk management is essential in both accurately assessing risks and avoiding entities that may stumble or fail. And we cannot stress this enough: Owning the index — passive — does not allow for the same risk assessment.

Risk management is also about understanding how the risks we anticipate compare with the risks our clients are taking. In other words, we leverage our risk capabilities to fully understand the risks inherent in clients' portfolios, because we recognize that for our clients, how you get there is just as important as getting there. That is why we closely monitor capacity management and close strategies to help protect the interests of clients and the management of the long-term performance of their assets.

Our focus on the long term has been part of our history for nearly a century, and we actually believe it is synonymous with sustainability and investing.

Long-term discipline

MFS believes in long-term thinking for two reasons. First, because we think that it aligns better with our client's goals and leads to better investment outcomes. We focus on factors that create a sustainable enterprise capable of driving long-term returns rather than short-term gains, factors such as unit growth, pricing power, durable competitive advantages, free cash flow, debt levels, financial materiality and management strength, to name a few. The second reason we believe in long-term thinking is time horizon. By holding stocks for longer, we take advantage of the greater return dispersion between the best- and worst-performing stocks and the potential to improve returns for investors. The strength of our research, garnered through collective expertise, gives us the conviction and patience to let investment ideas play out over time. Compensation for investment teams reflects this: We reward our teams for long-term performance, not for chasing short-term gains.

Conclusion

In our view, skilled active management is a critical component of any investment portfolio and especially relevant in the current environment. As active managers, we strive to identify companies that can sustain a competitive advantage over the long term. For us, active management is our culture, our DNA and how we create long-term value for our clients responsibly. At a time when the industry is facing pressure and consolidation, our focus is on allocating capital responsibly over the long term for the end investor, period. We operate from a position of strength — our process, our people and our clarity of purpose — as we seek the best investment ideas for the benefit of our clients. For nearly a century, we have aligned our active investment approach with the way we serve clients: bring together different perspectives, have conviction in our investment ideas and thoughtfully manage risk, all with the goal of delivering long-term, sustainable outcomes for clients. In other words, we have taken an Active 360° approach.

Endnotes

[1] Source: Bernstein. Monthly data from 31 January 1881 to 28 February 2021.

[2] Annualized return over the next 10 years. *MFS Long-Term Capital Market Expectations*, January 2021.

[3] Source: "Defining a Market Cycle," Manning & Napier.

[4] Source: May 2021 MFS Institutional Investor Compass (including 540 global institutional investors). (Q) How long are you willing to tolerate the underperformance of active asset managers?

[5] Source: May 2021 MFS Institutional Investor Compass (including 540 global institutional investors). Source: May 2021 MFS Institutional Investor Compass (including 540 global institutional investors). Source: May 2021 MFS Institutional Investor Compass (including 540 global institutional investors).

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