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Does Active U.S. Equity Management Have a Future?

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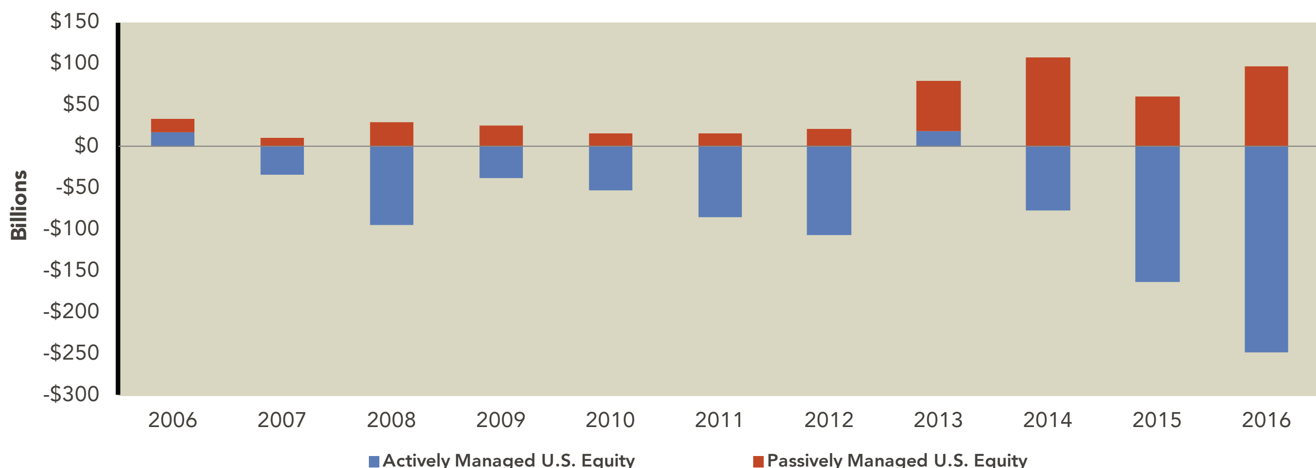
Active vs. Passive

To this day, significant debate continues about the topic of active versus passive investing in U.S. equities, with the discussion typically centering on the fundamental question of "Is the market efficient?" Active investors believe that the market is inefficient and an informational advantage can lead them to identify investments that will beat their respective indices. Critically, active investing features human judgment with respect to a company's relative attractiveness and profit realization over an investment horizon. Passive investors, on the other hand, believe the market is efficient and that stock prices reflect all available information which could affect their prices. If markets are truly efficient, then a diversified, low-cost exposure to an asset class would be the best course of action.

Passive's Growing Momentum

Over the past several years, a significant amount of pressure on active strategies has emerged as a result of continued underperformance versus their benchmarks. A further contributor to the pressure is asset flows: $864 billion has moved out of active U.S. equity strategies since 2006, while passive strategies have gained nearly $460 billion during this time frame. Strong passive flows can have a negative effect on active performance given that stocks are unable to differentiate themselves on fundamental factors. When passive strategies see inflows, all stocks in an index are purchased and see support. This can have a material impact on stocks with limited trading volume, thus being more of an issue in small-cap versus mid or large-cap.

Exhibit 1: Active/Passive Fund Flows 2006-2016



Source: Morningstar Direct

Despite these facts, a first cut of the data suggests that over the last ten years, the majority of active strategies have outperformed their respective indices. It is important to note, however, that the data below suffers from survivorship bias: Firms or strategies with poor performance cease to exist and are no longer included within the universe's performance calculation. This bias may result in an overestimation of the investment management industry's ability, as a whole, to outperform its respective indices.

While Exhibit 2 makes the case for active management appear favorable, it is important to realize that investment styles cycle in and out of favor over the course of a market cycle. This means that the likelihood of an active investment strategy consistently outperforming its benchmark year after year is quite unlikely.

Exhibit 2: % of active manager outperformance, 10-yr trailing basis

	Value	Core	Growth
Large	77	61	41
Mid	70	74	59
Small	93	78	62

Source: eVestment. Gross of fees. 1,354 products included. Data as of 12/31/2016

Furthermore, the table above is reported on a gross of fees basis, which distorts the amount of outperformance from actively managed funds, because the investor will only receive returns that are net of all fees. For example, the median large-cap value and small-cap value fees for a separately managed account are 65 and 100 basis points, respectively. This represents a hurdle over the benchmark which active strategies must surpass to justify their efforts.

The tables below highlight two calendar years, 2016 and 2006, when active management was especially challenged. In fact, 2016 was the worst year for active management underperformance since 2006. Only 23% of large-cap value strategies and 15% of small-cap value strategies outperformed their respective benchmarks. This represents the worst showing for active management within the nine U.S. equity style boxes. Interestingly, these two style boxes lagged in 2006 as well.

Exhibit 3: % of active manager outperformance – 2016 and 2006 calendar years

2016 Calendar Year

	Value	Core	Growth
Large	23	29	24
Mid	39	43	32
Small	15	41	44

2006 Calendar Year

	Value	Core	Growth
Large	15	45	48
Mid	18	27	40
Small	14	24	38

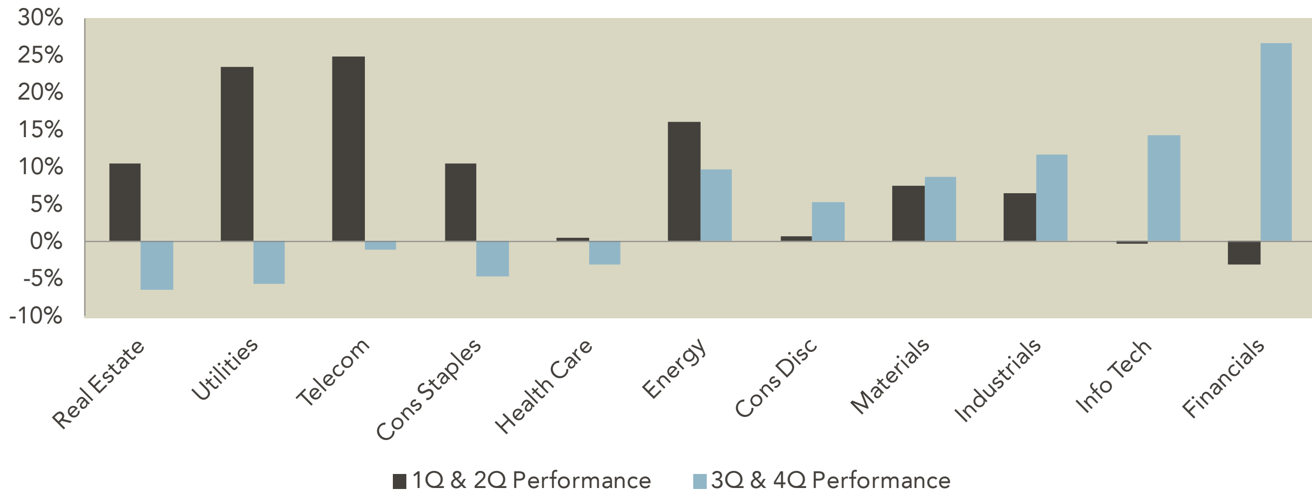
Source: eVestment. Gross of fees. 1,791 products included in 2016. 2,906 products included in 2006. Data as of 12/31/2016

2016: An Especially Difficult Year for Active

U.S. equity performance in 2016 can best be described as tumultuous with investor sentiment shifting frequently. Stocks experienced a sharp sell off at the beginning of the year with defensive, yield-oriented sectors rallying through the first half of the year. Being underweight these best performing sectors was a large detractor to active

performance during the first half of 2016. As economic growth accelerated in the third quarter, sector leadership rotated from defensive to cyclical outperformance over the second half of 2016. Some active strategies made up some of the lost ground during the second half, but largely not enough to outperform for the year.

Exhibit 4: Changing Sector Leadership in 2016

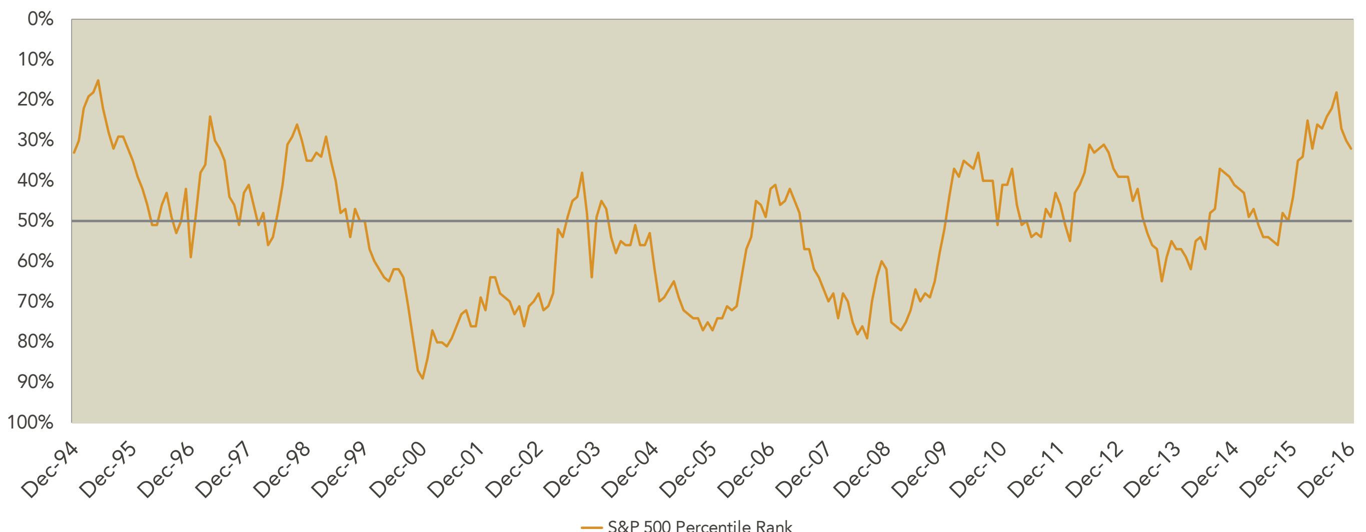


Source: Morningstar Direct

Several factors contributed to active underperformance during 2016:

- Active strategies tended to underweight defensive, yield-oriented sectors (such as consumer staples, REITs, Telecom, and Utilities) based on valuations and limited growth potential.
- Active strategies can hold up to 5% in cash which acts as a drag on performance during up markets.
- Active strategies generally equal weight portfolios rather than market cap weight their portfolios as occurs in most indices.
- Active strategies often hold out-of-benchmark holdings which may not find the support from passive flows that benchmark holdings receive. Additionally, these out-of-benchmark holdings within U.S. equity strategies are frequently non-U.S. stocks which underperformed their U.S. counterparts in 2016.

Exhibit 5: Has the Passive Pendulum Swung Too Far?



Source: eVestment

While the benchmarks have outperformed most active managers recently, it is important to remember that active management generally experienced better results during the credit crisis of 2007 and 2008 by protecting in a down market. This improved performance followed a difficult environment in 2006 for active management, thus highlighting how active manager outperformance can fluctuate year to year. With equity valuations near all-time highs, active management's ability to generate value-add through downside protection remains an attractive feature.

Exhibit 6: % of active manager outperformance – 2007 and 2008 calendar years

2007 Calendar Year

	Value	Core	Growth
Large	77	68	65
Mid	78	67	77
Small	81	65	63

2008 Calendar Year

	Value	Core	Growth
Large	63	69	46
Mid	63	67	58
Small	28	39	30

Source: eVestment. Gross of fees. 2,905 products included in 2007. 2,906 products in 2008. Data as of 12/31/2016

Conclusion

Given that active strategies can suffer from sustained periods of underperformance, the ability of a passive allocation to consistently deliver market returns is an attractive feature for client portfolios. We typically recommend clients maintain some low-cost index exposure in their U.S. equity composites, particularly for the more efficient sectors of the market. However, history suggests that active management can still deliver outperformance, especially with valuations near all-time highs. Thus despite recent struggles, active management allows investors to diversify exposure within an asset class and add some downside protection in the event of a market correction.

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