INVESTMENT BRIEF

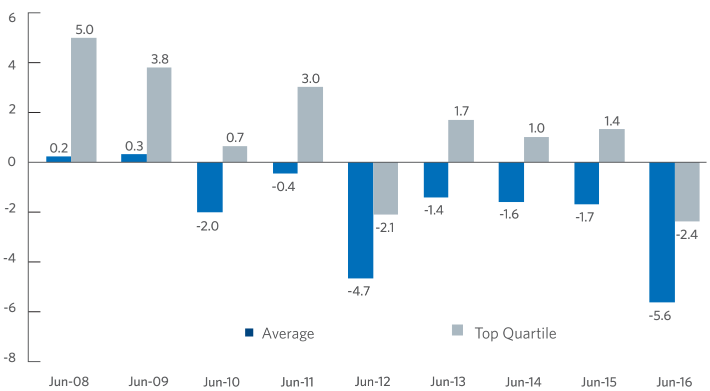
Q3 2016

Strategic Investment Group®

Tough Times for Active Management

In the best of times, adding value through active management is a difficult feat achieved consistently by very few highly skilled managers. This year has been especially challenging, as the vast majority of actively managed U.S. equity portfolios have underperformed. This unenviable record extends across large and small cap managers, those specializing in growth and value stocks, as well as both fundamental and quantitative strategies. Even top quartile active managers have trailed their benchmarks. The one-year period ending in June 2016 was the worst for active U.S. equity mutual funds in the past nine years, based on an equal-weighted average of all styles (Exhibit).

EXHIBIT:
Average U.S. Equity Mutual Fund Value Added (%)
June 2008 - June 2016
Sources: SPIVA Scorecard Mid-Year Reports 2008 - 2016, Strategic.



A similar, though somewhat less pronounced, record of broad based underperformance is apparent across non-U.S. equity managers, U.S. fixed income strategies, and hedge funds. Discouraged by this poor performance, investors have shifted assets away from active managers in favor of passive strategies, triggering sizeable flows.

This year, a number of factors have contributed to the difficult environment for active managers: the predominance of macroeconomic forces over fundamentals, significant leadership rotation, distortions created by the search for yield, outflows from active strategies, misplaced sector overweights, and idiosyncratic events hurting favorite holdings of active managers.

Of these factors, the predominance of macroeconomic forces is perhaps the most important. The share of market volatility attributable to macro causes has been at a very high level for much of the year, while fundamentals have explained only a small proportion of market movements.

Throughout the year, global equity and credit markets have fallen prey to wide swings in sentiment and momentum reversals across asset classes, regions, capitalizations, styles, and factors. These shifts have been driven largely by worries about Fed missteps, the risk of a hard landing in China, the implications of low oil prices, the late stage of the credit cycle in emerging markets, and uncertainties created by the unexpected Brexit vote.

Ebbs and flows in the intensity of investor concern about these issues have been mirrored in sharp asset price movements. As a result, the cross-correlation of stock returns has been at very high levels, with the highest correlations evident in the two places with the most accommodative monetary policies, Europe and Japan. Active managers, and in particular quantitative strategies, underperformed in large part because they were wrong-footed by abrupt and highly correlated reversals across a wide range of factors.

The relative performance of fundamental managers was also spoiled by these market dynamics. In addition, distortions created by the search for yield compounded their difficulties. Active bond managers who took a cautious approach to interest rate sensitivity because of valuation concerns suffered as yields fell further from very low levels throughout much of the year, touching all-time lows in many markets in July. In the equity markets, record low interest rates induced yield-seeking investors to bid up high dividend stocks, including utilities, telecom, REITs, and other bond-like equity investments typically not favored by active fundamental managers. As a result, valuations in those sectors spiked despite their low growth expectations.

In this environment, low quality and high beta stocks have trounced those with sounder fundamentals, adding to active managers' woes. Quality stocks – those with robust balance sheets, strong profitability, and resilient earnings growth – lagged the market, further confounding fundamental managers focused on valuations. In addition, idiosyncratic underperformance in an unusually large number of popular active positions also hurt active equity and hedge fund managers.

Brighter Days on the Horizon

Although the decoupling of market prices from fundamentals has bedeviled active managers in 2016, this year's market dynamics are sowing the seeds of their own destruction by increasing dispersion in the valuations of securities within and across markets. Wider valuation dispersion augurs well for active quantitative and fundamental managers seeking to take advantage of mispriced securities. It sets up new opportunities.

We have already begun to see a rebound in performance among active managers and expect skilled active managers to continue to exploit dispersion to add value. The tough times for active management experienced throughout much of the year do not shake our belief that price follows value. History has shown that patient strategies focused on fundamental valuations prevail in the long run.

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