

ACTIVE VS. PASSIVE

The Age-Old Debate

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Executive Summary

- Active management results tend to be cyclical; history shows that past out-of-favor periods were followed by strong reversals.
- Active management results vary with the direction and magnitude of market performance; and although passive management captures the upside movements of stocks, it also realizes all of the downside risk.
- Should we rethink active management as a strategy that ideally would self-adapt to changing market conditions?

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According to Morningstar, actively managed U.S. equity funds experienced \$98.4 billion of outflows while passive U.S. equity funds received \$166.6 billion in 2014.

Articles and discussions focused on the benefits and shortcomings of active versus passive investing have proliferated recently.

The debate rages on.

Many active managers have disappointed over recent years resulting in numerous investors steadily shifting assets to passive strategies. According to the Investment Company Institute, from 2007 through 2013, indexed U.S. equity mutual funds and ETFs received \$795 billion of net inflows while actively managed U.S. equity mutual funds experienced net outflows of \$575 billion.* According to Morningstar, actively managed U.S. equity funds experienced \$98.4 billion of outflows while passive U.S. equity funds received \$166.6 billion in 2014. Actively managed funds still hold the majority of assets worldwide; however, passive investing is gaining market share at a rapid pace.

But is this the right time to make an active decision to go passive?

Active management results tend to be cyclical

Many U.S. active managers underperformed in 2014: 54% within the eVestment U.S. Large Cap universe underperformed the Russell 1000 Index and 61% underperformed the S&P 500 Index. While U.S. large-cap growth stocks, as an asset class, posted very strong returns in 2014, only 35% of U.S. large-cap growth managers outperformed the Russell 1000 Growth Index and only 15% outperformed the S&P 500 Growth Index.¹ Global and non-U.S. equity strategies were notably better in 2014, but have not been void of disappointment. In light of these results, the popularity of passive strategies is expected to increase.

While many active managers failed to generate excess returns in recent years, empirical evidence shows that active management results tend to be cyclical and past out-of-favor periods have been followed by strong performance reversals.

* Source: Investment Company Institute

¹ The exhibits illustrated in this paper show returns gross of fees based on the eVestment database, which is an institutional database. Managers tend to populate the returns of their composite gross of fees since the level of fees applied to an institutional mandate is dependent on several factors, including the size of the mandate and the specific agreement between the two parties. While the database population rate is significantly lower for net of fees performance reporting, similar analysis was completed on a net of fees basis that also validated that active management is cyclical, and performance is influenced by the direction and magnitude of the market performance.

This is illustrated from an analysis of ranking an index (i.e. benchmark) over time in its respective active-management equity universe. As demonstrated in exhibit 1, the ranking of the index, which also corresponds to the percentage of active managers outperforming, appears to be very cyclical.

For example, following a challenging period for active managers in the late '90s, from 2000 to 2010, more than half of the active managers (eVestment U.S. Large Cap Universe) outperformed the Russell 1000 Index on a rolling

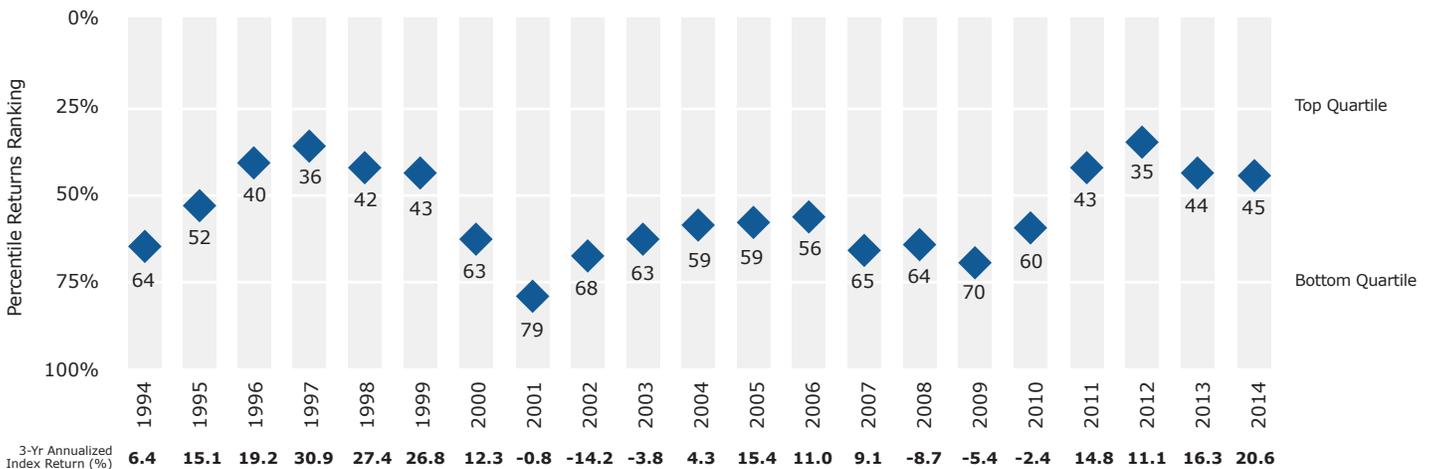
three-year basis (exhibit 1). Recent active-management results demonstrate a striking resemblance to what was observed during the late '90s. Effectively, on a rolling three-year basis, since 2011, more than half of U.S. large-cap active managers have been underperforming the Russell 1000 Index.

While challenging periods for active global equity strategies have been shorter in duration and less frequent, a similar analysis of the eVestment Global Large Cap universe illustrates that the ability for active global equity managers to outperform the MSCI World Index has been cyclical as well.

EXHIBIT 1

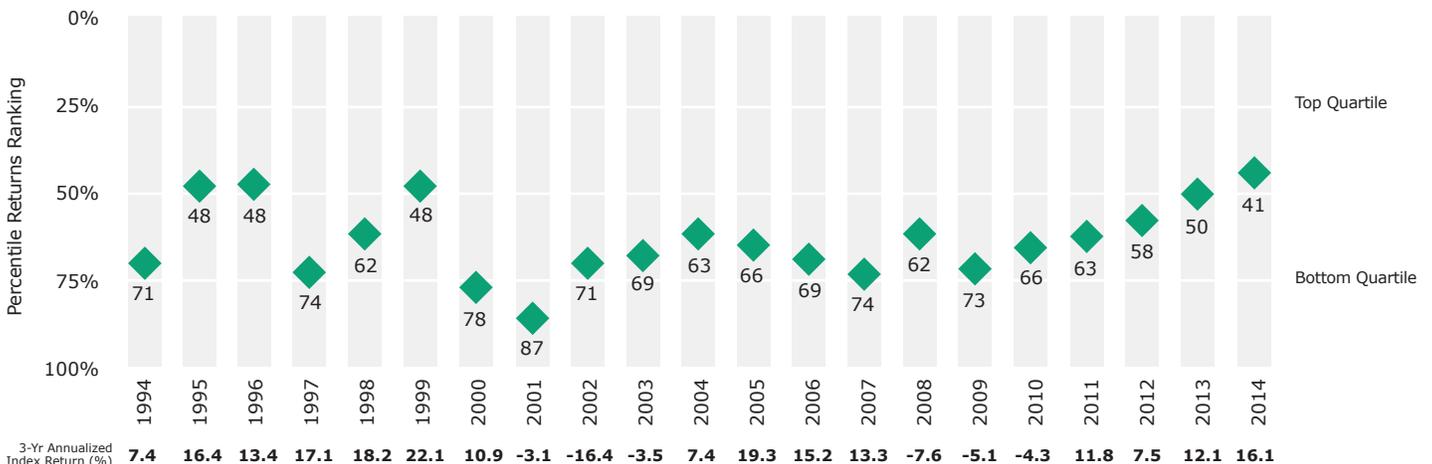
RUSSELL 1000 INDEX RANKING

Rolling 3-Year Ranking – eVestment U.S. Large Cap Equity Universe



MSCI WORLD INDEX RANKING

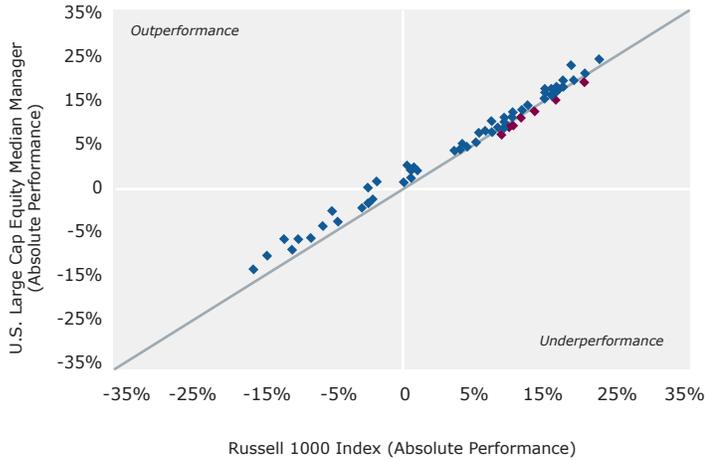
Rolling 3-Year Ranking – eVestment Global Large Cap Equity Universe



**EXHIBIT 2
MEDIAN MANAGER RETURN VS. RUSSELL 1000 INDEX
EVESTMENT U.S. LARGE CAP EQUITY UNIVERSE**

December 31, 1994 - December 31, 2014
(Rolling 3-Year Data)*

Annualized rolling three-year performance



The median manager tends to outperform when the market is down and tends to underperform when index performance is strong.

Active management results and market direction

Performance by active managers not only appears to be cyclical, but often tends to be influenced by the direction and magnitude of market performance.

The analysis in exhibits 2 and 3 compares the rolling three-year performance of the median active manager² in the eVestment U.S. Large Cap universe and Global Large Cap universe with the Russell 1000 Index and MSCI World Index, respectively. The relationship between market absolute return and the ability for active managers to outperform the equity market is striking. Active managers tend to do better in moderately up markets or down markets and tend to underperform in strongly up markets. For example, exhibit 2 illustrates that the median

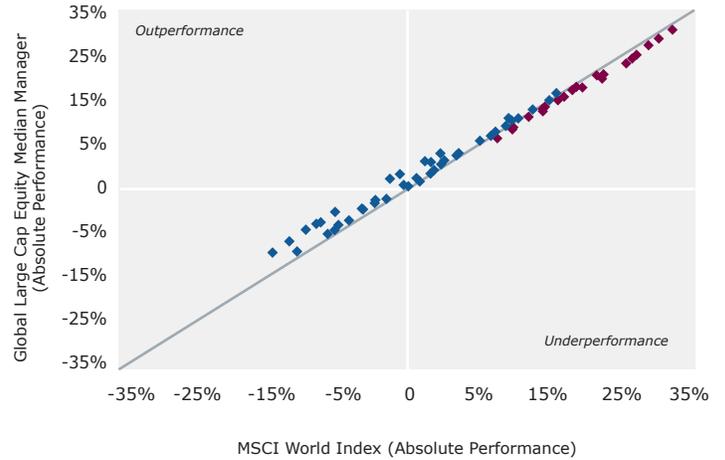
² Recurring investment in the median active manager is hypothetical and does not represent the return of any actual investment.

*Source: eVestment

**EXHIBIT 3
MEDIAN MANAGER RETURN VS. MSCI WORLD INDEX
EVESTMENT GLOBAL LARGE CAP EQUITY UNIVERSE**

December 31, 1994 - December 31, 2014
(Rolling 3-Year Data)*

Annualized rolling three-year performance

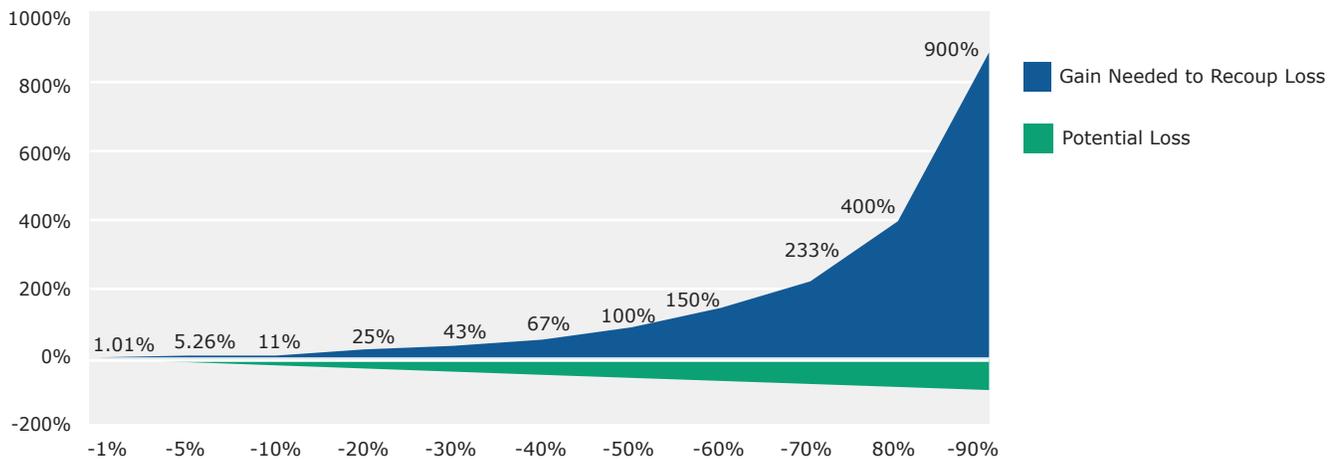


The median manager tends to outperform when the market is down and has only underperformed when index performance is strong.

U.S. Large Cap Equity manager outperformed the Russell 1000 Index, in all annualized rolling three-year periods, when the absolute performance of the Russell 1000 Index was less than 11.1%. Consistent results can be observed in global markets (exhibit 3), where the median Global Large Cap Equity manager outperformed the MSCI World Index, in all annualized rolling three-year periods, when the absolute performance for the Index was less than 12.2%.

In 2014, the U.S. stock market closed its sixth-consecutive year of annual gains, and has not experienced a correction of at least 10% for more than three years. As of the end of 2014, the annualized three-year return for the Russell 1000 Index was a whopping 20.6%, and the annualized three-year return for the MSCI World Index was 16.1%. Historically, in this kind of market environment, it has been very difficult for active managers to outperform.

EXHIBIT 4
IMPLICATION OF A SIGNIFICANT MARKET DRAWDOWN



Should we rethink active management?

By not realizing all the downside, skilled active managers tend to outperform over the long term regardless of the cyclical headwinds in sharply rising markets. Exhibit 4 illustrates that the gain needed to break even after various levels of market absolute loss increases substantially with the magnitude of the drawdown. For example, a market drawdown of 50%, as experienced during the 2008 Global Financial Crisis, requires a subsequent return of 100% just to get back to the initial investment and break even. Due to the effect of compounding, limiting losses during a market downturn has the potential to increase a portfolio’s return over the long term. Identifying a strategy that has the potential to outperform in down and modestly rising markets is essential in helping investors to meet their long-term investing goals. As a result, absolute-risk strategies are gaining in popularity. These strategies provide exposure to the equity market with a lower level of volatility regardless of the market environment. In periods of crisis, the greater volatility reduction a portfolio can provide, the better. However, in a sustained bull market, too much volatility reduction may not be needed and is likely to sacrifice returns.

Ideally, investors would like to benefit in all market environments.

Dynamically adjusting the level of risk reduction in their portfolios to become more defensive during crisis periods, and more *active* during normal market conditions, would be the preferred scenario. Constructing a portfolio that adapts to the level of market volatility as a result of dynamic risk reduction offers the potential for a proper balance between capital appreciation and capital preservation. Intech® has developed adaptive volatility portfolios that aim to achieve this dynamic volatility reduction based exclusively on volatility estimates without forecasting market or stock returns. (For more information on the Intech® Adaptive Volatility approach, please refer to its Thought Leadership paper “Smart Volatility Management in a Risk On/Risk Off World,” written by Drs. Adrian Banner and Vassilios Papathanakos.)

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What now?

Active-management results tend to be cyclical and active-management success is often influenced by the direction and magnitude of market performance. A skilled manager can potentially add value over time, particularly during down markets. After all, the risk that investors are the most concerned about tends to be the risk of losing money rather than underperforming an index in a strong bull market. Passive management is only as safe as the asset class it aims to replicate, and market risk can be significant at times. A passive implementation means that investors take on market risk in full while an active manager has the ability to potentially mitigate some of the market risk through its investment decisions.

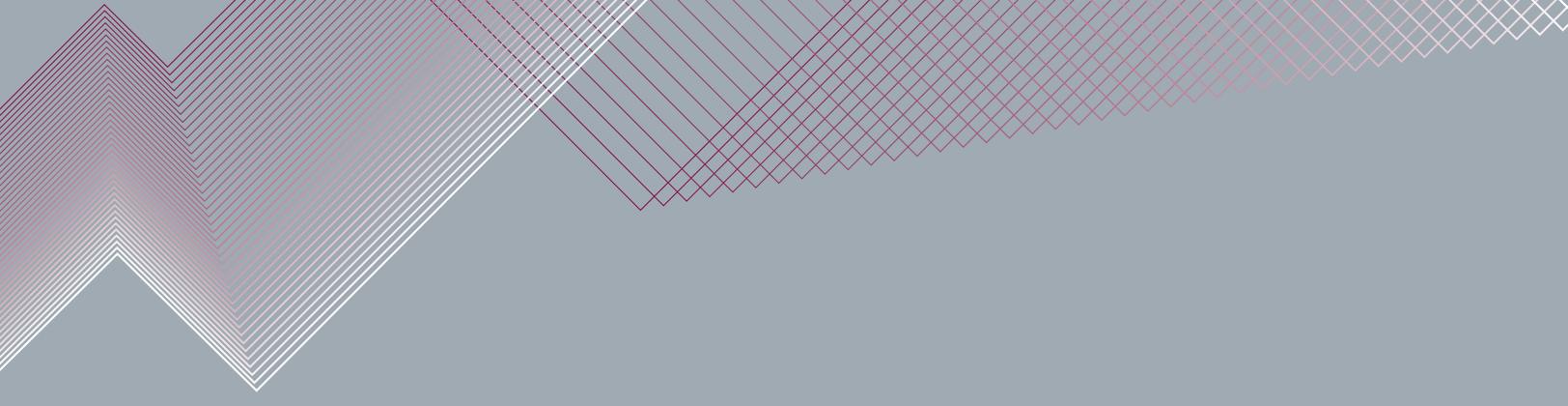
Given where we are in the active-management cycle and following the very strong performance of equity markets, it may be shortsighted to make an active decision to exit active management at this time. As long as the confidence in a manager's investment process, team and alpha source remains strong, a shift to passive could impede any recovery once the manager's investment process is back in favor.

Making the active decision to shift to a passive methodology at this time would be to ignore the cyclical nature of market trends. If investors made the decision to go passive in 1999 after a few years of poor results from active management, not only would they have missed out on a strong positive reversal and outperformance by active management, but they would also have realized the full equity market drawdowns during the Tech Wreck and 2008 Global Financial Crisis.

Conclusion

The following summarizes our views on the active versus passive debate:

- **Passive is inefficient:** Passive strategies realize the full downside of the equity markets, while active management has the potential to provide much-needed downside protection, while also participating in the upside.
- **Passive isn't truly passive:** Those who favor or re-allocate towards passive investing are making an ACTIVE decision by betting that active management is going to remain out of favor. Our research on active U.S. large-cap and global equity managers shows that active managers tend to outperform in modestly rising markets and down markets and tend to underperform in sharply rising markets.
- **Don't give up on active:** Active-management results tend to be cyclical and our research on active U.S. large-cap and global equity managers shows that past out-of-favor periods were followed by strong reversals. Additionally, active management of volatility has the potential to provide much needed downside protection during periods of market stress while still participating in the growth that equities may offer over the long term.



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