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Asset Matters: Reframing the Active/Passive Picture

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A fresh perspective provides support for the role of active management in investment portfolios.

With stock markets fueled by extraordinary central bank intervention in the wake of the Great Recession, passive equity strategies have seen great success in performance, fund flows and press coverage. Often overlooked in the haste to declare a victory in the active/passive debate, however, is the fact that active outperformance has persisted across a wide swath of managers over various time periods and market regimes. Looking at active manager performance over a longer time period and excluding managers that would not typically be considered by most investors provides a more meaningful view of the benefits of active management.

The Passive Argument: Missing Pieces

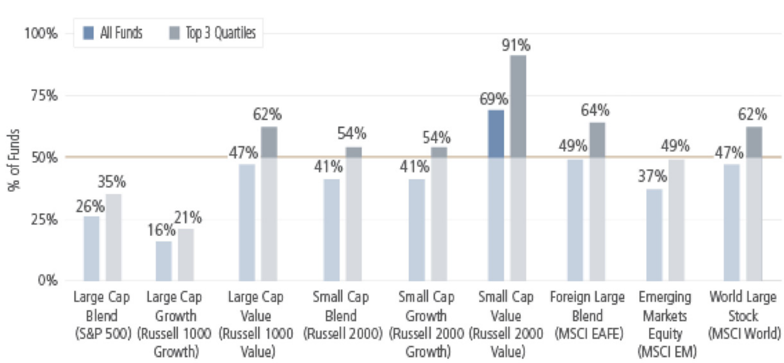
Proponents of passive investing have argued over the past decade that an active approach does not provide above-market returns after fees. Often presented alongside this argument is evidence that typically fewer than 50% of active managers outperform their benchmark indexes after fees over some static period of time. However, we believe this ignores a number of important considerations:

- The bull market that began in 2009 has been significant in terms of both gains and duration. A view across market regimes—not just raging bulls—can show more clearly how different approaches may perform in less frothy environments.
- Static time periods provide only a snapshot of an investment's performance. In contrast, rolling measurement periods (10 years through January, 10 years through February and so on) provide more performance data and may better depict an investor's experience over time.
- Investment categories used to represent active management usually have some bottom-performing funds that skew the numbers to the downside.

The display below depicts a typical argument in support of passive investing—as well as what happens to it once the poorest performers within each equity category are removed from the comparison. While we'd argue that a static time period—particularly one that fails to capture a full market cycle—isn't ideal in evaluating an investment, it is telling how the relative performance of active and passive shifts once the focus is only on those funds with a realistic hope of attracting assets.

A Typical Passive Argument, Reconsidered

Percentage of Active Funds that Have Outperformed the Index after Fees—Past 10 Years

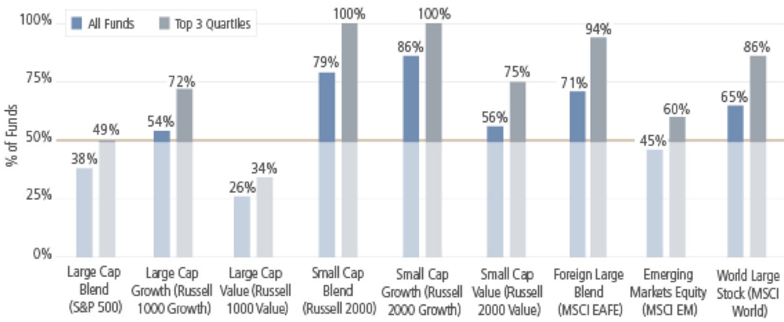


Source: Morningstar. Data as of December 2016. Represents actively managed open-end U.S. domiciled funds. Performance is based on funds' oldest share class. Quartile rank is based on the annualized 10-year returns. Investing entails risks, including possible loss of principal. **Past performance is no guarantee of future results.**

This next display provides another perspective on performance over long, static time periods—and reveals the sometimes staggering benefits that active managers can provide to long-term investors. While the previous chart showed some difficulties for active management during the current market environment, the one below suggests that active has performed quite well over multiple market cycles. Eliminating the bottom quartile of performers provides an even starker contrast between the returns historically provided by active and passive strategies.

A Typical Passive Argument, Reconsidered

Percentage of Active Funds that Have Outperformed the Index after Fees—**Past 20 Years**



Source: Morningstar. Data as of December 2016. Represents actively managed open-end U.S. domiciled funds. Performance is based on funds' oldest share class. Quartile rank is based on the annualized 20-year returns. Investing entails risks, including possible loss of principal. **Past performance is no guarantee of future results.**

Reframing the Debate

We think it's important to frame the active/passive comparison to reflect the nuances of an average investor's experience over time. A few elements seem critical to any realistic comparison of active and passive performance:

- **The analysis should emphasize those funds investors tend to favor.** Over the years, investors have overwhelmingly directed their investment flows into top-rated funds (i.e., those rated four or five stars), a trend that has intensified since the Great Recession.
- **Performance should be evaluated over multiple market cycles.** A measurement period beginning in January 1997 captures both bull and bear market periods, including the technology and financial bubbles.
- **More data is better.** Performance should be considered over many time periods instead of only one period that may differ dramatically from the norm. For example, rolling five-year and 10-year periods beginning in January 1997 capture 181 and 121 unique time periods, respectively, providing a more comprehensive view of an investment's performance.

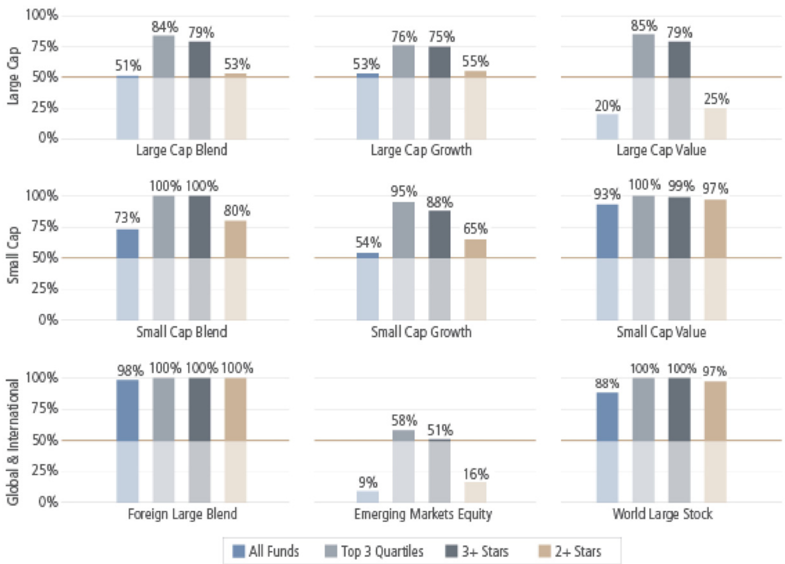
With historical fund flows in mind, we sought to narrow the universe of funds to better represent those that investors have generally targeted. While most of the past decade has been challenging for active managers overall, removing only a small subset of the poorest-performing funds results in a universe whose average return generally beat the index after fees.

However, eliminating that small group is only one way to reframe the active/passive argument to better reflect the average investor's experience; the display below incorporates the impact of rolling returns over a 20-year period that captures up, down and sideways markets. It considers the performance of active managers versus their benchmarks based on 10-year rolling returns since 1997, revealing that:

- Even considering the entire universe of equity funds, active managers beat their respective indexes, after fees, more often than not in all but two categories.
- Removing the bottom quartile in each category improved active's success rate significantly. For all nine categories, it outperformed more than half the time in this scenario, *with eight beating the index in at least 75% of the 121 measurement periods.*

An Adjusted Opportunity Set Tells a Different Story over Rolling Periods

Percentage of Time Periods Average Active Funds Outperformed Index Based on Rolling 10-Year Monthly Returns, January 1997 through December 2016



Source: Morningstar. Morningstar category net average annualized return covering 121 time periods (January 1997 through December 2016). Represents actively managed open-end U.S. domiciled funds, including funds that have been liquidated. Performance is based on funds' oldest share class. Quartile rank is based on each 10-year rolling month-end time period. Star rating is based on funds' "Overall Rating" as of each 10-year rolling month-end time period. Investing entails risks, including possible loss of principal. **Past performance is no guarantee of future results.**

Five-year rolling returns, which capture 181 unique measurement periods over the same time frame, tell a similar story. Applying the same simple screen that focuses on the top 75% of each category shows that in all nine categories active managers outperformed respective indices, after fees, more often than not. Even more compelling, 75% of managers in six of the nine categories beat their indices, after fees, in at least 80% of the 181 time periods in this scenario.

In short, actively managed portfolios to which investors have directed flows have shown they can outperform through multiple market cycles.

Conclusion

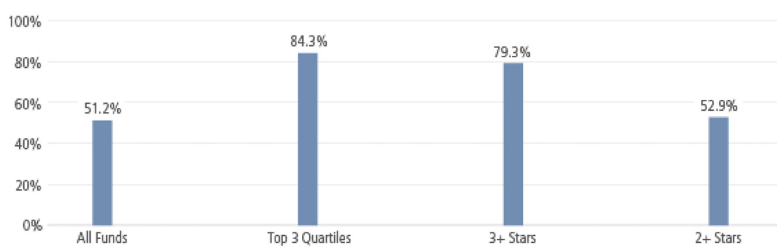
Passive investments have thrived in recent years, as extraordinary central bank intervention post-crisis fueled the rise of equity indexes and suppressed certain market dynamics such as stock correlations that under normal circumstances can provide active managers with opportunities to distinguish among stocks through fundamental research.

Even so, market-beating returns haven't been as elusive as conventional wisdom makes them out to be. In fact, reframing the active/passive comparison to better reflect the average investor's experience—simply by eliminating poor performers unlikely to be considered for investment and employing rolling returns data across full market cycles—reveals that active outperformance has persisted despite the considerable headwinds, across a wide swath of managers and over a variety of time periods and market regimes.

As the world's central banks begin to pull back on loose monetary policy by raising rates and trimming aggressive quantitative easing policies, we believe that markets may increasingly reflect fundamental differences and exhibit lower correlations among stocks. As a result, many active managers could have a strong wind at their backs, enhancing their ability to achieve outperformance for clients—and potentially building on their hard-earned achievements over the past decade.

Persistence of Active Outperformance

Percentage of Periods Large-Cap Blend Active Funds Have Beaten the Index after Fees—Rolling 10-Year Returns



Source: Morningstar. Morningstar category net average annualized return covering 121 (rolling 10-year returns) time periods (January 1997 through December 2016). Represents actively managed open-end U.S. domiciled funds, including funds that have been liquidated. Performance is based on funds' oldest share class. Quartile rank is based on each 10-year rolling month-end time period. Star rating is based on funds' "Overall Rating" as of each 10-year rolling month-end time period. Investing entails risks, including possible loss of principal. **Past performance is no guarantee of future results.**

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Correlation is a statistical measure of how a portfolio moves in relation to its benchmark. Correlation values range from +1.0 to -1.0. A positive correlation implies that they move in the same direction. Negative correlation means they move in opposite paths. A correlation of +1.0 means that the portfolio and benchmark move in exactly the same direction; -1.0 means they move in exactly the opposite direction; 0.0 means they do not correlate at all with each other.

Dispersion is a statistical measure of how much the returns of each variable (i.e. stocks within a benchmark) differ from the average return of an index.

The **S&P 500 Index** consists of 500 stocks chosen for market size, liquidity, and industry group representation. It is a market value weighted index (stock price times number of shares outstanding), with each stock's weight in the Index proportionate to its market value. The "500" is one of the most widely used benchmarks of U.S. equity performance. As of September 16, 2005, S&P switched to a float-adjusted format, which weights only those shares that are available to investors, not all of a company's outstanding shares. The value of the index now reflects the value available in the public markets. Please note that indices do not take into account any fees and expenses of investing in the individual securities that they track, and that individuals cannot invest directly in any index. Data about the performance of these indices are prepared or obtained by the Manager and include reinvestment of all dividends and capital gain distributions. The Fund may invest in many securities not included in the above-described indices.

The **Russell 2000® Index** measures the performance of the 2,000 smallest companies in the Russell 3000® Index, which represents approximately 10% of the total market capitalization of the Russell 3000® Index. The index is market cap-weighted and includes only common stocks incorporated in the U.S. and its territories.

The **Russell 2000 Value® Index** measures the performance of those Russell 2000® companies with lower price-to-book ratios and lower forecasted growth values.

The **Russell 2000 Growth® Index** measures the performance of those Russell 2000® Index companies with higher price-to-book ratios and higher forecasted growth values.

The **Russell 1000® Index** measures the performance of the 1,000 largest companies in the Russell 3000® Index, which represents approximately 92% of the total market capitalization of the Russell 3000 Index.

The **Russell 1000® Growth Index** measures the performance of those Russell 1000 companies with higher price/book ratios and higher forecasted growth values.

The **Russell 1000® Value Index** measures the performance of those Russell 1000 companies with lower price/book ratios and lower forecasted growth values.

The **MSCI EAFE Index** (Europe, Australasia, Far East) is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the U.S. and Canada. As of November 27, 2013, the MSCI EAFE Index consists of the following 21 developed market country indices: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Hong Kong, Ireland, Israel, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, and the United Kingdom. Please note that the index does not take into account any fees and expenses of investing in the individual securities that they track, and that individuals cannot invest directly in any index. Net total return indexes reinvest dividends after the deduction of withholding taxes, using (for international indexes) a tax rate applicable to non-resident institutional investors who do not benefit from double taxation treaties. Gross total return indexes reinvest as much as possible of a company's dividend distributions, regardless of withholding taxes that a nonresident may experience.

The **MSCI® Emerging Markets Index** is a free float-adjusted market capitalization-weighted index that is designed to measure the equity market performance of emerging markets. The index consists of the following 23 emerging market country indexes: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Greece, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Peru, the Philippines, Poland, Qatar, Russia, South Africa, Taiwan, Thailand, Turkey, and the UAE. Please note that indices do not take into account any fees and expenses of investing in the individual securities that they track, and that individuals cannot invest directly in any index. Net total return indexes reinvest dividends after the deduction of withholding taxes, using (for international indexes) a tax rate applicable to non-resident institutional investors who do not benefit from double taxation treaties. Gross total return indexes reinvest as much as possible of a company's dividend distributions, regardless of withholding taxes that a non-resident may experience.

The **MSCI® World Index (Net)** is a free-float-adjusted market-capitalization-weighted index that is designed to measure the equity market performance of developed markets. The MSCI World Index (Net) consists of the following 23 developed markets country indexes: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Hong Kong, Ireland, Israel, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, the United Kingdom, and the United States.

Morningstar Large Blend Category funds are fairly representative of the overall U.S. stock market in size, growth rates, and price. Stocks in the top 70% of the capitalization of the U.S. equity market are defined as large cap. The blend style is assigned to portfolios where neither growth nor value characteristics dominate. These portfolios tend to invest across the spectrum of U.S. industries, and owing to their broad exposure, the portfolios' returns are often similar to those of the S&P 500 Index.

Morningstar Large Growth Category funds invest primarily in big U.S. companies that are projected to grow faster than other large-cap stocks. Stocks in the top 70% of the capitalization of the U.S. equity market are defined as large cap. Growth is defined based on fast growth (high growth rates for earnings, sales, book value, and cash flow) and high valuations (high price ratios and low dividend yields). Most of these portfolios focus on companies in rapidly expanding industries.

Morningstar Large Value Category funds invest primarily in big U.S. companies that are less expensive or growing more slowly than other large-cap stocks. Stocks in the top 70% of the capitalization of the U.S. equity market are defined as large cap. Value is defined based on low valuations (low price ratios and high dividend yields) and slow growth (low growth rates for earnings, sales, book value, and cash flow).

Morningstar Small Blend Category funds favor U.S. firms at the smaller end of the market-capitalization range. Some aim to own an array of value and growth stocks while others employ a discipline that leads to holdings with valuations and growth rates close to the small-cap averages. Stocks in the bottom 10% of the capitalization of the U.S. equity market are defined as small cap. The blend style is assigned to portfolios where neither growth nor value characteristics predominate.

Morningstar Small Growth Category funds focus on faster-growing companies whose shares are at the lower end of the market-capitalization range. These portfolios tend to favor companies in up-and-coming industries or young firms in their early growth stages. Because these businesses are fast-growing and often richly valued, their stocks tend to be volatile. Stocks in the bottom 10% of the capitalization of the U.S. equity market are defined as small cap. Growth is defined based on fast growth (high growth rates for earnings, sales, book value, and cash flow) and high valuations (high price ratios and low dividend yields).

Morningstar Small Value Category funds invest in small U.S. companies with valuations and growth rates below other small-cap peers. Stocks in the bottom 10% of the capitalization of the U.S. equity market are defined as small cap. Value is defined based on low valuations (low price ratios and high dividend yields) and slow growth (low growth rates for earnings, sales, book value, and cash flow).

Morningstar Foreign Large Blend Category funds invest in a variety of big international stocks. Most of these portfolios divide their assets among a dozen or more developed markets, including Japan, Britain, France, and Germany. These portfolios primarily invest in stocks that have market caps in the top 70% of each economically integrated market (such as Europe or Asia ex-Japan). The blend style is assigned to portfolios where neither growth nor value characteristics predominate. These portfolios typically will have less than 20% of assets invested in U.S. stocks.

Morningstar Diversified Emerging Markets Category funds tend to divide their assets among 20 or more nations, although they tend to focus on the emerging markets of Asia and Latin America rather than on those of the Middle East, Africa, or Europe. These portfolios invest at least 70% of total assets in equities and invest at least 50% of stock assets in emerging markets.

Morningstar World Stock Category funds have few geographical limitations. It is common for these portfolios to invest the majority of their assets in the U.S., Europe, and Japan, with the remainder divided among the globe's smaller markets. These portfolios typically have 20% – 60% of assets in U.S. stocks.