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Catholic Responsible Investing

ACTIVE MANAGEMENT

Active vs. Passive: An Update

In June 2015, CBIS published "The Importance of Conviction", a white paper that reviewed the state of active equity management using data through yearend 2014. The analysis showed that successful long-term records for active managers typically include lengthy periods (often consecutive years) when returns are well below the benchmark and in the bottom quartile of peers. To achieve long-term outperformance, investors must remain patient and stay the course through these rough patches. A skilled investment strategy may require a complete market cycle, which can extend five years or longer, to show the desired results. In fact, the current half-cycle has endured by means of massive global central bank support for a near-record eight years, measured from the March 2009 low. Here we update and expand upon several themes developed in the Conviction paper.

Summary

- In June 2015, CBIS published "The Importance of Conviction", a white paper that showed successful long-term records for active managers typically include lengthy periods when returns are well below the benchmark. Here we update and expand upon several themes developed in the Conviction paper.
- Looking back over more than 25 years of data, it's clear that market trends can favor either active or passive strategies. Active managers tend to do better when value outperforms growth and smaller-cap stocks outperform large-cap stocks.
- The difference in results between the 45th percentile manager and the 50th percentile (median) manager is significant. A slight edge in manager selection can be quite meaningful over a longer-term time frame.
- We believe that investors willing to tolerate benchmark-relative volatility can gain incremental long-term return over a benchmark through active management. Passive strategies may be preferable for investors unwilling to accept such volatility.

I. U.S. Large-Cap Equity

The eVestment U.S. Large-Cap Equity universe includes nearly 1,200 currently active products and another 1,150 inactive products, which together create a database of historical returns that goes back 26 years to 1991. In examining this extended period of data, as shown in Table I, we can make a few immediate observations:

- Over the entire 26-year period, the median large-cap active manager exceeded its benchmark by 60 basis points annually, gross of fees
- 1991 through 1993 were good years for active large-cap managers
- 1994 through 1999 favored passive large-cap strategies
- 2000 through 2009 again favored active large-cap managers; the median manager outperformed on average by 2.09% per year
- For 2010 through 2016, the median large-cap active manager return was below benchmark gross of fees (this has provoked a large flow of capital from active strategies to passive index funds and exchange traded funds).

I. U.S. Active Large-Cap Equity Universe

Year	Median Manager Excess Return (%)
1991	2.89
1992	0.96
1993	1.97
1994	-0.24
1995	-2.18
1996	0.47
1997	-1.60
1998	-2.74
1999	-0.26
2000	9.00
2001	3.71
2002	1.54
2003	-0.14
2004	0.95
2005	1.98
2006	-1.34
2007	2.87
2008	0.77
2009	1.52
2010	-0.58
2011	-1.20
2012	-0.60
2013	1.03
2014	-1.18
2015	-0.04
2016	-1.91
26-Year Average	0.60

Source: eVestement universe of U.S. equity products

II. Median Manager's Average Excess Return

Years	Excess Return (%)	Trend Duration
1991 - 1993	1.94	3 Years
1994 - 1999	-1.09	6 Years
2000 - 2009	2.09	10 years
2010 - 2016	-0.64	7 Years

Source: eVestement Universe of U.S. Large-Cap equity products
Note: Average annual returns for periods indicated all returns shown before fees and expenses.

III. Active vs. Passive: Success Drivers

Years	S&P 500	R1000V –R1000G	R1000 –R2000	Favorable For
1994–1999	24.14%	-8.18%	9.53%	Passive
2000–2009	1.21%	5.42%	-4.16%	Active
2010–2015	13.23%	-0.14%	-0.90%	Passive

Source: eVestement Universe of U.S. Large-Cap equity products
Note: Average annual returns for periods indicated all returns shown before fees and expenses.

Table II distills the cyclicality evident in Table I. Table III provides strong clues that market conditions can favor either active or passive strategies (focusing on the U.S. large-cap universe) for extended periods. We can make a few further observations from the data shown in Tables II and III.

- It seems very difficult for active managers to outperform in a strongly rising market. The S&P 500's average annual return during the two periods that favored passive were +24.1% and +13.2%. The average return was just 1.2% when active strategies were dominant.
- Active managers generally do better when value outperforms growth (using the Russell 1000 Value and Growth Indices as style benchmarks). Value did much better than growth during the 10-year period of strength for active managers (2000-2009). Growth outperformed during the six and seven year periods that favored passive strategies.
- Active managers generally performed better when the Russell 2000 Index (small-cap) outperformed the Russell 1000 Index (large-cap). Conversely, indexing generally outperformed active management when large-cap stocks outperformed small-cap stocks. [2016 proved to be an exception to this trend as small-cap stocks outpaced large-caps by a wide margin, yet the vast majority of active managers could not keep up with passive alternatives.]

Cyclical Drivers

The data supports several generally accepted views about the impact of market conditions on active manager performance.

Cap Size and Efficiency — Academics and portfolio managers almost universally agree that strategies focused on large-cap companies compete for returns in the most "efficient" segment of the stock market. Efficiency in this context means a stock's price incorporates all available information relevant to forming a reasonable valuation. Market efficiency decreases somewhat as capitalization declines, in part because lower liquidity and smaller share totals mean smaller payoffs for the intense and costly effort required for investment analysis and/or provision of investment banking and other financial services. Most active managers believe it's easier to find unrecognized value among mid- to smaller-sized companies. As a result, active equity portfolios tend to:

- have a lower-cap bias relative to cap-weighted indexes,
- outperform passive indexes when the market trend favors smaller companies, and
- have a more difficult time when very large companies drive index outperformance.

Trending Markets — It also makes sense that active managers struggle to outperform in broadly rising bull markets. When markets rise in a highly correlated manner, there are fewer

IV. U.S. Active Large-Cap 45th Percentile

Year	Excess Return (%)	Year	Excess Return (%)
1991	3.82	2004	1.57
1992	1.55	2005	2.44
1993	2.75	2006	-0.91
1994	0.32	2007	3.45
1995	-1.64	2008	1.57
1996	1.03	2009	2.45
1997	-0.88	2010	-0.18
1998	-1.61	2011	-0.49
1999	0.90	2012	-0.29
2000	10.32	2013	1.63
2001	4.60	2014	-0.73
2002	2.22	2015	0.35
2003	0.48	2016	-1.45
		26-Year Average	1.18

Source: eVestement universe of U.S. equity products
Note: All returns shown before fees and expenses.

opportunities to differentiate between stocks simply riding the wave of optimism and those rising on the basis of truly improving fundamentals. Active stock pickers often shy away from benchmark names whose valuations seem unreasonably high, only to see those valuations rise higher in the short term as the dominant trend persists. These trends can last for painfully extended multi-year periods before sentiment shifts back to a value conscious regime. As all veteran managers know, such shifts are highly unpredictable and tend to destroy in a matter of months years of paper gains produced by increasingly and irrationally stretched valuations.

Valuation — Finally, it seems reasonable that active managers tend to perform better when value stocks outperform growth stocks. Active stock pickers, regardless of their specific market segment or style, almost universally look for securities they believe are undervalued based on a thoughtful assessment of a company's fundamentals and outlook. In a sense, they are looking across their investment universe for stocks that offer the best "value" relative to other potential holdings. When value stocks are underperforming, market condition can be loosely described as "expensive stocks getting more expensive and cheap stocks getting cheaper". This is suggested in Table III. When the Russell 1000 Value Index outperformed the Russell 1000 Growth Index, it was a good 10-year period for active management. When the Russell 1000 Growth Index outperformed, passive strategies performed better.

Gaining an Edge

So far we've compared active and passive strategies using median and average returns. But investors don't generally seek a median or average manager. Investors expect (or hope) to choose a manager who achieves results over the targeted investment horizon that rank among better-performing style peers. It's reasonable to ask how much a slight edge in choosing a manager is worth. Table IV shows that even a very slight edge can be worth a lot; the difference in results between the 45th percentile manager in the U.S. Large-Cap Equity universe and the 50th percentile (median) manager shown in Table I is significant.

- The 45th percentile manager outperformed the passive benchmark 17 times (a 65% success rate) versus the median manager's 50% success rate.
- The 45th percentile manager achieved an average gross of fee excess return of 118 basis points, almost double the median manager's 60 basis points.

An interesting observation about the recent seven-year period (2010 through 2016) is that even a 45th percentile manager lagged the benchmark in five of the seven years, offering further evidence of how difficult recent years have been for active equity managers.

II. Non-U.S. Equity

We can do a similar analysis for international active management. Table V shows 26 years of data for eVestment's All Non-U.S. Diversified Equity universe, which includes 853 active products and 474 inactive products for a total of 1,327 products. Given the broad diversity of products and styles, here we measure each product's results against the manager's preferred benchmark for that strategy in order to best capture their collective success against passive alternatives.

V. Non-U.S. Diversified Equity Universe

Year	Median Manager Excess Return (%)	45th Percentile Excess Return (%)
1991	2.40	2.93
1992	8.86	9.40
1993	5.35	6.82
1994	-5.45	-4.95
1995	2.07	2.73
1996	8.44	9.16
1997	6.11	7.26
1998	-2.24	-1.37
1999	8.61	11.65
2000	3.05	4.18
2001	2.38	3.19
2002	1.83	2.42
2003	.07	.73
2004	-.05	.23
2005	1.60	2.46
2006	.79	1.37
2007	1.14	1.78
2008	.32	.69
2009	.15	.87
2010	2.35	2.82
2011	.60	1.02
2012	2.24	2.62
2013	1.97	2.59
2014	.51	.89
2015	2.42	2.85
2016	-0.48	-0.10
26-Year Average	2.12	2.86

The diversity of geographical exposures inherent in international investing, as well as the breadth of stylistic approaches included in the data, makes it hard to cleanly associate trends in active management results with style shifts in the broad market; that is easier to do in specific regions or countries, as we did previously for the U.S. Large-Cap Equity universe. Nevertheless, international equity has long had a reputation for being a somewhat less efficient space than large-cap U.S. equity, and that seems evident here in the data. The median international manager outperformed their benchmark by 212 basis points on average over the 26-year period. The value of gaining an edge in manager selection is notable here too, worth about 75 basis points in additional annual excess return.

Considerations and Conclusion

Periods of underperformance can shake a client's faith in the skill of even the best managers, who then can go on to produce the hoped for results over a full investment horizon. Success from today's vantage point is defined only in terms of future performance. It's impossible to tell, today, if your active fund will deliver the desired investment outcome over the next five, ten or twenty years. But we believe certain characteristics can shift odds of success in your favor to a degree that justifies use of active strategies for many participants. CBIS' 35 years of experience with manager selection and oversight has shown us that firms and portfolio management teams who deliver superior performance generally exhibit the following traits:

1. Ownership and management team that is stable, structured and incentivized to share long-term success among themselves and with clients;
2. Well-defined investment philosophy and processes;
3. Consistent portfolio construction technique with fully integrated risk controls;
4. Disciplined buy and sell strategies;
5. Strong conviction in their philosophy and processes in order to weather the cyclical storms of underperformance that afflict all active investors at some point in a full market cycle.

We believe our current roster of CUIT sub-advisers embodies these traits and our due diligence process ensures we're immediately aware of any changes at the firm or investment team level that give us concern. While participants in CBIS funds have unique entry dates and investment time horizons, and while any time window is inherently subjective, trailing five-year peer group ranks for the CUIT active equity funds and Balanced fund meet or exceed our stated goal that they rank in the top third of the eVestment universe of competitive products.

CBIS participants include a diverse range of Catholic organizations in terms of portfolio size, investment horizon, anticipated cash inflows and outflows, risk tolerance and budget requirements. All share a desire to invest in accordance with Catholic values. Yet each may have reason to prefer active strategies, passive strategies or some combination within a full portfolio. Sequential years of below-benchmark results may try the patience of some investors. Others may be willing to endure these periods as a price of superior long-term growth of capital.

Even a small incremental excess return can meaningfully compound over a long time horizon; for example, a return of 7.3% compounded for 20 years results in nearly 6% more capital than a return of 7%. For an initial $20 million allocation, that means $4.5 million in additional wealth at the 20-year point produced by a 30-basis-point net-of-fee return gain over a passive benchmark.

By offering active and passive funds, CBIS is somewhat unique; other investment firms typically emphasize a single approach. As a result, we believe we can have a more candid discussion with participants about the pros and cons of active and passive investing. Our only goal is that of helping each choose investment vehicles that best address their unique sensitivities, needs and investment goals.■