STATE STREET GLOBAL ADVISORS

Global Fiduciary Solutions

Active Management – The Landscape

Active approaches once dominated investment management. In recent years, however, active management has come under substantial criticism, as academics and other market observers questioned the true sources of outperformance – and whether the results attributable to active asset-picking really justified active fees. Over the past decade, this drumbeat of criticism, together with a relatively weak performance track record, increasing access to liquid, low-cost index products, and the emergence of smart beta/factor-based strategies, have contributed to massive growth in index asset flows across a range of asset classes and regions.

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This trend may have serious consequences for investors and their prospects, because we believe that it's premature to conclude that active performance trends will be persistently and continually challenged. Instead, we believe that active management is influenced by cyclicality, and that this market and macro environment may be presenting unique headwinds to performance. In this article, we evaluate the performance patterns for active managers across various asset classes[1] and examine some of the changes that we've observed in the last decade.

Through our research, we found that:

- Active management still leads in terms of assets under management, although index market share has risen steadily.
- A substantial reversal in flows has occurred in the past five to six years, with inflows into index products accounting for nearly all of outflows from active strategies.
- Active-manager performance has diverged significantly in the period since the Global Financial Crisis. The past five years have been especially tough across many asset classes.
- Fewer active strategies are outperforming their respective indexes. There has been a steady compression in dispersions between top and bottom quartile managers.
- Active managers continue to demonstrate added value in some asset classes, including small-cap equities, international and emerging-markets equities, and core fixed income.
- Historical data reveals cyclicality in the performance of active strategies. This means that prudent manager selection is critical.

1 We have not set out to conduct an exhaustive review of every active universe in this piece, but rather have focused on some of the asset classes that typically attract active allocations.

Buildup in Index Assets

The massive inflows to index products in recent years have been widely discussed. It's worth noting, however, that actively managed products still command the majority of the overall market share. Index assets now comprise only about 25% of total assets that are professionally managed in U.S. open-ended mutual funds (excluding money market funds and fund-of-funds).

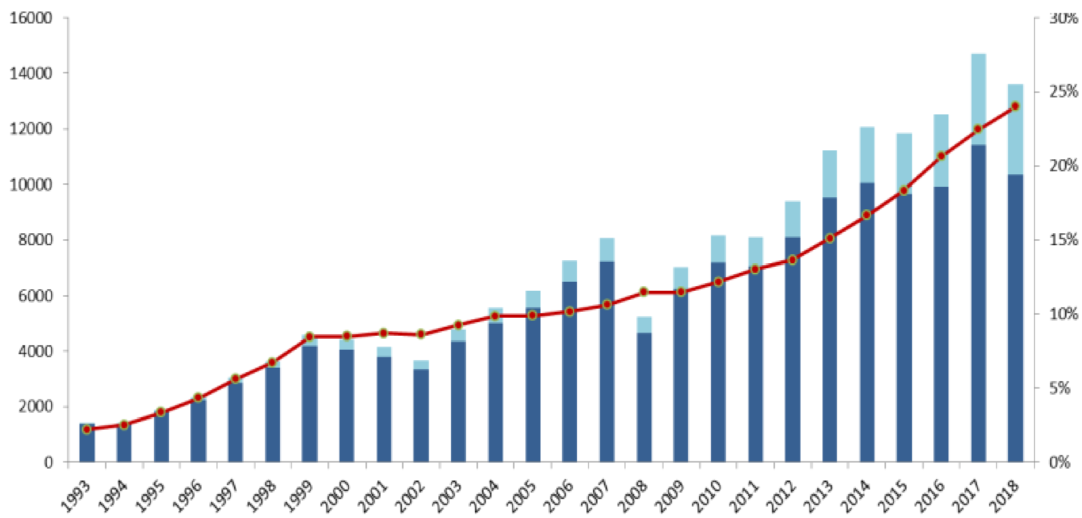
That said, growth in index funds over the past five years has been strong, as shown in Figure 2, which depicts the cumulative flows into index and active strategies. As this data shows, there has been a tremendous divergence in flows in the last six years, with inflows into index-based products capturing nearly all the outflows from active products.

Figure 1

Legend

- Active
- Passive
- % of Passive Assets

Total AUM in $Billion across active and passive funds



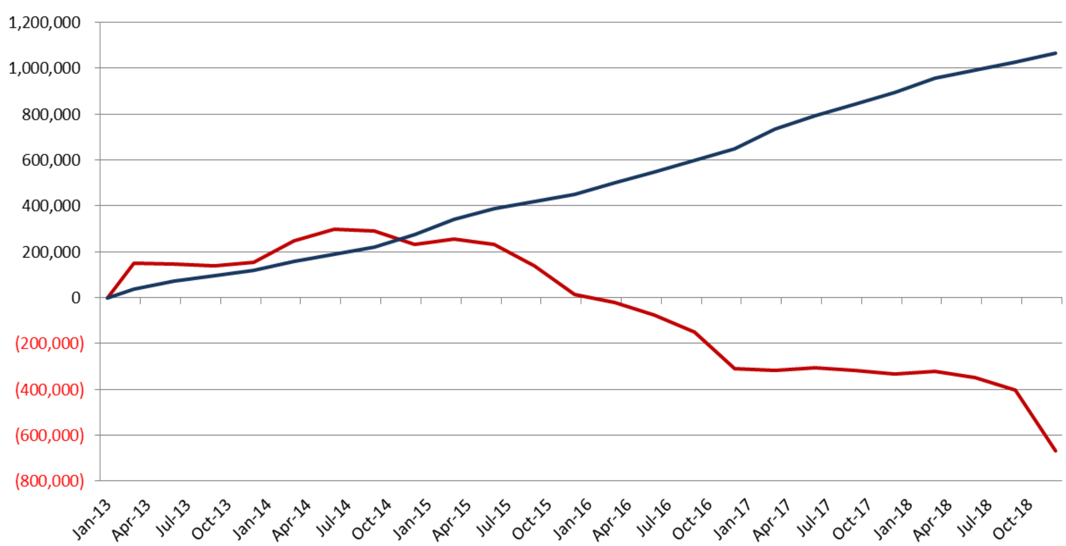
Source: Morningstar, US Open-ended funds ex. Money Market and FoFs

Figure 2

Legend

- Passive
- Active

Cumulative Flows (2013-2018) $ Millions



Source: Morningstar, US Open-ended funds ex. Money Market and Fund of Funds

Median Active Manager Performance

Rather than simply focusing on performance in the last few years, we assessed the historical performance patterns of the median active manager across multiple asset classes over the past two decades. Figures 3 and 4 show the rolling five-year excess return of the median manager (gross of investment management fees) across a range of asset classes and active universes. In each case, the excess return has been calculated using the benchmark which is representative of the asset class. In nearly all cases, we observed that outperformance of the median manager has dropped substantially over time – and even more so in the past five years.

Figure 3

US Active Equity Managers Median Relative Performance

Legend

- Negative Excess Return
- Mid Cap vs. Russell Midcap
- Large Cap Core vs. Russell 1000
- Small Cap vs. Russell 2000
- Large Cap Value vs. Russell 1000 Value
- Large Cap Growth vs. Russell 1000 Growth

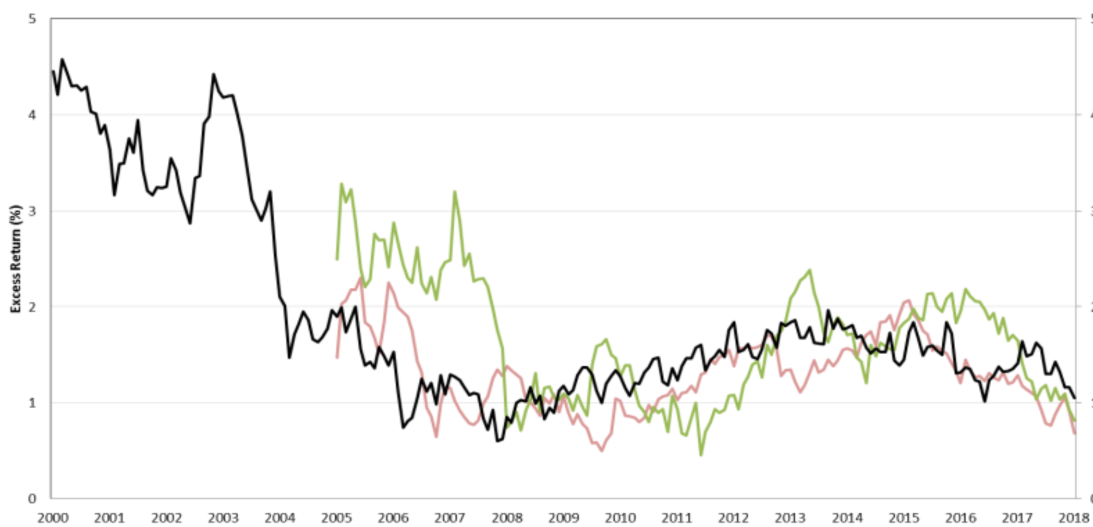
Source: eVestment (gross of fees). Past performance is not a reliable indicator of future performance.

Figure 4

Global & Non-US Active Equity Managers Median Relative Performance

Legend

- Global Large Cap vs. MSCI AC World
- Emerging Mkts vs. MSCI EM
- All EAFE vs. MSCI EAFE



Source: eVestment (gross of fees). Past performance is not a reliable indicator of future performance.

As expected, we also observe that markets which are perceived as more efficient, such as the US large cap equity market, have been the toughest terrain for active managers to navigate over the past two decades. Active managers have fared relatively better in markets widely considered less efficient, such as international equity and emerging markets equity. Even in markets where active managers have continued to outperform, however, the margin of outperformance has clearly continued to decline.

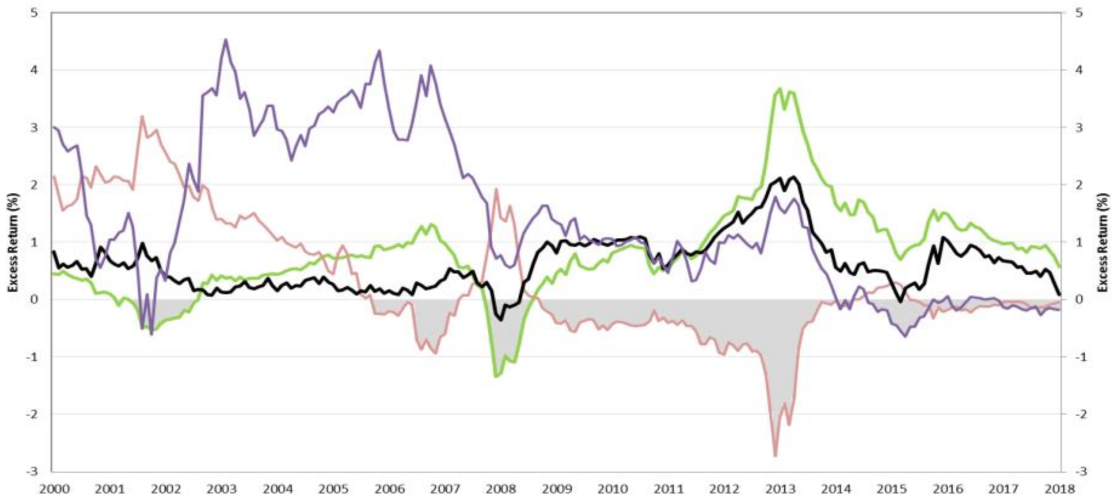
In the fixed income space, the trends are somewhat different; we cannot directly relate active managers' struggle to the level of market efficiency. The market for high yield bonds, for example, is generally considered to be relatively less efficient, but it has been particularly difficult for active managers to generate any meaningful excess return in that space *(see Figure 5)*. The Bloomberg Barclays US High Yield Index ranked in the fifteenth and sixteenth percentile in 2009 and 2016, compared to the eVestment US high yield universe. This underperformance may be related, in part, to the fact that the high yield index is difficult to track and replicate. We also believe, however, that structural tilts in active portfolios play a role.

Figure 5

Median Performance for Active Fixed Income Managers

Legend

- Negative Excess Return
- US High Yield FI vs. Bloomberg Barclays US High Yield
- Emerging Mkts FI (Hard CCY) vs. JPM EMBI Global Diversified
- US Core Plus vs. Bloomberg Barclays US Aggregate
- US Long Duration FI vs. Bloomberg Barclays US Long Gov/Credit



Source: eVestment (gross of fees). Past performance is not a reliable indicator of future performance.

Active managers in high yield often have a higher exposure to quality relative to the index. The past decade has seen strong rallies from lower-quality market segments, especially in 2009 and 2016 when CCC's returned 90.7% and 31.5%, respectively. If there is a 'quality bias' in many active strategies resulting in a broad underweight at the lower end of the ratings spectrum, these 'junk rallies' have been key detractors for active high yield strategies.

Active Managers – Then and Now

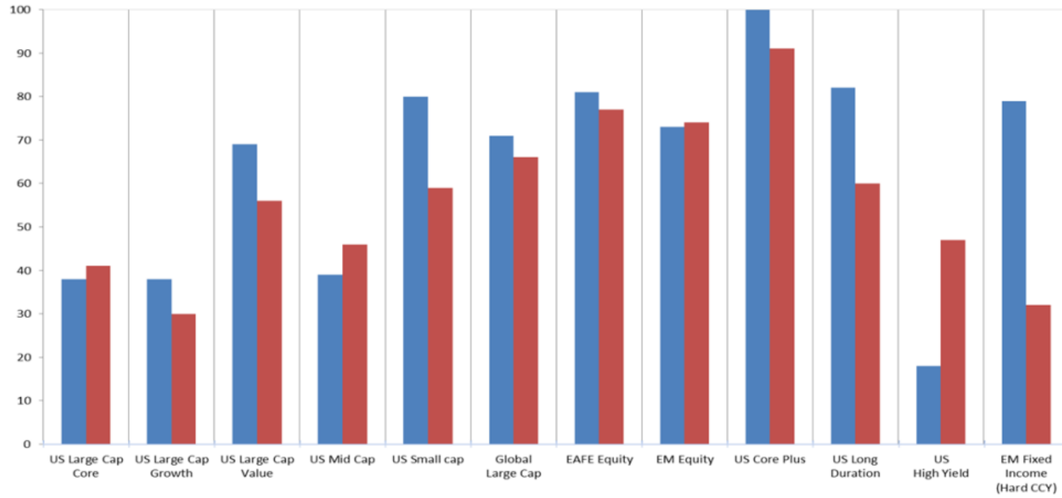
Splitting the 10-year period into two sub-periods of five years each provides additional perspective on this trend. Figure 6 compares active manager performance for the first five years and the latter five years following the GFC. In most cases, the first five-year period through 2013 was relatively better for active managers, but the latter half (2014-18) has been a period of struggle. This deterioration in performance is also consistent with the trend we observed in Figure 2, which illustrates the divergence in flows between active and passive strategies from 2013 through 2018.

Figure 6

Legend

- 5 Year Ending 12/2013
- 5 Year Ending 12/2018

Percentage of Active Managers Beating the Index



Source: eVestment (gross of fees). Past performance is not a reliable indicator of future performance.

In addition to this drop in the number of active strategies that were able to beat the benchmark, median manager performance has also trended downward. Figure 7 compares median active-manager excess returns for the same two, five-year periods following the GFC. With the exception of US mid cap and US high yield, median performance has seen a decline across categories. Furthermore, incorporating each asset class's median fee (bar plots below), shows that the median excess return for the most recent five-year period falls in negative territory for most asset classes.

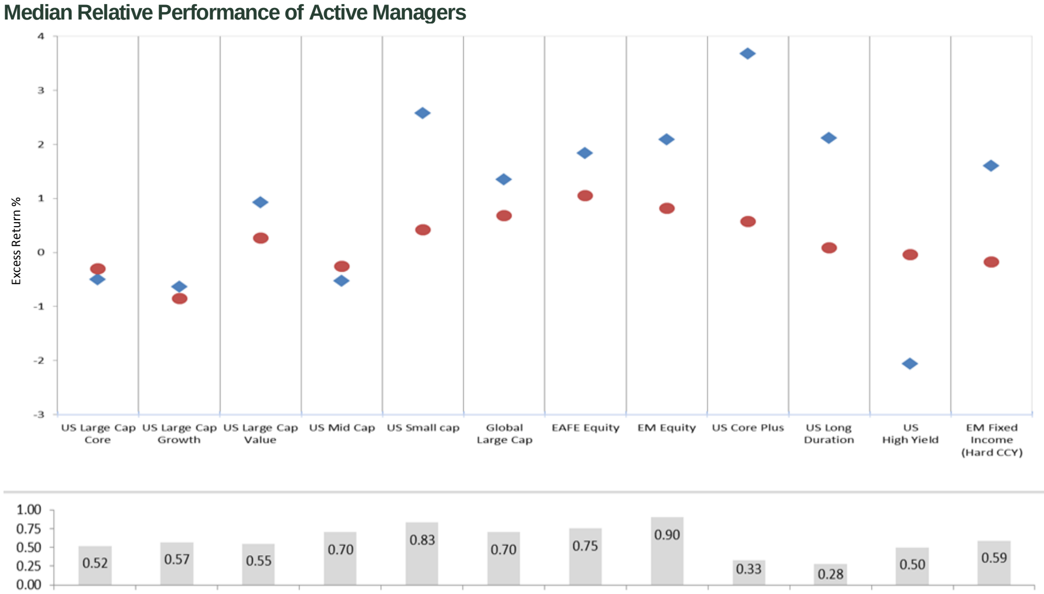
Figure 7

Median excess returns by asset-class category

Legend

- 5 Year Ending 12/2013
- 5 Year Ending 12/2018
- Universe Median Fee

Median Relative Performance of Active Managers



Source: eVestment (gross of fees). Past performance is not a reliable indicator of future performance.

Finally, looking at manager performance dispersion, Figure 8 displays the spread between active managers with excess returns at the twenty-fifth percentile and at the seventy-fifth percentile for each asset class, again split into five-year periods following the GFC. In this analysis, a larger numerical value indicates a greater spread in performance between top and bottom quartile managers.

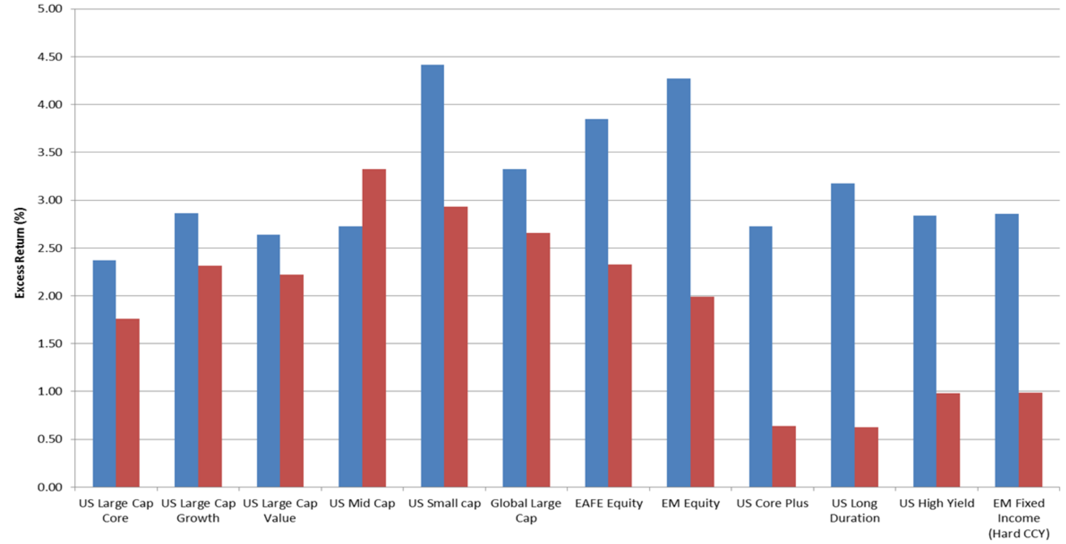
As we see in Figure 8, there is a notable compression in spreads between these groups over the most recent five year period, particularly in the case of fixed income. Persistently low interest rates and tight credit spreads are almost certainly playing a dominant role in this fixed-income trend. For equity managers, the lack of volatility alongside fairly narrow pockets of market leadership are likely at work.

Figure 8

Legend

- 5 Years Annualized Ending 12/2013
- 5 Years Annualized Ending 12/2018

Active Manager Percentile Spreads (25th – 75th percentile excess returns)



Source: eVestment (gross of fees). Past performance is not a reliable indicator of future performance.

Up-market versus Down-market Periods

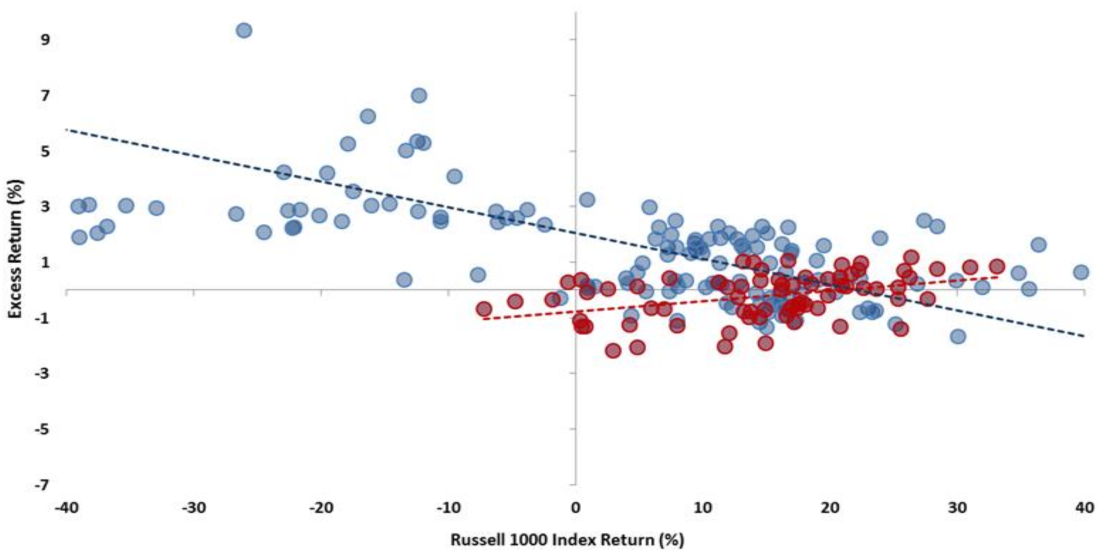
Active managers historically have done well during down-market periods. The scatter plot in Figure 9 captures the average excess return of active managers in the US Large Cap space on a rolling 12-month basis.

Figure 9

Legend

- Jan '01 - Dec'18
- Jan '13 - Dec'18

Average Excess Return for US Large Cap Active Managers versus the Russell 1000



Source: Morningstar (net of fees). Past performance is not a reliable indicator of future performance. Index returns reflect capital gains and losses, income, and the reinvestment of dividends.

The blue dots capture monthly rolling one-year data from January 2001 through December 2018. The red dots focus on the period from January 2013 until December 2018. The X-axis plots the absolute return for Russell 1000 Index which helps us divide the chart in two halves. The left half represents down-market periods while the right half indicates up-market periods. Average excess return for active managers has been plotted on the Y-axis. Trend lines derived from the scatterplots show that, for the more recent five-year period following the GFC, when markets have been on a strong upward run (mostly positive red dots to the right), active managers have struggled to generate excess returns (most red dots fall below zero on the vertical axis). In contrast, the trend line for the full period from 2001 through 2018 has a distinctly negative slope. This implies that active managers on average have added value during down-market conditions (there are many more blue dots than red ones in the upper left quadrant). We have observed similar trends in other asset classes as well.

There are several plausible explanations for active managers to hold up well during down-market periods:

1. Impact of Quality: Many active managers have some element of "quality" in their portfolio, which helps them to limit drawdowns. (As noted above, high yield bonds have been the classic example of this.) Over the past 10 years, however, we haven't witnessed any significant and sustained periods of losses. This has weighed on many active managers' relative performance.
2. During periods of market stress and volatility, dispersions in securities' performance typically widen, improving active managers' opportunities to generate alpha. Because volatility has been abnormally low over the past two decades, this opportunity has not arisen.

Cyclicality in performance

Even in light of these more recent trends, it's important to note that active manager outperformance has followed a cyclical path historically *(see Figures 10 and 11)*. The dotted trend line shows the 36-month average relative performance over time. While these figures show the cyclicality in the US large cap and international equities, we have witnessed similar cyclical moves in other asset classes as well to varying degrees.

Figure 10

Rolling three-year returns

Legend

US Large Cap Equity Active managers outperforming the R1000 Index

--- Trendline

Percentage of US Large Cap Active Managers Beating the Russell 1000 Index

Source: Morningstar (net of fees). Index returns reflect capital gains and losses, income, and the reinvestment of dividends.

Figure 11

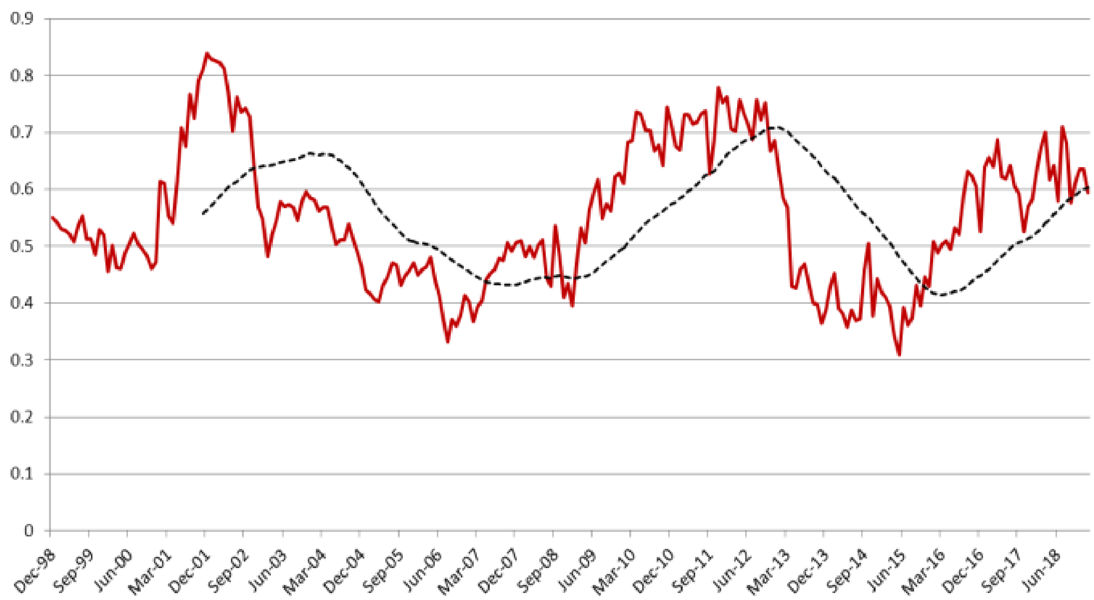
Rolling three-year returns

Legend

Int'l equity managers outperforming the MSCI EAFE Index

Trendline

Percentage of International Active Equity Managers Beating the MSCI EAFE Index



Source: Morningstar (net of fees). Index returns reflect capital gains and losses, income, and the reinvestment of dividends.

This cyclicality in performance does make intuitive sense to us given how different asset class/styles/disciplines of investing play out in different segments of a typical business cycle. It, therefore, makes it imperative to be able to spot such turning points in the market and be able to tactically rotate allocations. To this extent, a thorough and independent manager research and selection process can be extremely useful in identifying the right investment opportunities at the right time.

Conclusions

As we look ahead, it's clear that active management – across most major public asset classes – has been fundamentally challenged in recent years. Fewer managers have outperformed their respective indexes, the margin of excess returns has decreased and the spread of top and bottom managers has narrowed. Not surprisingly, these trends have put pressure on flows from active strategies and on fees.

Despite the persistence of these trends in recent years, we believe it's premature to suggest that these struggles will extend indefinitely. Indeed, the cyclical nature of historical performance suggests that we need to measure these trends over a full market cycle. To be sure, increasingly efficient markets will continue to present difficulties for active managers. But exceptional managers will be able to show their value, and less efficient markets are likely to show improved performance as well.

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Assets under management as of June 30, 2019

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