White Paper
Global Fiduciary Solutions

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Active Management — The Landscape

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Executive Summary

Active management continues to face criticism in the wake of its underperformance and the growing popularity of index and smart beta products. Asset flows continue to drift towards indexing strategies, leading to a shift in market share of the two camps. This has been more pronounced in the Fixed Income space where we saw a record number of new ETF launches in 2019. However, in line with the views we expressed in our earlier paper, the last 1.5 years has been an interesting period for active managers. The tide seems to have tilted slightly in favor of active management as performance has been encouraging, especially in Q1 2020. This also resonates with the cyclicality of performance that we noted in our previous paper and the "quality" aspect that a good active manager brings along with the investment process.

In the first section of this paper, we will share some of the long-term trends we see across the continuum of asset management. The second section would be geared towards the more recent period (Jan' 19–Jun' 20) to recognize some burgeoning trends we are seeing emerging across active management.

Our key observations can be summarized as:

- Despite the strong flows into indexed products, Active Management still holds the bulk of the AUM.

- In contrast to prior years (2013–18), the pace of flows in to indexed strategies has moderated in recent periods.

- Though it's too early to declare a return of active management, it has seen some rebound across asset classes in the past 18 months given the market conditions.

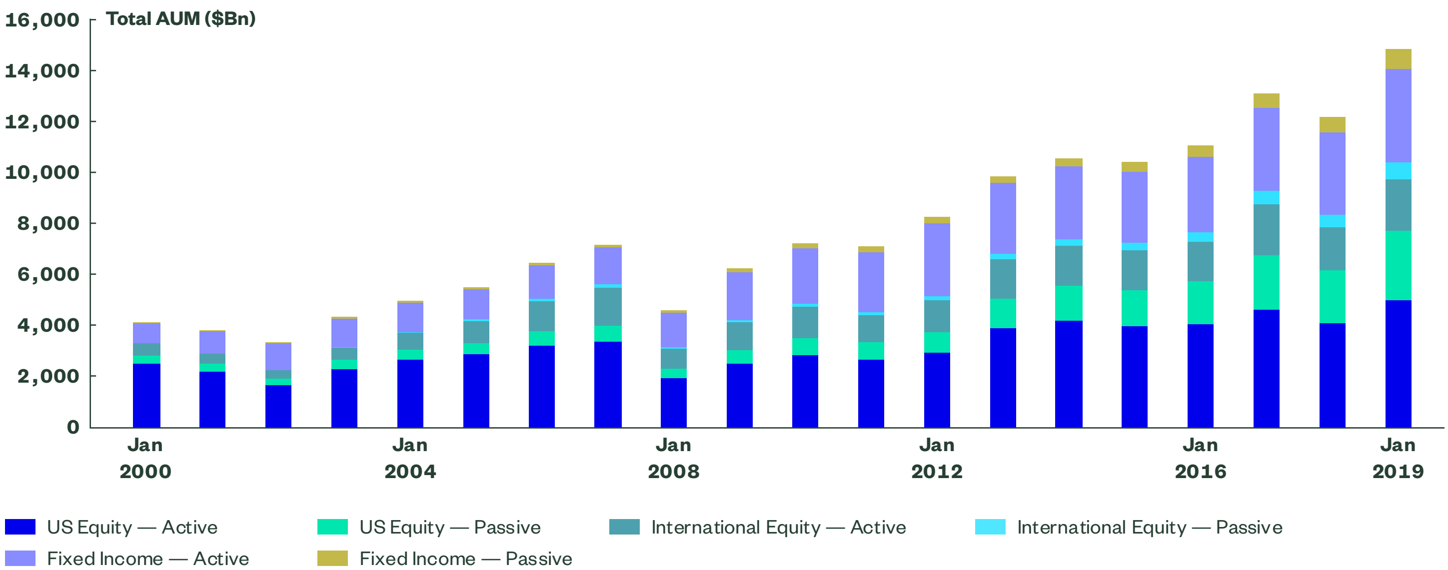
    — *This is also in line with our earlier inference on the cyclical nature of performance in active strategies which merits a prudent manager selection process. Our observations tell that being able to pick a top quartile manager and execute a timely allocation adds tremendous value.*

- Active managers continue to demonstrate added value in some asset classes, including small-cap equities, international and emerging-markets equities, and investment grade fixed income.

Trends in Assets Growth

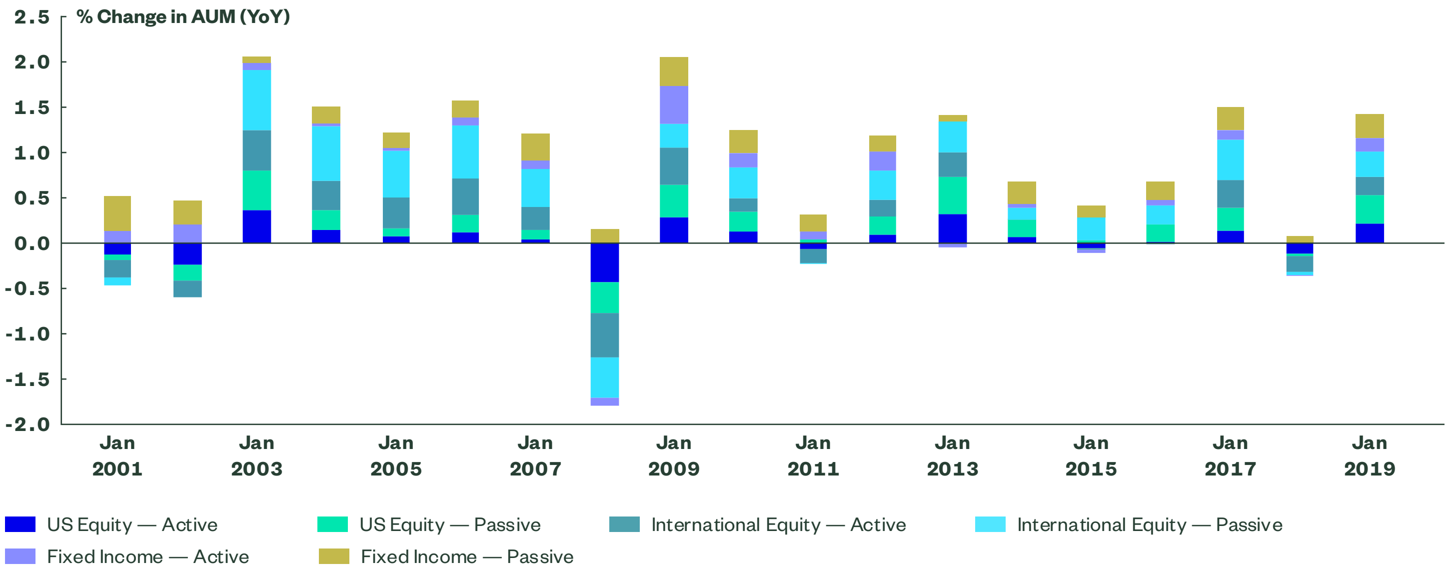
Indexed assets continue to grow in size but the growth rate has moderated over the past 18 months. The steep rise in the growth of indexed assets that we saw from 2013–18 has now plateaued a bit. Its share of market (as of Q2 2020) remains flat relative to YE2018. Active assets continue to grow at a steady pace, although the recent market pull back had an adverse impact, especially in Q1 2020. Figure 2 below depicts the year-over-year growth in AUM in some of the broad asset classes split by style of management (active/indexed). Key takeaway from this piece of data is the growth in Fixed Income index arena. In each of the last 20 years, indexed fixed income has registered positive growth in AUM and continues to keep growing.

Figure 1
Total AUM in $Billion Across Active and Passive Funds



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

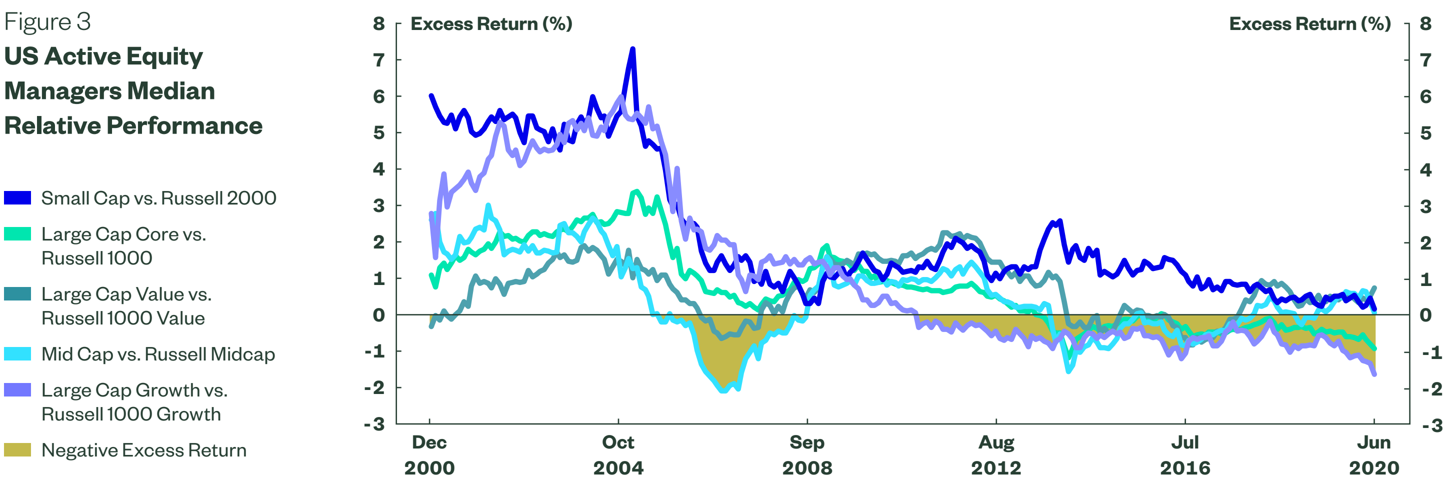
Figure 2
Year-over-year Growth in AUM Split by Active and Passive



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

Median active manager performance: In line with the recent long-term trends, active managers continue to face performance challenges. However those challenges seem to have improved in certain areas. For example, US Large Cap Value and Emerging Market Equities show signs of reversal in active managers' performance, which typically precedes growth in active AUM.

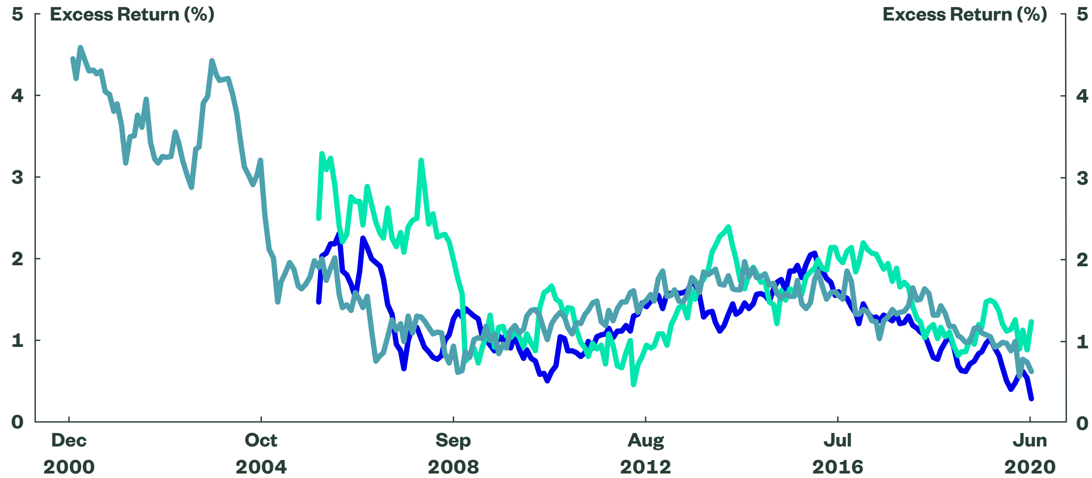
Figure 3
US Active Equity Managers Median Relative Performance



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

Figure 4
Non-US Active Equity Managers Median Relative Performance

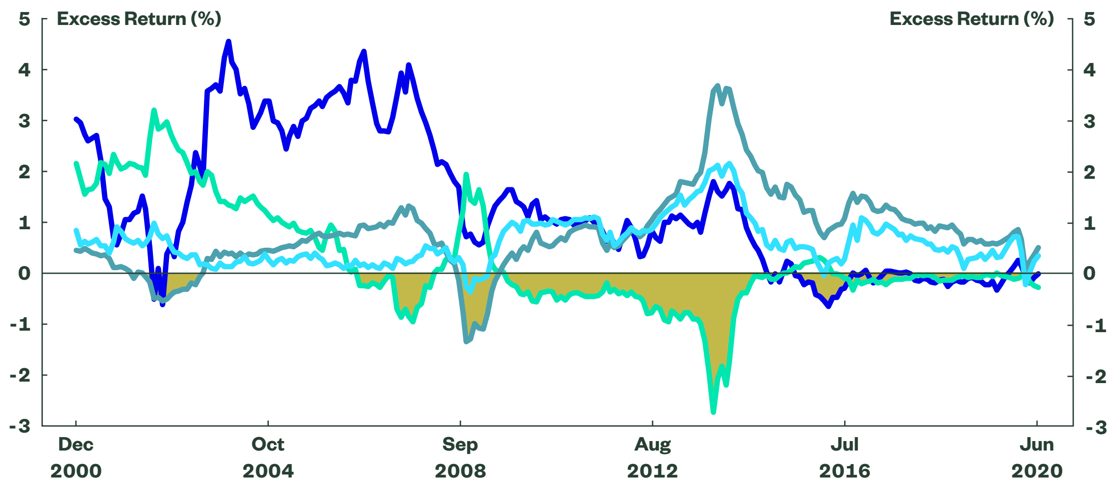
- Global Large Cap vs. MSCI AC World
- Emerging Mkts vs. MSCI EM
- All EAFE vs. MSCI EAFE



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

Figure 5
Active Fixed Income Managers Median Relative Performance

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



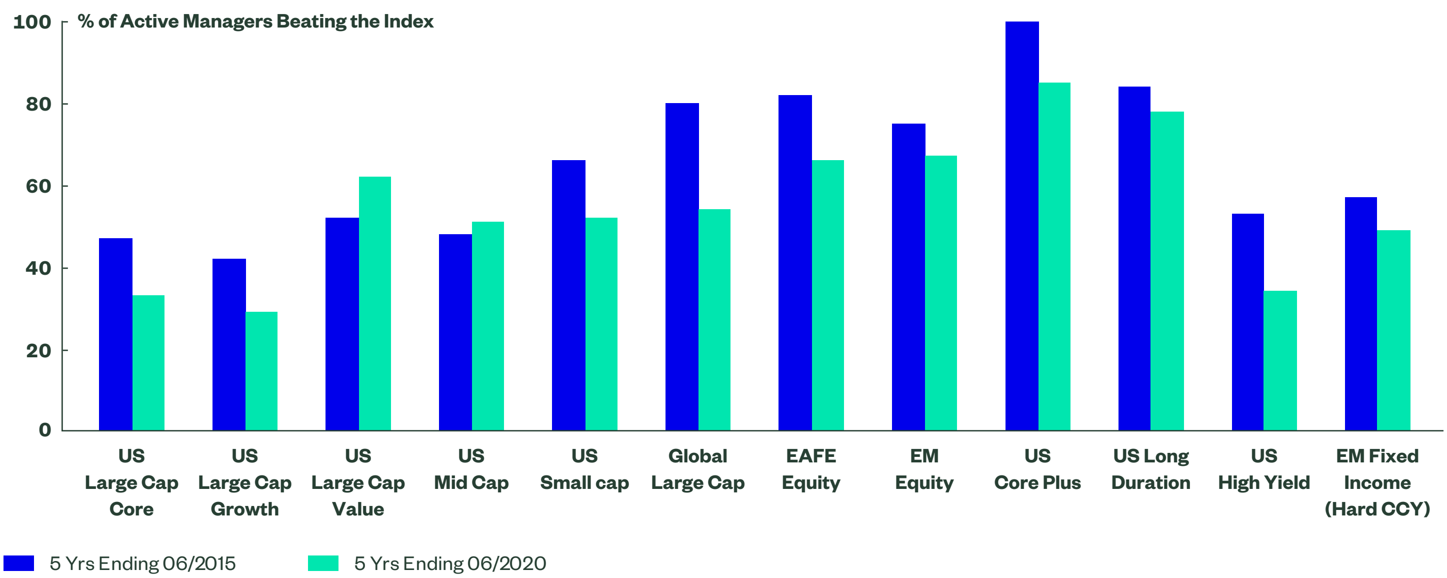
Source: eVestment (gross of fees). Past performance is not a reliable indicator of future performance.

In the fixed income space, active managers fared even better with the exception of High Yield which continues to be a challenging terrain for active managers. For high yield, the benchmark continues to be very competitive given the multiple junk rallies we have witnessed in the past decade. However, the recent performance (Q1 2020) during the selloff did uncover chinks in the armor as active high yield managers were able to beat the index comfortably given the "quality" preferences in active strategies.

Active Managers — Then and Now

Considering the last 10 years, we observe that there has been a notable shift in performance trends. Splitting the 10-year period into 2 sub-periods of 5 years each helps us understand the change in trend. The below chart shows a comparison of how active managers have fared in two different 5-year periods post the GFC. As we can see, in most cases, the first 5-year period until June 2015 were relatively better for active managers but the latter half has been a period of struggle.

Figure 6
Percentage of Active Managers Beating the Index

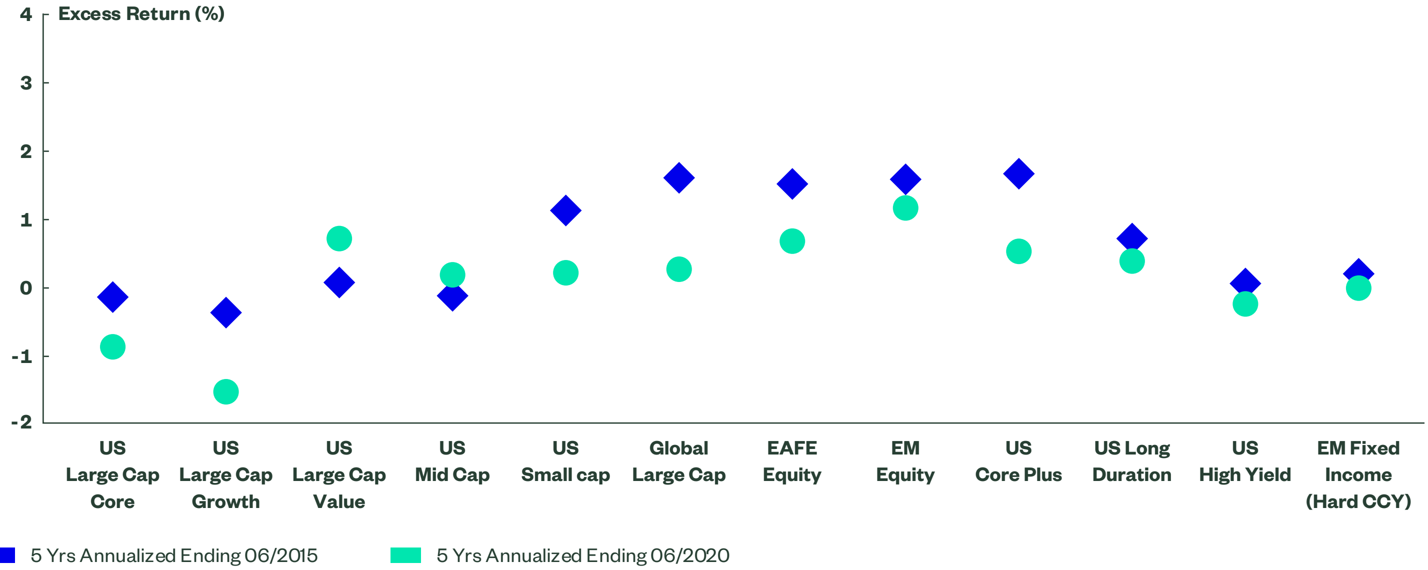


Source: eVestment (gross of fees). Past performance is not a reliable indicator of future performance.

In line with the drop in number of active strategies that were able to beat the benchmark, we also observe a downward trend in the median manager performance. The below chart shows a similar comparison across the two 5-year periods for the median active manager's excess return. With the exception of US midcap and US large cap value, median performance has seen a decline across all other categories. Taking the median fee (bar plots below) into account, median excess return for the most recent 5 year period would fall in the negative territory for most asset classes.

Figure 7

Active Manager Median Relative Performance

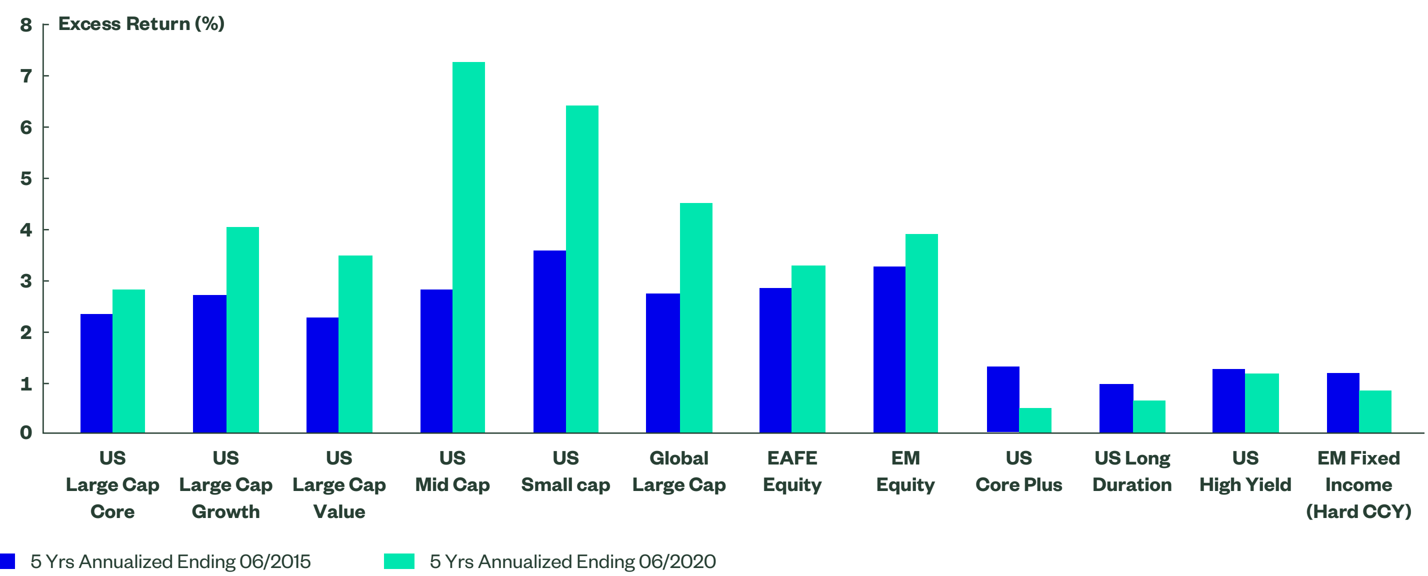


Source: eVestment (gross of fees). Past performance is not a reliable indicator of future performance.

Finally, looking at manager performance dispersion, the below chart shows the spread between the 25th and 75th percentile active manager in each asset class. As we can see there is a notable increase in dispersion in the recent 5 year period, more so in case of equity categories.

Figure 8

Active Manager Universe Percentile Spreads (25th–75th percentile)

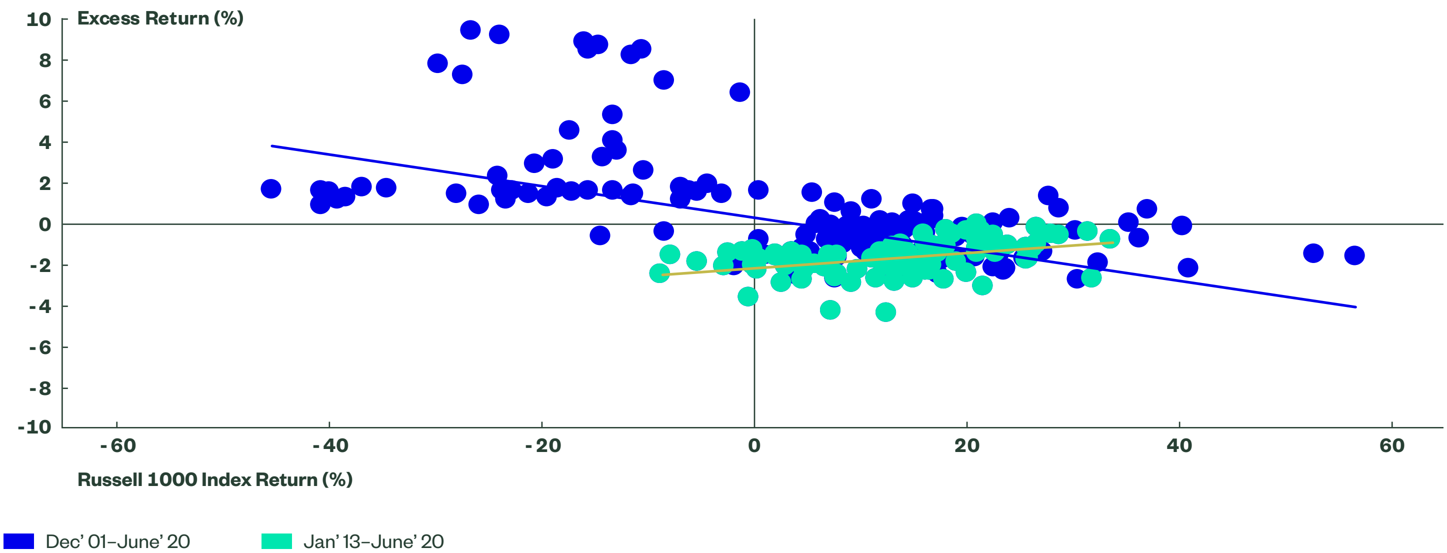


Source: eVestment (gross of fees). Past performance is not a reliable indicator of future performance.

Active Management in the Last 18 Months

The last 18 months have been particularly interesting given the market environments. In our previous paper, one of our key observations was that active managers tend to do well in a risk off market which is typically associated with increasing dispersion and reducing correlation of individual securities performance. 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 Core space on a rolling 12-month basis.

Figure 9
US Large Cap Core Active Manager Excess Return vs. R1000 (Rolling 12 months)



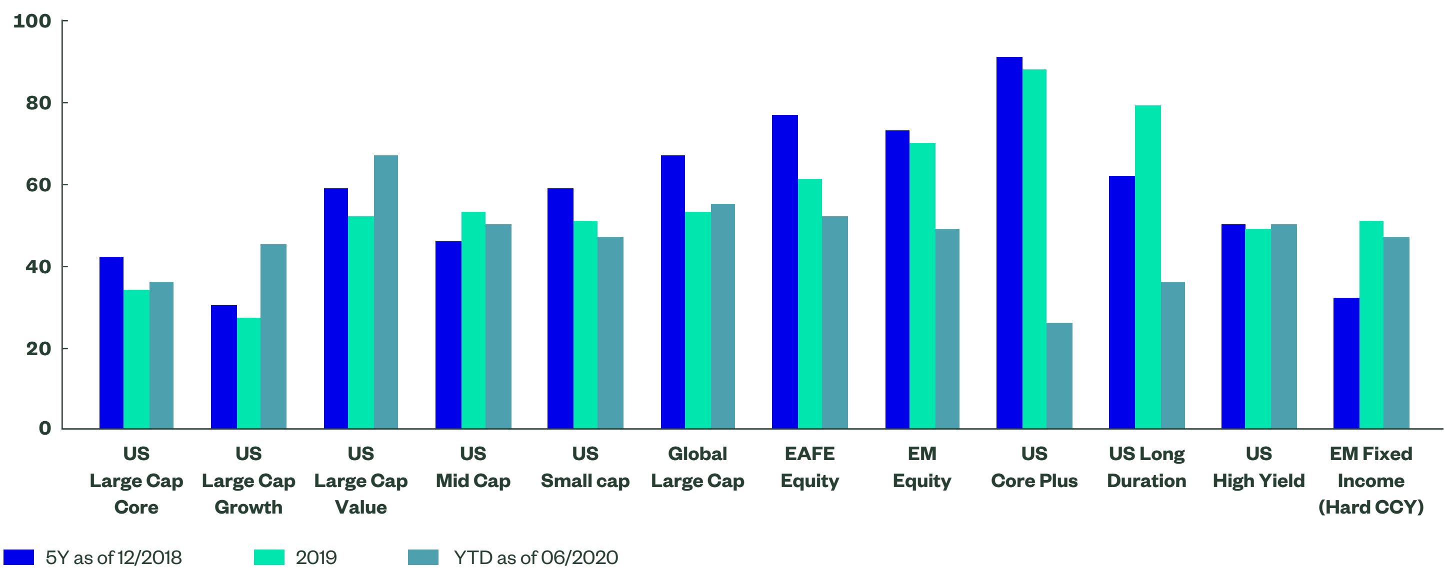
Source: Morningstar (net of fees). Past performance is not a reliable indicator of future performance. Index returns reflect capital gains and losses, income, and the reinvestment of dividends.

The blue dots capture monthly rolling data from January 2001 until June 2020 while the red dots focus on the period from January 2013 until December 2020. The X-axis plots the absolute return for Russell 1000 Index which helps us divide the Gaussian plane in two distinct halves vertically. 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. Comparing the trend lines in the chart, it is relatively flatter for the recent 5-year period when markets have been on a strong run and active managers have struggled to generate excess returns. In contrast, the trend line for the full period is distinctively negative slopped which implies that active managers on average have added value during down market conditions. We have observed similar trends in other asset classes as well.

Drilling down further into the more recent period from Jan 2019–June 2020, the market environment has changed significantly from the prior years. While valuation levels remain elevated, an unexpected and severe blow was dealt by the breakout of the Covid19 pandemic earlier this year and that pushed the world into a virtual shutdown, thereby impacting markets in a significant way. Equities across regions saw a massive pullback in Q1 2020 with some pockets experiencing drawdowns in excess of 30% (U.S. small caps, emerging markets). However, once clarity around the pandemic began to emerge and countries gradually eased lockdown protocols, markets reacted quite sharply to the trickles of positive news and were able to cover the lost ground within a short span of time. This dynamic market environment was, in fact, quite a challenge for asset managers. As such, it merits a closer look at how active managers across asset classes fared during this period and it could be a harbinger of what to expect from them in future.

The chart below compares the percentage of active managers beating their respective asset class indices across 3 specific time periods — last 5 years as of Dec 2018, FY2019 and YTD 2020 (as of June 2020). With the exception of a few asset classes, active manager performance shows an improving trend in 2019 and YTD 2020 compared to prior periods.

Figure 10
Percentage of Active Managers Beating the Index

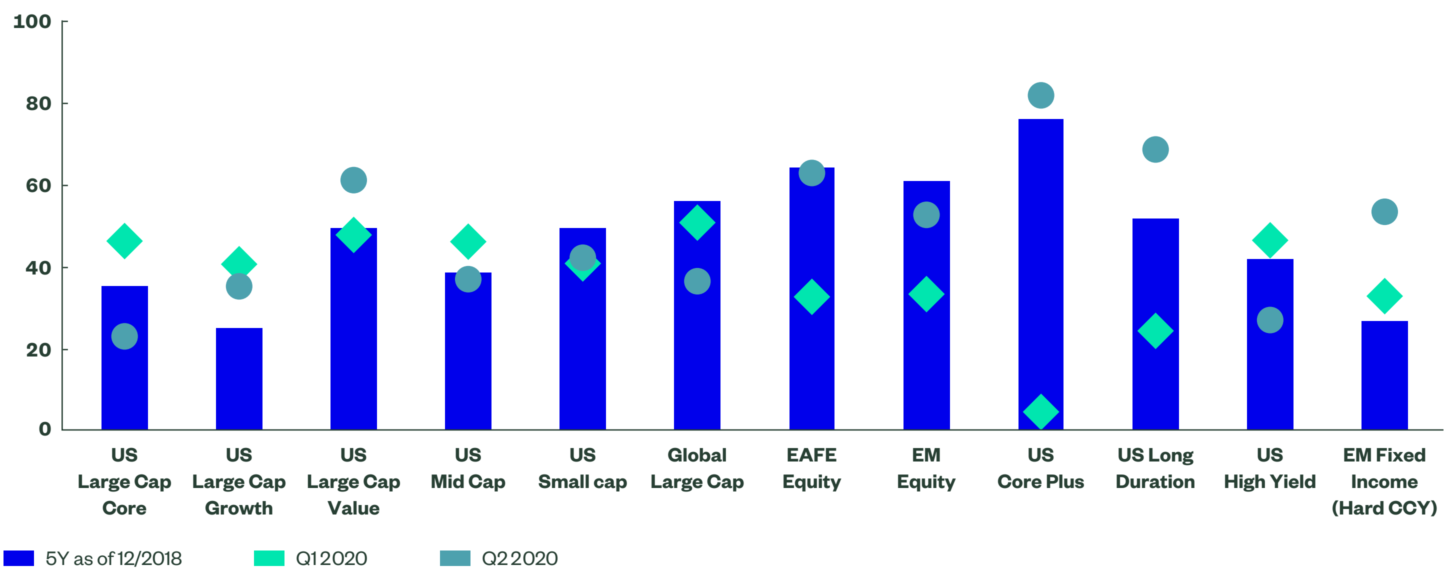


Source: Morningstar (net of fees). Index returns reflect capital gains and losses, income, and the reinvestment of dividends.

Further, looking at first 2 quarters of 2020, the change is even more pronounced and in line with how we expect active managers to behave. During Q1 2020, when market saw a selloff, active managers' performance improved noticeably across most asset classes, with the exception of US core plus, long duration, EM and EAFE equities. Especially noteworthy was the performance of high yield active managers, which had been a particularly tough area for active managers to beat the benchmark as outlined earlier. This is mostly attributed to the junk rallies we have seen in high yield and since active managers usually have a safety net in the form of a higher quality bias which tends to provide more liquidity as well their portfolios struggled. In Q1, however, when panic struck the markets, the lower quality high yield bonds suffered severe drawdowns and the quality bias in active managers helped them outperform the index.

Q2 2020 saw a strong risk-on rally and turned out to be almost a mirror image of what transpired in Q1. Markets across regions and asset classes made a quick recovery and made up for losses in the prior quarter. Expectedly, active managers couldn't sustain the strong returns that they put up in Q1.

Figure 11
Percentage of Active Managers Beating the Index

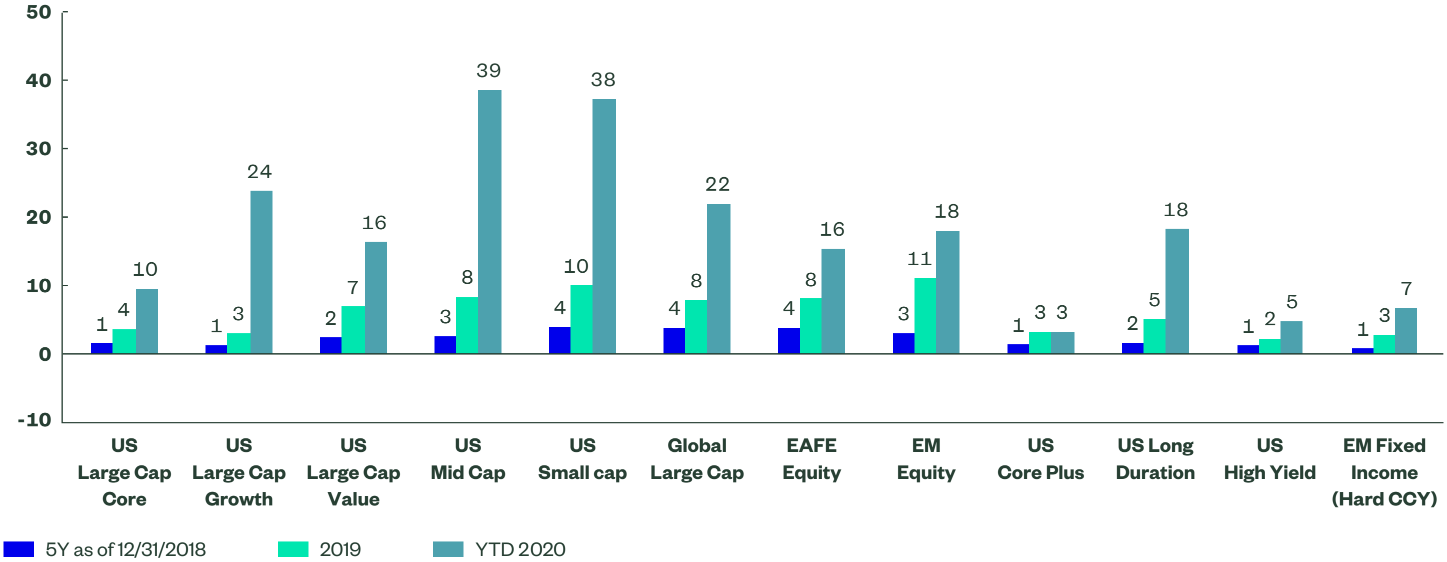


Source: Morningstar (net of fees). Index returns reflect capital gains and losses, income, and the reinvestment of dividends.

In light of such dynamic market conditions and an ever-changing macro landscape, it becomes imperative to focus and emphasize on picking the right managers at the right time. While empirical research suggests that asset allocation is one of the key drivers of performance in a portfolio, our assessment indicates that role of selecting the underlying investments is equally important. The charts below show the average excess return for the top 2 quartiles across asset classes and across multiple time frames. As can be seen, the top 50% of active managers have consistently been able to add value over time, more so in YTD 2020. Hence, we feel that a well-rounded manager selection process that is able to identify robust active strategies can be a key determinant of a portfolio's performance in addition to asset allocation decisions.

Figure 12

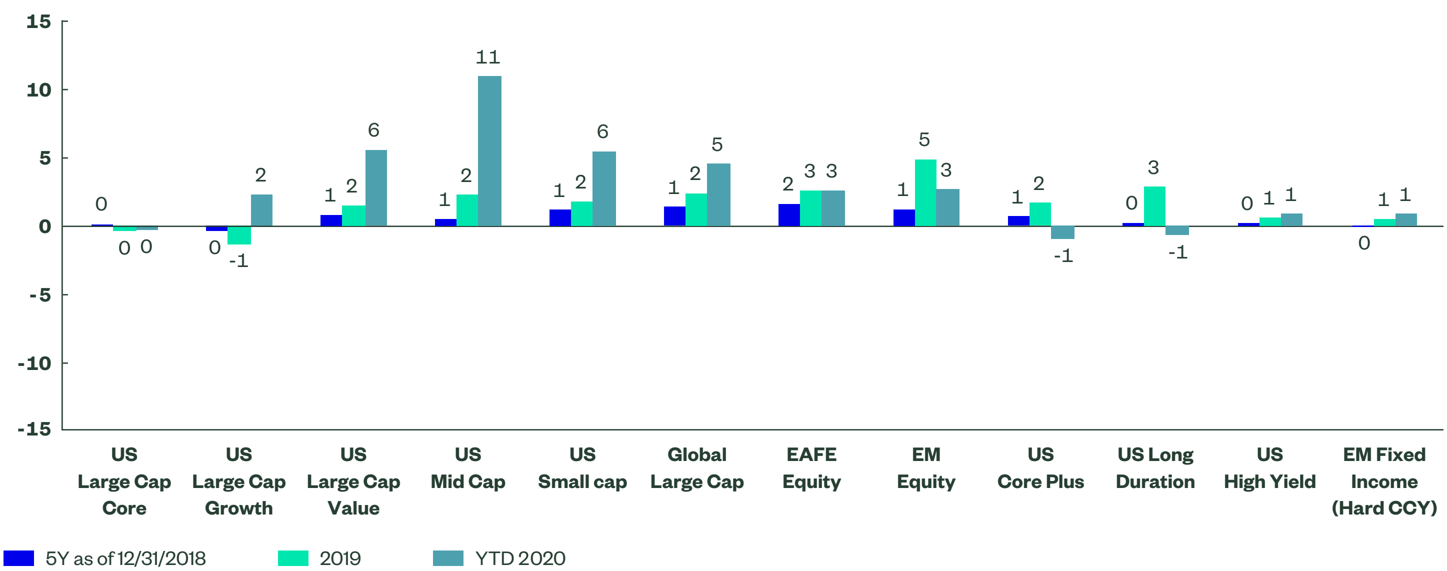
Average 1st Quartile Excess Return



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

Figure 13

Average 2nd Quartile Excess Return



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

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.

However, recent periods have been a silver lining for active managers as most asset classes have seen resurgence in active management outperforming their peers and indexes.

Despite the persistence of these trends in recent years, we believe it's premature to suggest that these struggles will extend indefinitely. As we have seen in recent periods, given the favorable market environment, active managers have managed to stage a comeback of sorts. 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. The role of prudent manager selection becomes more important now than ever. Embracing a thorough manager selection framework and implementing allocations in a timely manner has to ability to add an immense amount of value to one's portfolio.

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* This figure is presented as of June 30, 2020 and includes approximately $69.52 billion of assets with respect to SPDR products for which State Street Global Advisors Funds Distributors, LLC (SSGA FD) acts solely as the marketing agent. SSGA FD and State Street Global Advisors are affiliated.

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Investing involves risk including the risk of loss of principal.

Fixed income investments generally present less short-term risk and volatility than stocks, but contain interest rate risk (as interest rates raise, bond prices usually fall); issuer default risk; issuer credit risk; liquidity risk; and inflation risk. These effects are usually pronounced for longer-term securities. Any fixed income security sold or redeemed prior to maturity may be subject to a substantial gain or loss.

International Government bonds and corporate bonds generally have more moderate short-term price fluctuations than stocks, but provide lower potential long-term returns.

Investing in high yield fixed income securities, otherwise known as "junk bonds", is considered speculative and involves greater risk of loss of principal and interest than investing in investment grade fixed income securities. These Lower-quality debt securities involve greater risk of default or price changes due to potential changes in the credit quality of the issuer.

Issuers of convertible securities may not be as financially strong as those issuing securities with higher credit ratings and may be more vulnerable to changes in the economy. Other risks associated with convertible bond investments include: Call risk which is the risk that bond issuers may repay securities with higher coupon or interest rates before the security's maturity date; liquidity risk which is the risk that certain types of investments may not be possible to sell the investment at any particular time or at an acceptable price; and investments in derivatives, which can be more sensitive to sudden fluctuations in interest rates or market prices, potential illiquidity of the markets, as well as potential loss of principal.

Investing in foreign domiciled securities may involve risk of capital loss from unfavorable fluctuation in currency values, withholding taxes, from differences in generally accepted accounting principles or from economic or political instability in other nations.

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