Is It Time to Give Up on Active Management?

CFA Society of Pittsburgh 3rd Annual Endowments and Foundations Conference
May 2015

Gregory Woodard
Portfolio Strategist
Active vs Passive Performance Cycles

Active Large Cap Equity Funds vs. S&P 500\textsuperscript{1} Average Excess Returns – Trailing One Year (1987-2014)

<table>
<thead>
<tr>
<th>Active Strategies Tend to Outperform:</th>
<th>Passive Strategies Tend to Outperform:</th>
</tr>
</thead>
<tbody>
<tr>
<td>• When correlations among stocks are lower</td>
<td>• When correlations among stocks are higher</td>
</tr>
<tr>
<td>• When market returns are broad (average stock performs similar to the benchmark)</td>
<td>• When market returns are narrow (majority of stocks perform worse than the benchmark)</td>
</tr>
<tr>
<td>• When fundamentals are driving returns (valuations, earnings, growth, etc.)</td>
<td>• When emotions are driving returns (fear, greed)</td>
</tr>
<tr>
<td>• During the early-to-mid bull phase and early bear market phase of a stock market cycle</td>
<td>• During the speculative bullish phase of a stock market cycle or late in a bear market</td>
</tr>
</tbody>
</table>

Source: Morningstar, Inc. Active large Cap Core Category is defined as all mutual funds categorized by Morningstar as a large Cap Growth, Large Cap Value, or Large Cap Blend.
Where Are We Today? Higher Correlations


During the fourth quarter of 2014 correlations among stocks rose to levels consistent with those seen during the speculative bull market of the late 1990s and the end of the bear market in 2002 – during both environments, emotion (greed, then fear) tended to drive market returns.

*Calculated by the daily returns for the individual constituents of the S&P 500 Index. Source: FactSet.
Where Are We Today? Narrower Market Breadth

Percent of Stocks in Russell 3000\(^2\) Lagging Largest 20 Stocks (Last Twelve Months) (December 31, 1994 – September 30, 2014)

<table>
<thead>
<tr>
<th>Date</th>
<th>Russell 3000 Index(^2)</th>
<th>NASDAQ Composite Index(^3)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Index Return</td>
<td>10.45%</td>
<td>13.40%</td>
</tr>
<tr>
<td>Return of Average Stock</td>
<td>4.07%</td>
<td>1.11%</td>
</tr>
<tr>
<td>Return of Median Stock</td>
<td>3.34%</td>
<td>-0.21%</td>
</tr>
</tbody>
</table>

Note: Includes stocks that were in the Index at the beginning of 2014 and price was available on 12/31/2014. Data shown is from 01/01/2014 – 12/31/2014. Returns are based off Price Index (Dividends Excluded). Source: FactSet
Given that:

Active versus passive outperformance is cyclical and we are many years into a cycle where passive has outperformed...

There may be more potential opportunities going forward for:

- Lower correlations
- Broader market participation
- Stronger distinction between winners and losers

In short, we would argue that now is the wrong time to give up on active management

We are entering an economic environment where countries are beginning to decouple in terms of their position in the economic cycle, monetary policies, and stock market valuations
Divergences: Economic cycle, Monetary policies, and Stock Market Valuations

- **U.S. Treasury Bonds**
- **Emerging Markets**
- **EuroZone**
- **U.S. Corporate Bonds**
- **U.S. Equities**
- **U.S. High Yield Bonds**

**Bear Market**
Sustained period of negative market returns

**Recovery**
Period from market bottom until prices rise to prior peak

**Bull Market**
Sustained period of positive market returns following recovery

<table>
<thead>
<tr>
<th>Increase Exposure</th>
<th>Increase Exposure at Slower Rate</th>
<th>Decrease Exposure</th>
</tr>
</thead>
<tbody>
<tr>
<td>Buy into Weakness</td>
<td></td>
<td>Sell into Strength</td>
</tr>
</tbody>
</table>

**Active Management Allows for Adjustments Across Markets**

- Increase Exposure
- Increase Exposure at Slower Rate
- Decrease Exposure
Truly Active Managers Show Consistent Value Added Despite Changing Market Environments

Relative Annualized Performance in Various Market Environments

<table>
<thead>
<tr>
<th>Time Period</th>
<th>S&amp;P 500¹ Return</th>
<th>Excess Performance: Top Quartile Active Share Manager*</th>
<th>Excess Performance: Below Median Active Share Manager*</th>
</tr>
</thead>
<tbody>
<tr>
<td>1987 Bear Market (09/01/1987 - 11/30/1987)</td>
<td>-29.58%</td>
<td>-0.22%</td>
<td>1.01%</td>
</tr>
<tr>
<td>90s Bull Market (12/01/1987 - 03/31/2000)</td>
<td>19.51%</td>
<td>-1.95%</td>
<td>-1.67%</td>
</tr>
<tr>
<td>Tech Bubble Drawdown (04/01/2000 - 09/30/2002)</td>
<td>-20.56%</td>
<td>9.55%</td>
<td>1.45%</td>
</tr>
<tr>
<td>Failed Recovery (10/01/2002 - 10/31/2007)</td>
<td>15.54%</td>
<td>1.72%</td>
<td>-0.94%</td>
</tr>
<tr>
<td>Credit Crisis Drawdown (11/01/2007 - 02/28/2009)</td>
<td>-41.39%</td>
<td>0.96%</td>
<td>0.79%</td>
</tr>
<tr>
<td>Current Bull Market (03/01/2009 - 12/31/2014)</td>
<td>21.87%</td>
<td>-1.46%</td>
<td>-1.45%</td>
</tr>
<tr>
<td>Current U.S. Stock Market Cycle (04/01/2000 - 12/31/2014)</td>
<td>4.15%</td>
<td>3.09%</td>
<td>-0.12%</td>
</tr>
</tbody>
</table>

- Active Share was developed by professors at the Yale School of Management and is presented in a study originally published in 2006; most recently updated in 2013**

- Active Share measures the difference between an investment manager's portfolio and the benchmark on a holdings basis

- A portfolio's active share will range between 0% and 100%
  - 0% signifying that the portfolio is identical to the benchmark
  - 100% signifying that the portfolio and benchmark have no common holdings

- A higher active share may signify a greater level of active management.

Source: Morningstar, Inc
Universe includes all U.S. domiciled open end mutual funds with a Morningstar Institutional Category of All-Cap Core, Giant Core, Large Core, Large Valuation-Sensitive Growth, or Large Relative Value.
The oldest available share class of each fund was used.
*Manning & Napier defines top quartile active share managers as managers that have an active share of approximately 88% or above, and below median active share managers as managers that have an active share of approximately 77% or below.
The Real Risk of a Passive Approach in Today’s Environment: Locking In Mediocrity

Starting valuations today suggest that returns over the next ten years may annualize in the low single digits, implying that the market is unlikely to meet most investors’ objectives over the long run.

Source: Robert Shiller
(http://www.econ.yale.edu/~shiller/data.htm)
Analysis: Manning & Napier
Conclusions

• Active versus passive management is largely a cyclical debate, with certain market conditions causing one to outperform the other over time

• Since the end of the financial crisis, market characteristics such as higher correlations, more narrow markets and non fundamentals-based drivers (e.g., search for yield, risk-on/risk-off sentiment) have led passive strategies to largely out perform

• We believe the current market environment argues for a more active approach as global economies become uncoupled in terms of economic growth, monetary policy and market valuations

• Active strategies attempt to take advantage of differing market opportunities, but investors must separate truly active managers from closet indexers

• The key risk of a passive equity strategy for long-term investors in today’s environment is locking in mediocre return potential, given where valuations are today
Disclosures

©2015 Morningstar, Inc. All rights reserved. The information contained herein: (1) is proprietary to Morningstar and/or its content providers; (2) may not be copied, adapted or distributed; and (3) is not warranted to be accurate, complete or timely. Neither Morningstar nor its content providers are responsible for any damages or losses arising from any use of this information, except where such damages or losses cannot be limited or excluded by law in your jurisdiction. Past financial performance is no guarantee of future results.

1 The S&P 500 Total Return Index (S&P 500) is an unmanaged, capitalization-weighted measure of 500 widely held common stocks listed on the New York Stock Exchange, American Stock Exchange, and the Over-the-Counter market. The Index returns assume daily reinvestment of dividends and do not reflect any fees or expenses. S&P Dow Jones Indices LLC, a subsidiary of the McGraw Hill Financial, Inc., is the publisher of various index based data products and services and has licensed certain of its products and services for use by Manning & Napier. All such content Copyright © 2015 by S&P Dow Jones Indices LLC and/or its affiliates. All rights reserved. Neither S&P Dow Jones Indices LLC, Dow Jones Trademark Holdings LLC, their affiliates nor their third party licensors make any representation or warranty, express or implied, as to the ability of any index to accurately represent the asset class or market sector that it purports to represent and none of these parties shall have any liability for any errors, omissions, or interruptions of any index or the data included therein.

2 The Russell 3000® Index is an unmanaged index that consists of 3,000 of the largest U.S. companies based on total market capitalization. The Index returns are based on a market capitalization-weighted average of relative price changes of the component stocks plus dividends whose reinvestments are compounded daily. The Index returns do not reflect any fees or expenses.

3 The NASDAQ Composite Index is a broad-based capitalization-weighted index of domestic and international based common type stocks listed in all three NASDAQ tiers: Global Select, Global Market and Capital Market. The NASDAQ Composite includes over 3,000 companies. The Index returns do not reflect any fees or expenses.