Light at the End of the Tunnel—Are We Seeing the Return of Active Management?

By: Nancy B. Prial, Co-Chief Executive Officer & Senior Portfolio Manager

As active managers, we have seen firsthand the impact of the rise of passive investing over the past decade and a half. We have watched this phenomena with concern as to how we could effectively communicate our message that active management can add value over passive strategies without needing to make an either/or choice between the two elements of investing. Indeed, we have two core beliefs regarding the active/passive debate: firstly, that there is a cyclicality to the relative performance between active and passive investing and secondly, that there are specific sectors and investment styles that enhance the opportunity to add value through active focused stock selection. We will explore these two key points in the following piece.

Percentage of U.S Equity Funds Outperformed by Benchmarks			
Fund Category	**1 - Year (%)**	**5 – Year (%)**	**15 – Year (%)**
All Domestic Funds	60.49	85.82	82.23
All Multi-Cap Funds	74.88	87.19	88.15
Mid-Cap Growth Funds	94.58	92.18	97.35
Small-Cap Growth Funds	95.96	97.64	99.43

Source: Essex Investment; July 2018

S & P published a study in late 2016 that spoke to the relative outperformance/underperformance of actively managed funds against their respective benchmarks over a 15-year time horizon. As you can see in the chart below, passive strategies have outperformed across all funds over 1,5, and 15 years.

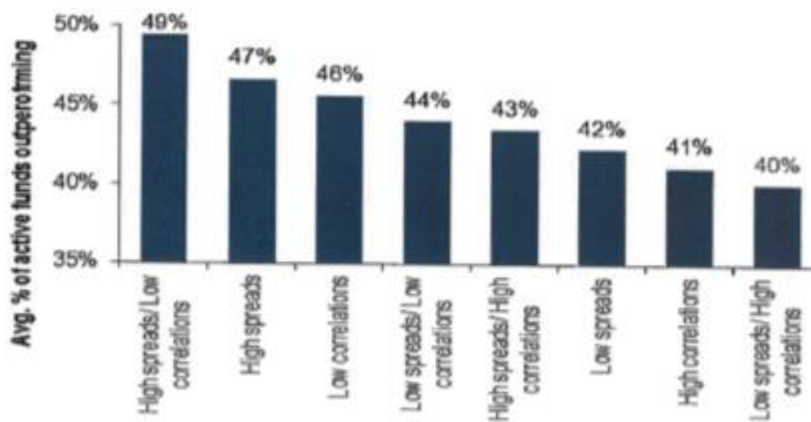
However, there is much more inconsistency when results are viewed on an annual basis. Based on these numbers, as shown in the chart below, the last three years (through 2016) have been on the high end of the trend lines.

% Of Active Funds Outperformed By Their Benchmark								
Fund Category	2009	2010	2011	2012	2013	2014	2015	2016
All Domestic Funds	40.68	48.28	84.65	64.91	43.26	86.89	74.03	60.49
All Multi-Cap Funds	3930	6039	8388	6522	4684	8162	70.10	7488
Mid-Cap Growth Funds	5401	84.11	7653	8681	3448	5537	7968	9458
Small-Cap Growth Funds	3134	6225	94.12	6291	5525	6398	8750	9596

Source: Essex Investment; July 2018

Many people have written about the reasons for the recent outperformance of passive over active strategies citing the above average return environment since 2009, consistently declining interest rates, the Fed pumping massive amounts of liquidity into the economy. Not surprisingly, these factors have made it more difficult to identify individual winners as the rising tide lifted all boats. The move towards increased indexing also led to some self-fulfilling actions as increased flows lead to increased performance across all stocks in the indexed funds. However, the headwinds from the above factors may be easing as we see tighter monetary policy with rising rates and potentially, rising inflation.

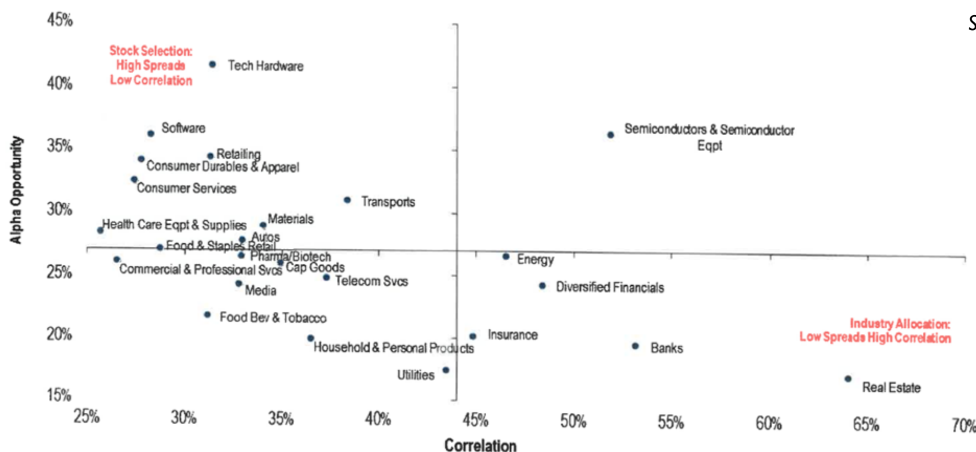
If we are correct, and we are entering a period of outperformance potential for active managers, what is the best way to capitalize on that trend? In short, we can add value by focusing on inefficient markets as well as by employing robust, consistent risk management. In an environment where correlations are lower and, even more importantly, dispersion is higher, our focus on finding stocks that are less- well known, less- well owned, and less- well understood can lead to outperformance both within sectors as well as overall versus our benchmarks. Indeed, B of A Merrill Lynch did a study that showed that active funds add the most value when both dispersion is high and correlations are low.



Source: BOA/ML; May 2018

Drilling down further, B of A Merrill Lynch shows that dispersion and correlation vary based on industry with the opportunity for alpha creation greatest in those areas with high spreads and low correlation. In general, those industries tend to be the areas that we have identified as the best growth opportunities within our portfolios, technology hardware, software, healthcare equipment and supplies, consumer services, and others as shown in the chart below.

Correlation & dispersion analysis for S&P 500 industry groups: Historical median intra-stock correlation vs. performance spread (2Q86-1Q18)

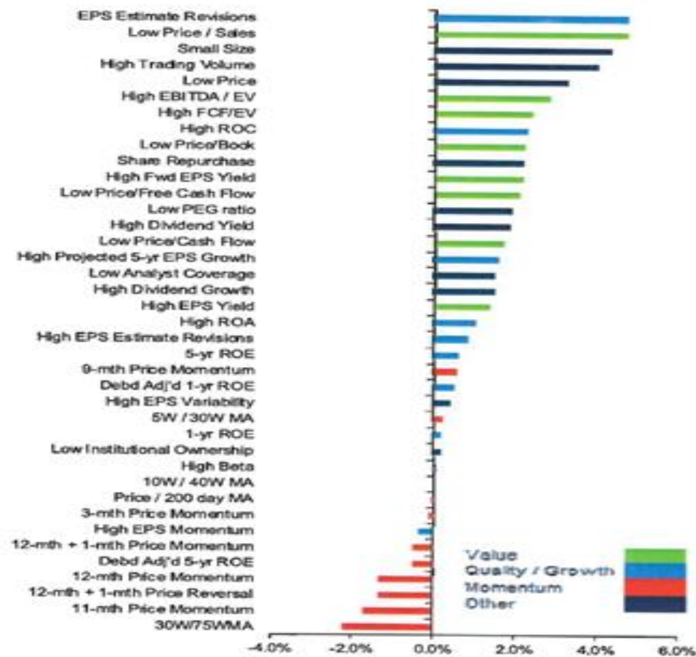


Source: BOA/ML; May 2018

We have long believed that we add alpha by the early identification of growth, when those future growth prospects are not yet fully reflected in the price of the stock. In fact, our strategies rely on the twin supports of high and improving growth with attractive valuation characteristics to identify compelling growth companies and industry exposures at a period when these companies and industries may not yet have been discovered by other growth investors. The evidence provided by B of A/Merrill Lynch in the following two charts, supports our investment philosophy that by trafficking in the less-well followed parts of our universe we have the opportunity to add significant value. Our process, which leads us to these neglected companies as their growth prospects are showing the early signs of fundamental acceleration, should be well-suited to capitalize on these phenomena.

Fundamental investment strategies in the less covered universe beat the benchmark almost across the board

Relative annualized total return performance (vs. equal-weighted S&P 500) of top quintile by each factor within the S&P 500 Sell Side Neglect universe monthly rebalancing 3/2003-3/2018



Source: BOA/ML; May 2018

Value stocks (Low Price/Sales) within the Sell Side Neglect universe outperformed the benchmark

Cumulative relative total return performance (vs. equal-wtd. S&P 500 total return) of top quintile by Low Price/Sales within the Sell-Side Neglect universe, monthly rebalancing 4/2003-4/2018

Stocks with highest return on capital (ROC) within the Sell Side Neglect universe outperformed the benchmark

Cumulative relative total return performance (vs. equal-wtd. S&P 500 total return) of top quintile by high ROC within the Sell-Side Neglect universe, monthly rebalancing 4/2003-4/2018

Source: BOA/ML; May 2018

In closing, we are encouraged that the tides are shifting so that the time has come for active management to regain the opportunity to add value and outperform our benchmarks. We are pleased that the first half of 2018 validated this thesis with strong performance across most of our equity strategies. We believe that we are early in a cyclical change to lower correlations and higher dispersions as QE ends, leading to higher interest rates, tighter monetary policy, more differentiation between winners and losers, and higher variability in market returns. This environment is one where we believe our focus on finding previously undiscovered, under owned, underappreciated growth stocks is one that can shine.

Important Disclosures:
This document is for informational purposes only as produced on June 30, 2018. It does not constitute investment advice and is not intended as an endorsement of any specific investment. The opinions and analyses expressed in this commentary are based on Essex Investment Management LLC's ("Essex") research and professional experience, and are expressed as of the date of the article. Certain information expressed represents an assessment at a specific point in time and is not intended to be a forecast or guarantee of future results, nor is intended to speak to any future periods. Accordingly, such statements are inherently speculative as they are based on assumptions that may involve known and unknown risks and uncertainties.

This document does not constitute an offer to sell or the solicitation of an offer to purchase any security or investment product, nor does it constitute a recommendation to invest in any particular security. It should not be assumed that any of the securities discussed herein were or will prove to be profitable.

An investment in securities is speculative and involves a high degree of risk and could result in the loss of all or a substantial portion of the amount invested. There can be no assurance that the strategy described herein will meet its objectives generally, or avoid losses. Essex makes no warranty or representation, expressed or implied; nor does Essex accept any liability, with respect to the information and data set forth herein, and Essex specifically disclaims any duty to update any of the information and data contained in the commentary. This information and data does not constitute legal, tax, account, investment or other professional advice.

This communication is (i) intended only for the person or entity to which it is transmitted, (ii) for information purposes only and (iii) confidential and may not be copied or retransmitted without permission. Any reproduction or distribution of this letter, in whole or in part, or the divulgence of any of its contents is strictly prohibited.