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The cyclical nature of active & passive investing

Reporters often prepare obituaries in advance for ailing celebrities so that when the end comes, they can publish instantaneously. Occasionally, someone hits "publish" prematurely, posting tributes for public figures who are very much alive.

In the same way, much ink has been hastily spilled recently in obituaries for active management. Most of the negativity has focused on the rise of passive investing, which has enjoyed strong performance during the past few years. But simply because one style of investing has come into favor does not mean others are going the way of the dodo.

So why are so many pundits ready to write off active management? And what makes us so sure that investing actively is not only a viable but essential part of investor portfolios?

Key Points

- The performance of active and passive management has been cyclical, with each style trading periods of outperformance.
- Market corrections are a regular and unavoidable part of market cycles.
- Active management has typically outperformed passive management during market corrections, because active managers have captured alpha[1] as the market recovers.

[1] The measure of the performance of a portfolio after adjusting for risk. Alpha is calculated by comparing the volatility of the portfolio and comparing it to some benchmark. The alpha is the excess return of the portfolio over the benchmark.

What Have You Done For Me Lately?

Recency bias is the tendency to believe that recently observed patterns will continue into the future, and it's a powerful force that can influence investor decisions. But investors who only take recent performance into account are missing the forest for the trees. After all, yesterday's events shouldn't determine how tomorrow's investment decisions are made.

Morningstar Large Blend is the largest Morningstar category, with $2.80 trillion in net asset size, constituting 17% of the US mutual fund market.[2] We selected this category because it is widely believed to be the most efficient—the one in which active investing supposedly makes the least sense. To represent active, we removed all index funds and enhanced index funds. For passive, we used the Morningstar S&P 500 Tracking category. As shown in **FIGURE 1**, passive large-blend strategies have outperformed active large-blend strategies for the last five years, which helps to explain why in 2018 passive US equity funds had inflows of $271 billion, while more than $175 billion under active management headed for the exits.[3]

But the past five years only tell part of the story. A wider look at the chart reveals active and passive have traded the lead in performance over time like two evenly matched racehorses. From 2000 to 2009, active outperformed passive nine out of 10 times. During the decade before that, passive outperformed active seven out of 10 times. And over the course of the past 34 years, active outperformed 16 times, while passive outperformed 18 times.

We've seen that the cyclical nature of active vs. passive investing definitely applies to the Morningstar Large Blend Category. The same holds true for other investment categories such as mid-caps, small-caps, and global/international equities. And just like performance, investor sentiment moves in cycles. If a certain style or asset class is doing well, investors are quick to extol its virtues and pour their money into it. It's no surprise, then, that passive investing is the new darling of many investors and much of the financial press. But just as a marathon isn't decided by the final 100 yards alone, we believe the dismissal of active management based on recent performance alone could be imprudent.

[2,3] Source: Morningstar Direct, 1/19

All investments are subject to risks, including the possible loss of principal. Performance data quoted represents past performance and does not guarantee future results.

"From 2000 to 2009, active outperformed passive nine out of 10 times."

FIGURE 1

No Clear Winner in Active vs. Passive Large-Cap Funds

■ Winner

	Active Large Blend Category (%)	S&P 500 Index Funds (%)
1985	29.78	**31.37**
1986	**17.84**	17.25
1987	2.51	**4.09**
1988	**16.52**	15.33
1989	26.86	**30.02**
1990	-4.07	**-3.33**
1991	**32.92**	29.39
1992	**9.33**	7.01
1993	**11.92**	9.42
1994	-0.36	**0.84**
1995	34.02	**36.84**
1996	22.16	**22.45**
1997	30.08	**32.68**
1998	21.54	**28.19**
1999	18.91	**20.29**
2000	**-2.00**	-9.46
2001	**-8.91**	-12.31
2002	**-20.67**	-22.45
2003	**29.05**	27.97
2004	**10.94**	10.34
2005	**6.20**	4.43
2006	14.51	**15.21**
2007	**6.82**	4.98
2008	**-37.02**	-37.24
2009	**28.71**	25.99
2010	**14.55**	14.51
2011	-0.07	**1.64**
2012	15.37	**15.43**
2013	**32.44**	31.73
2014	11.48	**13.10**
2015	-0.55	**0.90**
2016	10.64	**11.44**
2017	20.47	**21.26**
2018	-6.59	**-4.80**

Data Sources: Morningstar and Hartford Funds, 1/19

*Active Large Blend is made up of funds from the Morningstar Large Blend category that are not index or enhanced index funds.

*S&P 500 Index Funds is represented by the Morningstar S&P 500 Tracking Category.

Active or Passive? Yes.

Like the ocean tides, active and passive management's performance ebbs and flows. And as **FIGURE 2** demonstrates, their performance cycles are clearly defined. The chart compares the rolling monthly 3-year performance percentile rankings for active managers with that of passive managers ranked within the Morningstar Large Blend category.

FIGURE 2 shows that while overall there is no clear winner over the past 30 years, there has been a clear winner in active vs. passive performance for multiple and sustained periods, followed by a trading of positions. Once again the recent outperformance of passive is evident, and is preceded by 10 years of dominance by active management, and so on.

The story that **FIGURES 1 and 2** tell is clear. Just when it seems that active or passive has permanently pulled ahead, markets change, performance trends reverse, and the futility inherent in declaring a "winner" in active vs. passive is revealed anew.

Active Share: The True Measure for Active Managers

When it comes to active and passive, the debate isn't as simple as an either/or choice. Many so-called active funds closely mirror the indexes that serve as their benchmarks. These "closet indexers" offer no real value to active investors, and instead aim to slightly outperform the index by including a few different names. The problem, of course, is that this modest objective may not offer a real upside to justify the fees associated with active management.

Investors who are looking for a true active manager should examine the fund's active share, or measure of the percentage of equity holdings in a manager's portfolio that differ from the benchmark index. By examining active share, investors can get a clearer picture of how an active manager is adding value, instead of relying upon returns alone. It's a critical metric when trying to determine which funds are truly active or passive.

The Active-Share Spectrum

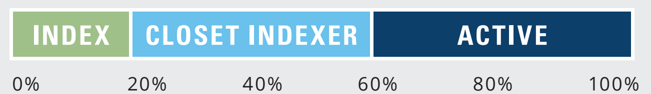
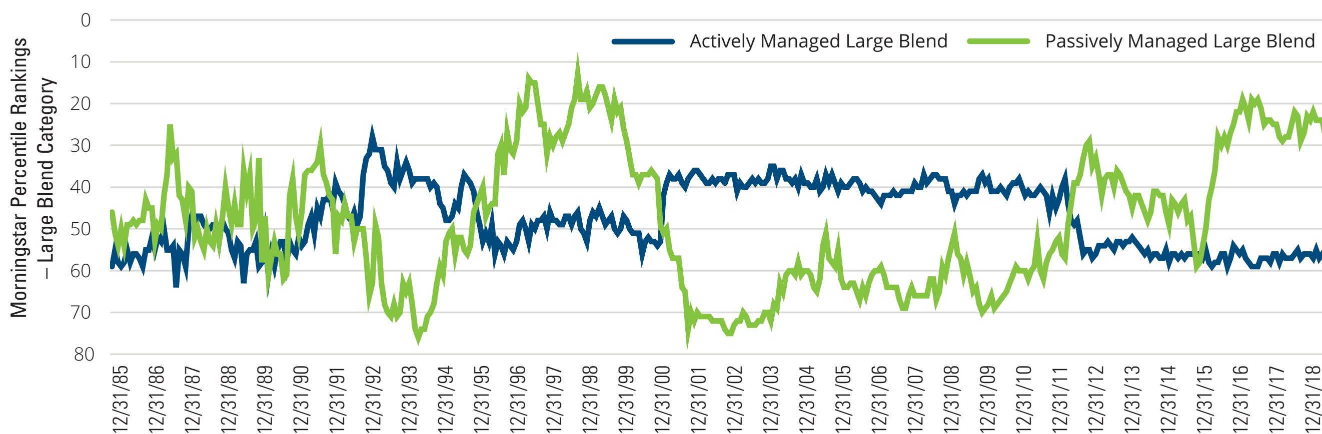


FIGURE 2

Active and Passive Outperformance Trends Are Cyclical

12/31/1985 to 12/31/2018 Rolling Monthly 3-Year Periods



Data Sources: Morningstar and Hartford Funds, 1/19

Home Runs: Part of the Cycle

Active/passive cyclicality is further demonstrated with high and low amounts of stock "home runs"—that is, a stock that outperforms the benchmark by 25% or more. Markets that feature large amounts of home runs signal dispersion in stock returns. High dispersion should benefit active managers who can single out the winners, whereas a low number of home runs indicates stocks are moving together, which typically benefits passive management.

In **FIGURE 3**, we've ranked the past 34 years from highest to lowest in terms of which stocks within the S&P 500 Index had the most home runs. The average number of home runs during this time period was 212. Sure enough, in years that feature a high number of home runs, active tended to outperform. And when there were fewer standouts, passive was the clear winner. It's just another example of how the performance of active and passive management has remained faithful to cyclical trends.

FIGURE 3

Active Managers Have Generally Outperformed in High Dispersion Markets

S&P 500 Index (1985 - 2018)

■ Active Outperforms

	Home Runs	% of HR	% Active Outperform
2001	322	63%	**70%**
2000	305	59%	**74%**
1992	269	53%	**60%**
2002	272	53%	**65%**
2004	264	52%	**55%**
2010	253	50%	46%
2009	258	50%	**62%**
2005	243	48%	**70%**
2016	242	47%	39%
2011	232	46%	30%
2015	233	45%	31%
2014	231	45%	30%
1993	226	45%	**65%**
1994	227	44%	37%
1986	211	43%	50%
2007	218	43%	**65%**
2018	216	42%	29%
1988	210	42%	**62%**
2003	209	41%	**54%**
1991	205	41%	**58%**
1987	201	41%	40%
1990	203	40%	48%
2013	198	39%	**60%**
1985	186	38%	41%
2012	182	36%	**56%**
2006	180	36%	44%
2008	184	35%	**53%**
1989	175	35%	24%
2017	170	33%	42%
1997	155	30%	30%
1996	151	30%	41%
1999	135	26%	43%
1995	125	25%	30%
1998	114	22%	23%

Past performance is not indicative of future results. Indices are unmanaged and not available for direct investment.

Data Sources: Factset, Morningstar, and Hartford Funds, 1/19

Active, Passive, and an Aging Bull

So what does cyclicality in active and passive management performance mean for you, the investor? We believe it demonstrates the importance of maintaining perspective (and sight of your investment goals) over time, and minimizing the undue influence of fickle market sentiment as you navigate changing market cycles. Instead of letting recent performance enchant you into chasing returns, you should instead consider current market conditions and what the future could hold.

As shown in **FIGURE 4**, the current bull market in equities is nearly a decade old, making it the longest bull market on record.[4] Not only that, the value of the S&P 500 Index has more than tripled since its low in March 2009.[5]

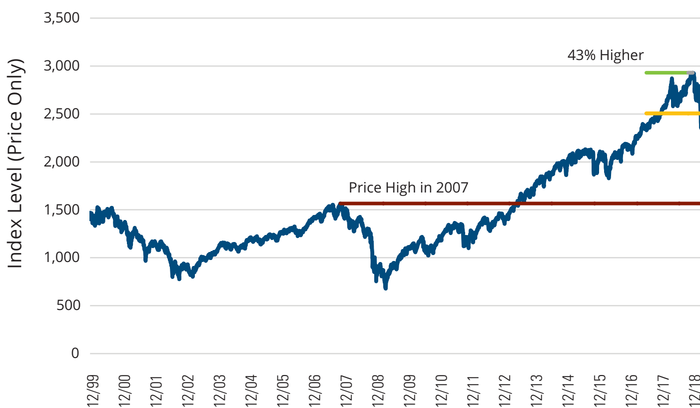
At the individual sector valuation level, the S&P 500 Index has a historical price/earnings ratio (the ratio of a stock's price to its earnings per share) of 18.7. As of the publication of this piece, this ratio is close to the historical average. **FIGURE 5** illustrates that although we've been in a bull market for about a decade, eight out of 11 sectors in the S&P 500 Index are trading at a discount to their 30-year historical average. Active managers have the flexibility to seek out opportunities in undervalued sectors, while passive investments are locked into the sector allocations determined by the index.

While this bull has run for years, it hasn't been immune to occasional corrections (as measured by a loss of 10% or greater) to help keep it healthy. Like speed limits on highways, market corrections are a necessary evil in investing, but not one to be feared. They keep markets from becoming overinflated and prevent valuations from reaching heights that lead to damaging crashes. They can also provide opportunities for active management.

FIGURE 4

Equity Valuations Have Generally Risen the Past Decade

S&P 500 Index Price Only (12/31/99-12/31/18)



Data Sources: Morningstar and Hartford Funds, 1/19

FIGURE 5

Many Sector Valuations Are Below Historical Averages

S&P 500 Sectors	30 Yr Avg P/E	12/31/18	% Change
Communication Services	19.7	11.9	-39%
Consumer Discretionary	18.7	19.7	5%
Consumer Staples	21.4	20.1	-6%
Energy	17.2	13.1	-24%
Financials	14.3	10.4	-27%
Health Care	23.2	24.0	3%
Industrials	18.5	15.6	-16%
Information Technology	24.1	18.9	-22%
Materials	18.7	17.9	-4%
Real Estate	29.0	35.6	23%
Utilities	15.8	17.9	14%
Total	**18.7**	**17.0**	**-9%**

Data Source: FactSet, 1/19

Current P/E ratio is as of 12/31/18

[4] Data Sources: Ned Davis Research and Hartford F unds, 2/19

[5] Data Sources: Morningstar and Hartford Funds, 1/19

Active Management Has Fared Better During Corrections

The most recent market correction arrived in December 2018. When corrections occur, you may not want to be exclusively invested in passive. Instead, you may want to consider investing in actively managed funds.

There have been 26 market corrections over the last 31 years. **FIGURE 6** shows that during those corrections, active outperformed passive 15 out of 26 times, with an average rate of outperformance of 1.3%.[6] Again, we compared active to passive by removing index and enhanced index funds from the Morningstar Large Blend Category to represent active, and used the S&P 500 Tracking category to represent passive.

By allowing investors to respond to ever-changing markets, active management empowers investors to maximize opportunity as conditions demand. But if you're locked into an index fund, you could be exposed to significant downside due to single-sector performance. For example, during the collapse of the dot-com bubble in 2000, active management outperformed passive significantly, -0.3% to -9.50%.[7] Much of the blame for passive's underperformance during that period can be laid at the feet of a single sector.

As **FIGURE 7** shows, the technology sector made up almost 30% of the S&P 500 Index at that time. The sector (as represented by the S&P 500 Information Technology Index) crashed hard, to the tune of a 38.71% decline in 2000.

Meanwhile, the average active manager was significantly underweight technology relative to the index (21% vs. 30%), which helped limit the damage done to their portfolios when the tech bubble burst. Active managers with a positive return during this time were more underweight to technology with 15%, and those with a negative return hewed closer to the index with a 28% weighting.[8] For a more recent example, one need only look back to the decline in oil prices in 2014 to see how passive investors were hurt by their inability to reduce exposure to an underperforming sector.

When bull markets inevitably turn, passive managers could be left holding stocks and sectors with poor fundamentals and inflated valuations. Meanwhile, active managers have the ability to mitigate risk by reducing exposures to expensive areas that will be hit hardest, and conversely, increase exposure as sectors or asset classes recover to capture upside as the new market cycle begins.

[6] Source: Ned Davis Research, 2/19

[7] As represented by the S&P 500 Index, from 1/1/00 to 12/31/00

[8] Source: Morningstar, 2/18

FIGURE 6

Active Management Has Taken Corrections in Stride

Date	Active Management Large Blend 12.31.18	S&P 500 Tracking 12.31.18	Difference
08/26/1987-10/19/1987	-17.50	-19.73	2.23
10/22/1987-10/26/1987	-14.20	-14.52	0.32
11/03/1987-12/04/1987	-9.69	-10.77	1.08
10/10/1989-01/30/1990	-9.61	-9.15	-0.46
07/17/1990-10/11/1990	-19.07	-18.82	-0.24
10/08/1997-10/27/1997	-9.39	-10.77	1.38
07/18/1998-08/31/1998	-19.71	-18.47	-1.23
09/24/1998-10/08/1998	-10.84	-9.89	-0.95
07/17/1999-10/15/1999	-11.93	-11.91	-0.03
03/25/2000-04/14/2000	-10.43	-11.12	0.70
09/02/2000-04/04/2001	-21.75	-27.09	5.34
05/22/2001-09/21/2001	-24.97	-26.18	1.21
01/05/2002-07/23/2002	-28.78	-31.59	2.81
08/23/2002-10/09/2002	-18.51	-19.06	0.55
11/28/2002-03/11/2003	-13.49	-14.35	0.87
10/10/2007-03/10/2008	-16.91	-18.09	1.17
05/20/2008-10/10/2008	-36.51	-36.51	0.00
10/14/2008-10/27/2008	-15.87	-15.43	-0.44
11/05/2008-11/20/2008	-24.82	-24.99	0.17
01/07/2009-03/09/2009	-25.77	-27.22	1.45
04/24/2010-07/02/2010	-15.72	-15.71	-0.01
04/30/2011-10/03/2011	-20.04	-18.81	-1.23
05/22/2015-08/25/2015	-11.90	-11.99	0.08
11/04/2015-02/11/2016	-13.73	-12.82	-0.91
01/27/2018-02/08/2018	-9.91	-10.10	0.19
09/21/2018-12/31/2018	-14.33	-14.08	-0.25

Average Outperformance	1.30
Active Wins	15
Passive Wins	11

Data Sources: FactSet, Morningstar, and Hartford Funds, 2/19

FIGURE 7

Index Funds: Individual Sectors Can Have Outsized Impact

1/1/2000 to 12/31/2000 S&P 500 Index Sectors

Sector	% Average Weight	% Total Return	% Impact on Performance
Consumer Discretionary	9.85	-23.75	-2.67
Consumer Staples	8.78	5.95	0.50
Energy	6.49	20.04	1.11
Financials	14.04	25.40	3.11
Health Care	11.57	37.93	3.58
Industrials	8.82	3.36	0.16
Information Technology	29.59	-38.71	-11.82
Materials	2.02	-16.22	-0.38
Real Estate	0.10	-26.65	-0.03
Telecommunication Services	6.75	-38.82	-3.02
Utilities	1.98	53.59	0.80
Total	**100.00**		

Data Source: FactSet, 1/17

Investment Implications:

This insight focused on active vs. passive investing in the Morningstar Large Blend category because it's widely believed to be the most efficient category—the one that should invariably favor passive investing. Yet even this category shows the cyclical nature of active and passive performance. The same cyclicality is present in other investment categories such as mid-caps, small-caps, and global/international equities.

Just as we think declaring active management dead is premature, we don't contend that active management is the only suitable choice for investors. Far from it. We believe that the choice between active and passive management is not a zero-sum game, but that each has a place in investor portfolios based on the individual needs and wants of the investor. With that in mind, here are some conclusions to take away from this piece:

- The performance of active and passive management is cyclical, meaning each style goes through extended periods of outperformance.
- When evaluating active and passive management, looking beyond recent performance and measuring active share is important.
- As we saw in December 2018, market corrections are inevitable and a common occurrence in equity markets over time.
- There have been 26 market corrections over the past 31 years, and active management outperformed passive management in 15 out of 26 corrections.
- During market corrections, the flexibility of active management allows for reducing exposure on the downside and ramping up exposure to capture alpha in the early stages of recovery.

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