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Active equity managers may outperform in the coronavirus era

Equities Team

Nuveen

Equity investors continue to debate the merits of active versus passive management. But rather than frame the discussion in absolute terms, at Nuveen we believe it's more important to understand how and why different market environments tend to favor either an active or passive approach. The investment landscape in the era of coronavirus invites such an inquiry. After their fastest-ever selloff into a bear market during the first quarter of 2020, U.S. equities have rallied hard, fueled in part by massive monetary and fiscal stimulus. The outlook from here, however, remains uncertain. In this analysis, we show why this evolving market environment is likely to be more conducive to active management.

KEY POINTS

- Asking whether active or passive equity management is superior may be the wrong question. Results for the two approaches are cyclical – each has historically delivered extended periods of outperformance.
- During market corrections, active management offers the flexibility to reduce exposure on the downside and increase opportunities to capture alpha as the market begins to recover.
- In our view, the market environment emerging from the coronavirus-driven downturn presents compelling opportunities for stock selection and active management. We have identified specific factors that we believe may help active managers outperform on a relative basis.

THE DIFFERENCE BETWEEN ACTIVE AND PASSIVE IS CRUCIAL

It's important to understand the respective goals of these two investment approaches. Passive investing seeks to match the performance of a given benchmark index by owning all the stocks in that index in the same proportion, often through an exchange-traded fund (ETF) or index mutual fund. In contrast, active investing seeks to beat the benchmark by having professional portfolio managers use their judgment to overweight, underweight or avoid exposure to specific stocks relative to the index — and, if their investment guidelines permit, to hold stocks outside of the benchmark.

Such flexibility brings with it a necessary focus on effective risk management and the ability to better align portfolios with prevailing market conditions and anticipated developments. For example, amid rising credit concerns leading up to the 2008-09 global financial crisis, an active manager could have reduced or eliminated portfolio holdings in financial stocks, thus mitigating risk and protecting the downside. A passive manager would not have had that option.

Moreover, there are times when market indexes become overly concentrated in a particular sector and/or specific holdings, resulting in higher risk exposure for a passive investor. A recent example: As of May 31, 2020, the top five stocks in the S&P 500 Index based on market capitalization — Apple, Microsoft, Amazon, Alphabet (Google's parent company) and Facebook — represented 20.3% of the index.[1] Meanwhile, the bottom 349 stocks accounted for the same percentage. Active managers can adjust these weightings in their portfolios to reduce concentration risk.

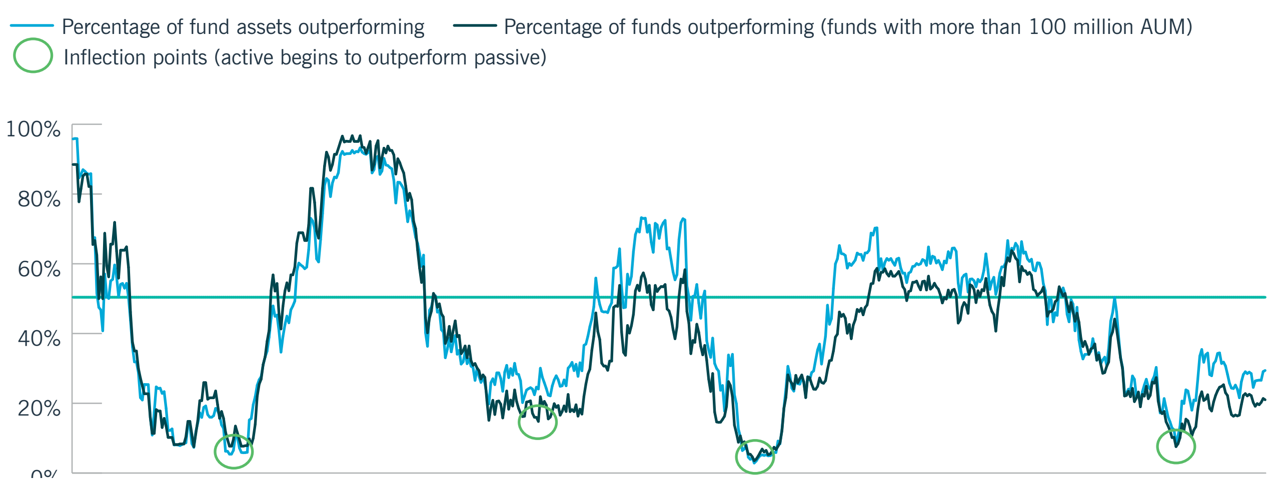
ACTIVE EQUITY MANAGERS TEND TO PERFORM BETTER IN CERTAIN ENVIRONMENTS

As shown in Figure 1, trends in active versus passive flows and performance have been somewhat cyclical, and date as far back as 1975, when index mutual funds began trading — long before the advent of exchange traded funds (ETFs) in 1993, which drove flows into passively managed strategies. Active managers lagged during the late 1990s, enjoyed a period of strong relative performance through most of the 2000s and have struggled over the past 10 years. We believe this latest trend of underperformance may be ending.

The bull market that began in March 2009 was the longest in history, lasting 131 months. In that time, from trough to peak, the S&P 500 returned 401%.[2] Despite its magnitude, this period was

Figure 1: Alpha generation in active strategies has been cyclical

Percentage of funds (fund assets) outperforming S&P 500 on a 5-year basis



Sources: CRSP, Bloomberg, Robert Shiller data, Nomura-Instinet, Joseph Mezrich, as of 9 June 2020. Used with permission. **Past performance does guarantee future results.**

often referred to as "the most hated bull market" due to the lasting effects and recency bias of the global financial crisis. For much of this time, a combination of rising markets, low volatility and narrowing differences in performance between and among individual stocks made it harder for active managers to apply their skills.

As a result, passive investing and ETFs gained in popularity. In August 2019, equity fund assets under management in passive strategies exceeded those in active strategies for the first time.[3] In a market where basically every stock was appreciating in value, regardless of fundamentals, buying a low-cost ETF or index fund benchmarked to the S&P 500, for instance, was a prudent decision. But in today's volatile environment, fee sensitivity may be less important. It's unclear to what extent investors will still prioritize saving, as an example, 50 basis points (bps) per year in fees when the index they are passively tracking tumbles by 3% or more in a single trading session — as the S&P 500 did multiple times in March 2020.

Why do active managers collectively tend to outperform or underperform in different environments? Based on our experience, we believe it's easier for active managers to add value when certain factors are present. We highlight four of these factors in Figure 2, then review each one in the context of the current market.

Figure 2. Active managers have generally performed well in these environments

Equal weight > Cap weight	Interest rates ↑
Dispersion ↑ Correlations ↓	Credit spreads ↓

"Trends in active versus passive performance have been somewhat cyclical … We believe it's easier for active managers to add value when certain factors are present."

1. When equal weight is outperforming cap weight

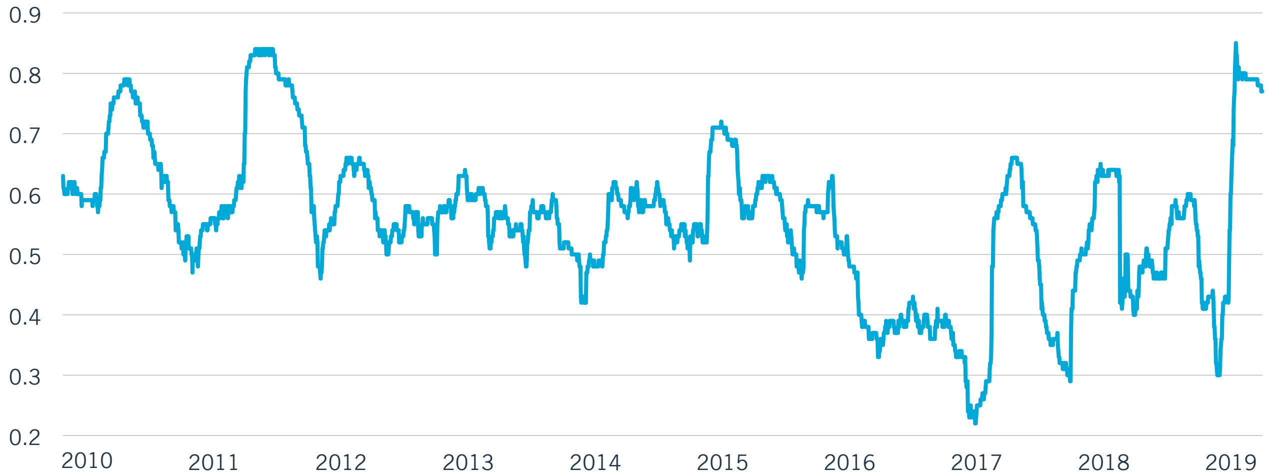
An equal-weighted version of an index consists of the same stocks as the capitalization-weighted index, but each constituent company in the equal-weighted version is assigned the same fixed allocation as a percentage of the whole. When an equal-weighted index outperforms its cap-weighted counterpart, active managers should have more opportunities.

For example, as of May 31, 2020, the trailing 12-month performance spread between an equal-weighted basket of the 30 top-performing stocks in the S&P 100 Index and an equal-weighted basket of the 30 bottom-performing stocks in the S&P 100 Index was 67.8% — up from 57.7% on February 19, 2020, before the market's steep drop.[4] The larger this performance spread, the less likely it is for a passive strategy tied to the market-weighted version of the S&P 100 to outperform.

2. When dispersion of returns is rising/correlation of returns is falling

Despite some notable exceptions, overall market volatility has been relatively low over the past several years. Such an environment compresses the performance spread between the best- and worst-performing stocks, indicating they are moving more in tandem than their individual characteristics would imply. This typically benefits passive management while making active stock selection more challenging. Even if active managers pick the best-performing companies, they're less able to add value when return correlations are high.

Figure 3: S&P 500 rolling 65-day correlations



Sources: Strategas Research Partners, Bloomberg as of 9 June 2020.

Conversely, greater dispersion between winners and losers creates a more favorable environment for active managers. A market environment in which many stocks outperform the benchmark by a wide margin signals a higher degree of dispersion (and thus lower correlation) of returns. As shown in Figure 3, correlations between individual stocks in the S&P 500 Index have recently stabilized at around 0.8 — the highest level in approximately eight years. This indicates that the market has been driven primarily by macro forces, namely the COVID-19 pandemic and its economic impacts, and not by stock-specific factors. Going forward, we expect investors to shift their focus more toward company fundamentals, resulting in lower correlations and enhanced opportunities for active managers.

3. When interest rates are rising

When interest rates fall, equity returns are typically driven by valuations. When interest rates climb, earnings become more important. Put another way, company fundamentals matter more in a rising rate environment because active managers pay close attention to earnings quality. U.S. rates were moving up unevenly over the past few years before plummeting to historic lows in March 2020 as the coronavirus exacted its economic toll. In the third and fourth quarters of 2020, with the economy likely beginning to emerge from the pandemic-driven recession, we expect rates to trend slowly higher, which should benefit active management.

4. When credit spreads are narrowing

The first quarter's dramatic widening of credit spreads has abated. After moving 277 bps higher, from 96 bps on February 19, 2020, to 373 bps on March 23, investment grade spreads began to tighten steadily.[5] By the end of May, spreads stood at 174 bps, having retraced nearly three-quarters of their widening from the early days of COVID-19. Narrowing credit spreads generally signal an improving economy. And when economic growth accelerates, earnings growth tends to thrive, allowing active managers to be more selective.

WHICH ACTIVE MANAGERS MIGHT OUTPERFORM?

In our view, the four factors examined on pages 3 and 4 should create an improved market environment for active managers and those of their clients who are patient and prepared to take a long-term investment view. But not all active managers are created equal. Which ones might be poised for better performance?

First, it's important to understand the environment over the past several years. From the end of the global financial crisis in 2009 until the first quarter of 2020, equity markets were relatively steady and in the midst of a strong bull market — a textbook example of a rising tide lifting all boats. When most stocks in a given universe have been performing well, it's difficult for active managers to add value. But when market returns soften or dip into negative territory, active managers have more opportunities to shine.

Figure 4. Rolling 3-year returns, quarterly periods

Source: Morningstar Direct. Based on three-year rolling quarterly returns for the last 20 years ended 31 Mar 2020. **Past performance does not guarantee future results.** Fund categories include all active large cap U.S. mutual funds available, including Morningstar Large Value, Large Blend and Large Growth.

Figure 4 compares three-year rolling returns of all actively managed large cap U.S. mutual funds versus the S&P 500 Index (which we consider a reasonable proxy for passive management) over the past 20 years. The trend is unmistakable: Passive strategies dominated when market returns were extremely high. In contrast, when gains were in single digits or returns fell below zero, active styles outperformed.

Based on this analysis, investors may want to take a closer look at active management — unless they're convinced markets will deliver exceptionally strong returns for years to come. Given reduced earnings expectations for 2020 and still relatively high valuations for U.S. equities, we anticipate muted performance that may trend lower than the market's long-term average.

IDENTIFYING THE RIGHT ACTIVE MANAGER

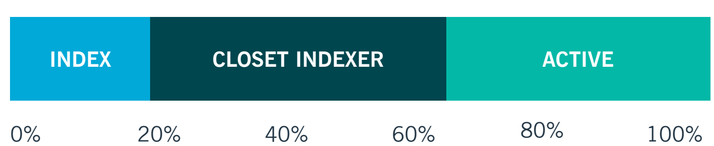
We believe a set of common factors may be associated with active management outperformance. Among these are high active share and manager ownership.

High active share

Many managers that claim to be active deviate only modestly from their benchmark indexes. One way to quantify the degree of divergence is through active share, a statistical measure comparing a fund's holdings against those in the fund's benchmark.

Developed by former Yale University finance professors Martijn Cremers and Antti Petajisto, active share can be assessed along a spectrum, shown in Figure 5. Under this model, an active share of 60% or higher is required to be considered genuine "active management"; 20%-60% is designated "closet indexing"; and less than 20% is deemed "index" (passive). By taking active share into account, investors needn't rely solely on returns to gauge how an active manager is adding value.

Figure 5. The active share spectrum



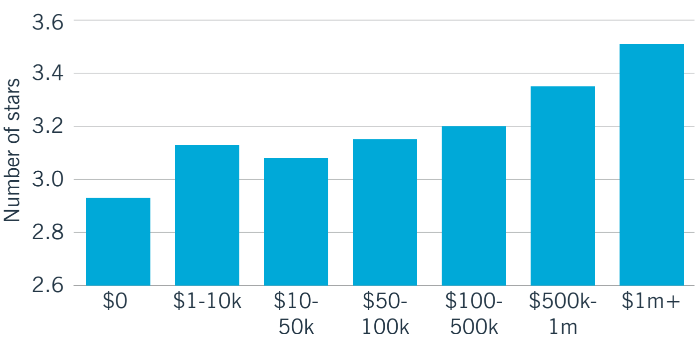
Source: Morningstar, as of June 2020.

Manager ownership

It's also important to ensure that active managers align their interests with those of their clients. To what degree do managers invest their own assets in the funds they manage? Morningstar has periodically conducted studies to determine the correlation between manager ownership and the number of stars the funds receive. Not surprisingly, funds with high levels of manager ownership have tended to perform better. Results from the most recent of these studies are illustrated in Figure 6.

Figure 6. Manager ownership makes a difference

Morningstar rating based on amount of ownership



Source: Morningstar. More Evidence Supports Manager Ownership, 2011. Based on average stars in the Morningstar Core Stock Fund Categories based on reported manager ownership. For funds with at least a three-year history, a Morningstar Rating™ is based on a risk-adjusted return measure (including the effects of sales charges, loads, and redemption fees) with emphasis on downward variations and consistent performance. The top 10% of funds in each category receive 5 stars, the next 22.5% 4 stars, the next 35% 3 stars, the next 22.5% 2 stars, and the bottom 10% 1 star. Data is not intended to represent the performance of any product managed by Nuveen. **Past performance does not guarantee future results.**

In addition to active share and manager ownership, we believe investors should consider additional factors when selecting an active manager, including: consistency in approach and style, low cash levels, a transparent and proven investment process, relatively small fund size and low expenses.

LOOKING AHEAD

Although neither passive nor active management can be declared the overall "winner" of the past 30 years, each has taken turns leading the other for sustained periods. The outperformance of passive strategies in recent years was preceded by a decade of dominance by active management, and so on. Ultimately, just when it seems that one approach may have "permanently" pulled ahead, the market landscape shifts, performance patterns change and the folly of declaring the absolute superiority of either active or passive is revealed anew.

We believe U.S. equities may be nearing another of those inflection points. The market environment is still being transformed by a pandemic that has yet to run its full course. The varying impacts of the virus on different companies and sectors continue to unfold. Some companies have experienced a near-total shutdown of operations, but others are busier than ever. Those that are highly dependent on cash flows may struggle to service debt or return cash to shareholders, while firms with more resilient business models and stronger balance sheets are better positioned to survive and thrive amid the uncertainty. Still others remain at risk of severe financial distress, including bankruptcy.

While passively managed strategies, by definition, are forced to own all of these types of companies to the extent they're represented in the designated benchmark index, active managers are not. Through fundamental, bottom-up research on individual companies, along with careful portfolio construction and risk management parameters, active managers can tilt toward higher-quality holdings while avoiding those of lower quality. They also may use forward-looking analysis to identify stocks that are likely to sustain their dividend payments in times of crisis. These advantages—together with the historical and current trends, investment environments and market factors examined in these pages — point to skilled active management as the preferred approach to navigating the pandemic and its aftermath.

For more information, please visit nuveen.com.

Endnotes

1 FactSet
2 FactSet
3 Morningstar
4 FactSet
5 Barclays Live. Spreads are for the Bloomberg-Barclays U.S. Corporate Investment Grade Index

Glossary

An **exchange-traded fund (ETF)** is a marketable security that tracks an index, a commodity, bonds, or a basket of assets like an index fund. An ETF trades like a common stock on a stock exchange. **The Russell 1000® Index** is an index of approximately 1000 of the largest companies in the U.S. equity market. **The S&P 500 Index** is a capitalization-weighted index of 500 stocks designed to measure the performance of the broad domestic economy.

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