Large-Cap Equities: The Heart of the Active-Passive Debate

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- The S&P 500 Index places outsized importance on its largest holdings—mostly technology stocks—which can be expected to drive performance on any given day.
- Historically, passive strategies have led in bullish periods, while active strategies generally led in downturns.
- Active strategies can gain more overall when outperformance (via fewer losses) during downturns is more significant than underperformance (via fewer gains) during upturns.

The S&P 500 Index (a market-capitalization weighted Index of publically traded large U.S. companies considered representative of the broad U.S. stock market) has become the default index in debates about the merits of passive investing—that is, investing in a strategy that tracks an index. The solid performance of the S&P 500 Index in recent years has generated media attention, particularly given the typically low fees of strategies that seek to replicate its performance. Investors have responded by moving a lot of money into passive strategies.

Unboxing the Index

Good performance at a low cost: who doesn't love that combination?

This approach has proven popular enough that passive investment products have been created to cover every asset class by seeking to track a wide range of indexes—many sharing similar benefits such as low fees—although performance results vary across asset classes. Today, there are actually more investment-tracking indexes than U.S. stocks.[1]

Indexing could represent a great proposition—as long as you're aware of the limitations.

At first glance, mirroring such a broad-based index may seem like a smart way to achieve a diversified portfolio. After all, your assets would be spread across hundreds of stocks. While that's true, consider the following about the S&P 500 Index:

- The four largest companies make up 10% of its combined market capitalization.
- Information technology companies make up three out of its four largest stocks—and half of its 10 largest stocks.

[1] Source: "There Are Now More Indexes Than Stocks." Bloomberg Businessweek. May 12, 2017.

Other considerations are a bit more technical, such as price-to-earnings ratios (data used to determine a stock's attractiveness relative to peers). Six out of the Index's 10 largest stocks have price-earnings ratios above 30—meaning they cost more than 30 times their annual earnings—suggesting they are priced expensively at this point.

The S&P 500 Index places outsized importance on its largest holdings—mostly expensive technology stocks—which can be expected to drive performance on any given day. This trend has gained momentum as technology's share of the 10-largest constituents grew in each of the last three years (through May 31, 2017).

A Story of Cyclicality: U.S. Equity Leadership

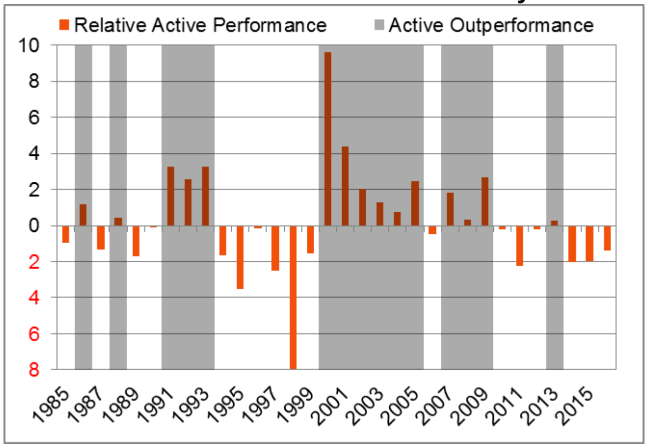
While the S&P 500 Index has enjoyed a strong run of performance in recent years, the historical picture tells a more nuanced story.

As the ball dropped on New Year's Eve in 1999, the threat of a systemic Y2K meltdown bringing civilization to a halt was only one of at least two concerns on investors' minds. Morningstar's Active Large Blend category average (Active Strategies) had underperformed the S&P 500 Index Funds category (Index Funds) for the prior six consecutive years. At that point, it would have been understandable for investors to have turned their backs on active management.

But not only did civilization survive Y2K, January 1, 2000 happened to be the pivot point for a six-year run of active outperformance. Active Strategies recouped the performance deficit generated over the prior six years in the first two years of their turn at the top. In fact, from 2000 through 2009, Index Funds outperformed only once (in 2006).

The pendulum then swung again: from 2010 to 2016, Active Strategies underperformed Index Funds in all but one year (2013).

Exhibit 1: Active-Passive Performance Cycles



Source: Morningstar

Exhibit 1 depicts the cyclicality of active-passive performance. The rotation between active and passive leadership reveals a thought-provoking pattern: passive led during heavily bullish periods, while active led in downturns.

- Index Funds beat Active Strategies in four of their top five years of performance from 1985 through 2016.
- Active Funds beat Index Funds in all four of their worst-performing years during the same period.

Compound Returns Cut Both Ways

These cyclical tendencies are more than just interesting anecdotes. Index Funds only had five negative showings during this 32-year period, or about 16% of the time. That's below the 27% rate for the S&P 500 Index (and the S&P 90 Index, its predecessor, until 1957) going back to 1928, according to Bloomberg.

Considering that positive Index Fund performance has occurred far more often than negative Index Fund performance—and that Active Strategies have generally seen the greatest outperformance during these less-frequent downturns—it would seem to indicate that Active Strategies have less time to shine.

However, from 1985 through 2016, a dollar invested in Index Funds would have grown to $23.27, while a dollar invested in Active Strategies would have grown to $25.63—earning $2 more.[2]

Active Strategies came in ahead over the full period thanks to their greater propensity to outperform in challenging periods. They gained more overall by losing less on the downside than they sacrificed by gaining less on the upside.

A Story of Cyclicality: To Be Continued…

The bull market that began in March 2009 has reached near-historic levels:

- At 98 months as of May 9, 2017, the S&P 500 Index has surpassed all but one other period since World War II (October 1990 to March 2000).
- At 254%, only two bull markets have gone further (October 1990 to March 2000 and June 1949 to August 1956).

We believe the case for a continued bull market is sound, but must acknowledge that turns eventually come and never announce their arrivals. The S&P 500 Index—a top-heavy portfolio with no risk-mitigating qualities—does not strike us as a thoughtful approach to large-cap equity investing, especially at this late stage in the cycle.

Regardless of whether a bear market eclipses the bull sooner rather than later, the contrast between types of environments in which active and passive each excel should not detract from the idea that skilled active managers can capitalize on opportunities that indexes cannot. Noting the story of cyclicality underscores an important fact: active managers are capable of managing risk in portfolio construction that indexes have no ability to replicate.

The virtue of active discipline does not end with U.S. large-cap allocations. Financial services market research firm DALBAR's *Quantitative Analysis of Investor Behavior* study has demonstrated year after year that investors as a group sacrifice returns by poorly timing their buying and selling decisions. This year, DALBAR also conducted a study on *Active versus Passive Investor Returns*, which found that investors in active funds outperformed investors in passive funds over the 15-year period ending 2016 (the longest period measured in the study). Passive investors outpaced active over the one- and three-year periods ending 2016.

Perhaps the longer-term outperformance of active investors is partially because they are comforted during downturns by having a skilled manager at the wheel—and therefore less inclined to sell based on emotion. Whatever the reason, the moral of the story is clear: historically, cyclical tendencies seem to favor active over passive.

[2] Source: SEI. Calculated based on annual Morningstar category average returns. Assumes reinvestment of distributions.

Research Information

DALBAR Active versus Passive Investor Returns: This study uses data from the Investment Company Institute (ICI), Standard & Poor's and proprietary sources to compare mutual fund investor returns of Active and Passive Investments. Covering the period from January 1, 2002 to December 31, 2016, the study utilizes mutual fund flows as the measure of investor behavior. These behaviors reflect the "average investor." Based on this behavior, the analysis calculates the "average investor return" for various periods.

Morningstar Large Blend Category: Large-blend portfolios are fairly representative of the overall U.S. stock market in size, growth rates and price. Stocks in the top 70% of the capitalization of the U.S. equity market are defined as large cap. The blend style is assigned to portfolios where neither growth nor value characteristics predominate. These portfolios tend to invest across the spectrum of U.S. industries, and owing to their broad exposure, the portfolios' returns are often similar to those of the S&P 500 Index.

- The Active Large-Cap Blend Category comprises funds from the Morningstar Large Blend category that are not index or enhanced index funds.
- The S&P 500 Index Funds Category is represented by the Morningstar S&P 500 Tracking Category.

Important Information

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The performance data quoted represents past performance. Past performance does not guarantee future results.