OppenheimerFunds®
The Right Way to Invest

The Case for High Conviction, Active Investing

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Executive Summary

- Not all active managers are created equal. Managers with high active share and low portfolio turnover have generated meaningful outperformance, net of fees, both domestically and globally.
- Global markets are particularly well suited to active management.
- Passive investments present a number of hidden risks.
- The coming market environment may favor active management.
- Patient, highly active investment management is vital to helping investors meet their long-term financial goals.

Why Active?

We don't believe the active versus passive asset management debate should be viewed as a winner-take-all proposition. While both approaches have a role to play, given all the attention passive investing has recently received, we think investors need education as to which approach is most appropriate to reach their investment goals. Indexing across all asset classes is never the answer nor is treating all asset managers the same. Investors' goals and time horizons should be aligned with those of their portfolio manager. Patient, highly active investment management remains vital to the achievement of investors' long-term investment goals.

Not All Active Managers Are Created Equal

It seems intuitively obvious that a portfolio can outperform a benchmark only if it is differentiated from that benchmark. Differentiation can come through a combination of owning different weightings of securities in the benchmark, not owning securities in the index, or owning those outside the benchmark. "Active share" has become a now widely recognized measure that quantifies the percentage of a portfolio that is different from its benchmark. For a portfolio to be considered active, at least 60% of its security weightings must be different from its benchmark.[1] Examining a portfolio's "activeness" has become increasingly important because of the dramatic rise in "closet indexers"—those funds that are theoretically actively managed, but in reality take very little risk versus the benchmark. In 1980, closet index funds essentially did not exist, but by 2009, they accounted for nearly half of purportedly active funds.[2]

Funds that stick close to their index tend to generate market-like returns that translate into underperformance once fees are taken into account. Given the volume of closet index funds in the market today, these portfolios' returns drag down the average performance of active managers, tarnishing the reputation of truly active managers who deliver superior returns justifying their fees.

Studies of Domestic Equity Portfolios Show Two Attributes Deliver Outperformance

The concept of active share was first identified in 2009, in the groundbreaking paper, "How Active Is Your Fund Manager? A New Measure That Predicts Performance," authored by Martijn Cremers and Antti Petajisto. That paper, along with subsequent academic work, demonstrated that high active share was a critical component of outperformance for active managers of U.S. equity portfolios.

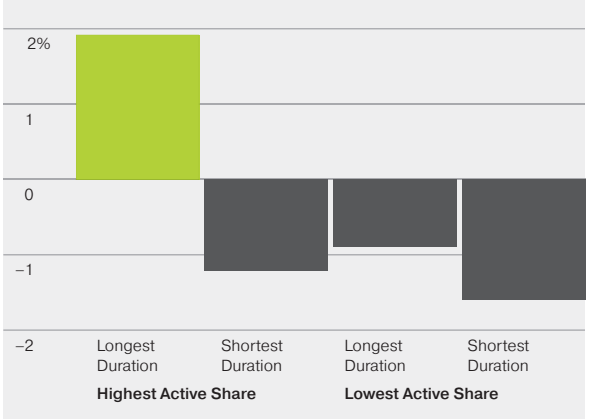
But a more recent paper by Cremers and another co-author, Ankur Pareek, identified a second key attribute for delivering outperformance in U.S. equities—long-term investing, measured as the duration for which securities are held in a portfolio. Retail mutual funds were grouped into quintiles on the basis of the duration of their holdings and active share. Only those with the longest duration (average holding periods of two years) and the highest active share were able to consistently outperform over the 19-year period the study examined—from 1995 to 2013.[3]

The portfolios with high active share and the patience to hold onto the securities they selected delivered an average outperformance of 1.92%, even after fees were taken into account. That outperformance becomes more dramatic when considered in dollar terms. For simplicity's sake, let's assume a benchmark delivered an average annual return of 10% on an initial investment of $10,000 over that 19-year period. An extra return of 1.92% every year, net of fees, would enable the investment to grow to $84,000 vs. $61,000 for the benchmark-level returns, thereby generating $23,000 in alpha for an investor. **Exhibit 1** ▼

Exhibit 1

Only Long Holding Periods and High Active Share Deliver Outperformance

U.S. equity mutual funds (after-cost relative annualized returns by quintile of duration & active share*; 1995-2013)



Source: Empirical Research Partners. Martijn Cremers and Ankur Pareek, 2014. "Patient Capital Outperformance: The Investment Skill of High Active Share Managers Who Trade Infrequently." Working Paper. * Annualized returns relative to fund's self-declared benchmark where available, otherwise benchmark that minimizes active share is selected. **Past performance does not guarantee future results.**

Long Holding Periods, High Active Share Equally Important for Global Funds

OppenheimerFunds' own analysis reveals that high active share and long holding periods are equally critical for global portfolios. We looked at funds in the Morningstar World Stock Category and grouped them into four categories on the basis of their active share and portfolio turnover ratio, which serves as an indicator of how long they hold on to securities in their portfolios.

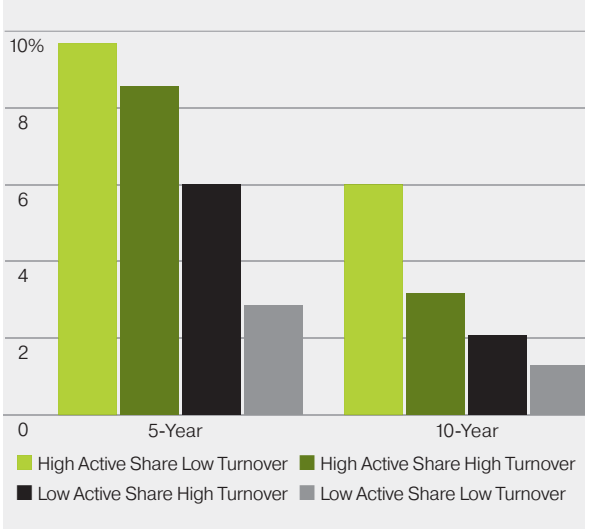
Examining returns over both 5- and 10-year time frames demonstrated that portfolios with high active share and low portfolio turnover ratios outperformed. The closet indexers—those with low active share—significantly underperformed both when they had low and high portfolio turnover ratios.

On both the domestic and global fronts, it is clear that superior outperformance can come only when investors don't hug the index and have the patience to continue owning stocks that impatient investors typically shun. Often that means having the discipline to stick with lower volatility, higher quality companies that were initially available at a discount. In short, it pays to have the courage of your convictions. **Exhibit 2** ▼

Exhibit 2

Highly Active, Low Turnover Managers Outperform Globally As Well

Total returns in Morningstar World Stock Category (%)



Sources: OppenheimerFunds Proprietary Research, Morningstar Direct (12/31/14).

Global Markets Are Particularly Well Suited to Active Management

It is a commonly accepted notion that international equity markets are fertile ground for active managers because these markets are often less liquid and less efficient than the U.S. equity market. But there is additional, concrete evidence to support this view. The returns of international equities are much more highly dispersed.

Dispersion is a measure of the variability of returns. The dispersion of U.S. equities, for example, can be measured by looking at the difference in the best and worst performers every month over the course of a year, and then calculating the average of the previous 12 months to state a one-year dispersion percentage. Greater dispersion of returns basically means there is a broader range of performance outcomes, and that variability creates more opportunities for active managers to outperform.

A look at the dispersion of equity returns since 2000 shows the stark difference between the United States and international markets. During that period, the U.S. equity market, as measured by the stocks in the Standard & Poor's 500 Index, had an average 12-month dispersion of 86%. Global markets were much higher at 110%.[4]

Exhibit 3 ▼

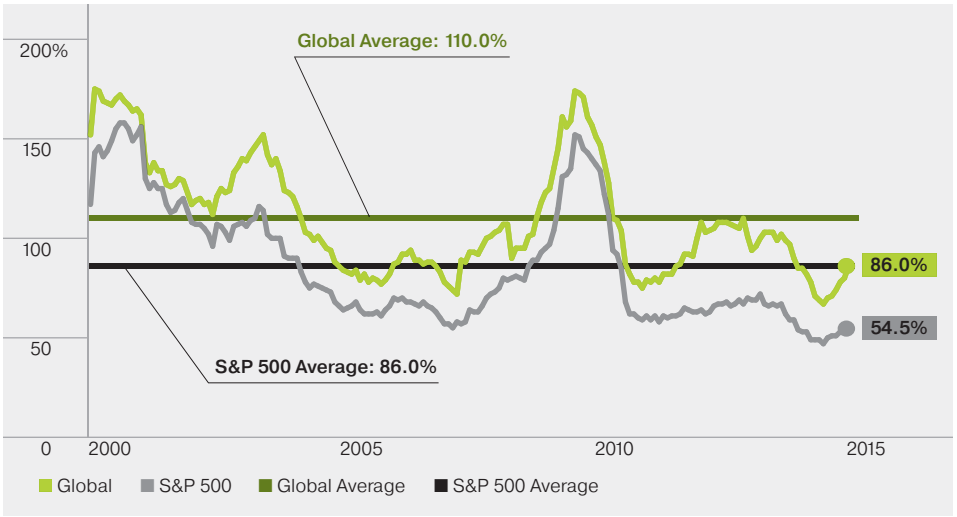
This higher dispersion may explain the relatively weak performance of passive products in the international and global equity categories and further reinforces the value of taking a patient, high conviction, active approach when investing outside the United States.

Passive Investments Present a Number of Hidden Risks

Passive investing has become more popular for a reason. For certain asset classes over short time frames and in certain market environments, passive vehicles can be useful. These short-term instances when passive investments can do well, however, can create a false sense of security for investors because they mask many of the risks inherent in a passive approach.

Exhibit 3

Returns Are Consistently More Dispersed in International Markets
Equity Dispersion (Range of Monthly Returns: Max-Min, 12M average)



Source: Strategas Research Partners (1/30/15) Note: the chart shows the performance spread between the index's best and worst performer each month, expressed as a 12-month average. The S&P 500 Index is a broad-based measure of domestic stock market performance. Indices are unmanaged and cannot be purchased directly by investors. Index performance is for illustrative purposes only and does not predict or depict the performance of any Oppenheimer funds. The global series includes the S&P 500, the Europe Stoxx 600, Nikkei 225 & top 100 holdings of the MSCI EM Index. **Past performance does not guarantee future results.**

Greater dispersion of returns creates more opportunities for stock pickers to make a difference.

Index performance turns lackluster over long periods. If one ranks the performance of indices in their Morningstar asset class categories, it becomes clear that indices significantly underperform over long periods. The Standard & Poor's Index ranks only in the second quartile over the past 5 and 10 years, and only in the middle of the pack for the past 15 years, a highly relevant time frame for any long-term investment goals such as retirement or college savings. Similarly, domestic small cap falls from the middle of the pack over 10 years to the bottom of the third quartile over 15 years. For international indices, the picture looks even worse, with most indices in the lower half of performers for the 5-, 10- and 15-year periods. **Exhibit 4** ▼

Exhibit 4

Inconsistent in the Short Term, Sub-Par in the Long Term

Index Rank in Morningstar Category	5-Year Percentile Ranking	10-Year Percentile Ranking	15-Year Percentile Ranking
S&P 500 Index rank in Morningstar Large Blend Category	26th	28th	50th
Russell 2000 Index rank in Morningstar Small Blend Category	49th	52nd	74th
MSCI Europe Index rank in Morningstar Europe Stock Category	42nd	28th	72nd
MSCI EAFE Index rank in Morningstar Foreign Large Blend Category	57th	55th	49th
MSCI EM Index rank in Morningstar Diversified Emerging Markets Category	59th	68th	54th
MSCI World Index rank in Morningstar World Stock Category	49th	52nd	70th

Source: Hypothetical rankings of index performance created by OFI based on Morningstar performance data, 12/31/14. Rankings are subject to change. The S&P 500 Index is a broad-based measure of domestic stock market performance. The Russell 2000 Index measures the performance of small-capitalization stocks. The MSCI Europe Index is designed to measure the equity market performance of the developed markets in Europe. The MSCI EAFE Index is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed international markets. The MSCI EM Index is designed to measure global emerging market equity performance. The MSCI World Index is a free-float weighted equity index which measures the performance of developed markets and does not include emerging markets. Indices are unmanaged and cannot be purchased directly by investors. Index performance is for illustrative purposes only and does not predict or depict the performance of any investment. **Past performance does not guarantee future results.**

Replicating an index is not always easy. Those who try to make the case for passive investing often compare the returns of active managers with indices. But the problem is that you cannot invest in an index, and the passive vehicles that attempt to match indices cannot exactly mirror their returns. The first obstacle is that passive investments have fees which tend to be materially higher in domestic small cap and international asset classes. Once fees are taken into account, all passive vehicles underperform their index. Passive products have an even harder time matching the price behavior of an index, a problem that becomes highly apparent when you look at tracking error, which measures the price behavior of a portfolio relative to an index. Even in the highly efficient, U.S. large-cap equity market, the leading index vehicle has slight tracking error. Tracking error becomes more pronounced in the less efficient U.S. small-cap market. Among international markets, tracking errors become highly significant. **Exhibit 5** ▼

Exhibit 5

Particularly in Less Efficient Markets, Passive Products Have Notable Tracking Error and Fees

Tracking error and expense ratios of select passive investments

Asset Class	Benchmark	ETF	Tracking Error	Expense Ratio
U.S. Large Cap	S&P 500	SPY	0.3%	0.10%
U.S. Small Cap	Russell 2000	IWM	0.6	0.20
Europe	S&P Europe 350	IEV	3.8	0.60
Japan	MSCI Japan	EWJ	10.5	0.48
Emerging	MSCI EM	EEM	6.2	0.67
Global	MSCI ACWI	ACWI	2.2	0.33

Source: Bloomberg (1/30/15).

Clearly the case for passive investing cannot be made by looking at index returns alone. When considering the passive products that aim to "replicate" indices, the arguments for passive investing become less persuasive.

The rules about what goes in an index are not always based on a security's merits. While the securities in an index are not managed, there generally is an index committee that determines what securities are in the index and what their individual weightings will be. These decisions are generally based on rules of the index and not on assessments of the fundamentals of each security. Whenever the securities in the index or their weightings are changed, managers of passive portfolios must automatically match the change without giving any consideration to the rationale or implications of the change.

A recent study by three researchers in Pomona College's economics department revealed the potential flaws in this approach. They looked at changes in the Dow Jones Industrial Average from 1929 through 2005. For every occasion in which a stock was removed from the index and replaced by another, they compared the subsequent 5-year performance of the deleted stock versus the new entrant. The difference was startling and significant, with the removed stocks delivering an average cumulative gain of 173% vs. 65% for the new entrants.[5]

Indices' backward-looking nature leaves them vulnerable in volatile markets. With the exception of the price weighted Dow Jones Industrial Average, the majority of major indices used in the creation of passive products are market-cap weighted. These indices are backward-looking in that they assign increasing weights to the best performing stocks that may be prone to overvaluation. Meanwhile, stocks that have underperformed, and may sport more attractive valuations, have reduced representation. Therefore, passive products have greater exposure to potentially overvalued highflying stocks, a risk that becomes more pronounced as leadership changes when markets change direction.

In a severe market disruption, that leaves an index highly exposed to the rapid downturn of overvalued stocks, there is less potential for cushioning the overall portfolio's fall from stocks whose prices might not have as far to drop.

The Tech Bubble of 1999 and the Credit Crunch of 2008 offered dramatic illustration of this risk for indices and the passive products that mirror them. The Standard & Poor's 500 Index was heavily exposed to the highly overvalued sectors—information technology stocks in 1999 and financial services companies in 2008—that experienced the most significant drawdowns in the ensuing market collapses. **Exhibit 6** ▶

Relative to active managers, who had the flexibility to either avoid or minimize their exposure to these sectors, passive vehicles underperformed during these crises.

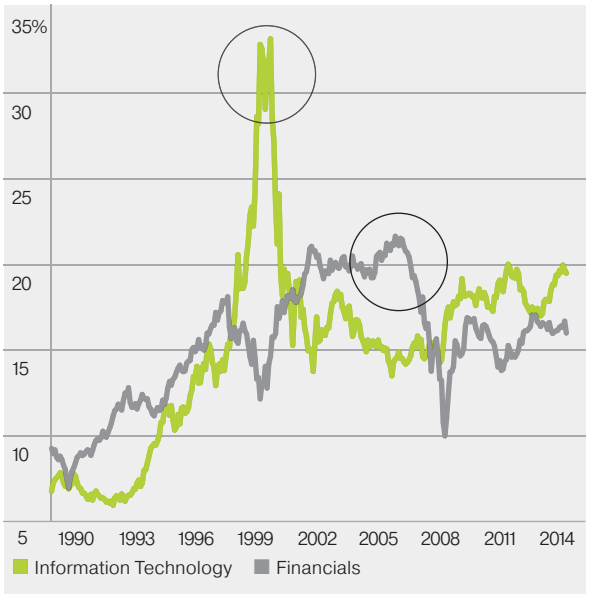
Indices often don't offer broad sector, or even security-level, diversification. The passive products that replicate many leading U.S. and international equity indices often don't provide broad sector diversification. The weighting by individual securities' market capitalizations can create a severe disparity in the weightings of various sectors. In fact, the weighting of the top three sectors dwarfs the weighting of the smallest five sectors in the Standard & Poor's 500 Index and seven leading MSCI international indices.

In the emerging and frontier markets, this lack of sector diversification is compounded by a lack of individual security diversification. In regional indices for these markets, the top 10 individual securities can constitute as much as 35% of the index; for individual country indices that disproportionate representation of the top 10 names can soar as high as 65% of the index.[6] **Exhibit 7** ▶

Exhibit 6

The S&P 500 Was Heavily Exposed to the 1999 Tech Bubble and the 2008 Credit Crunch

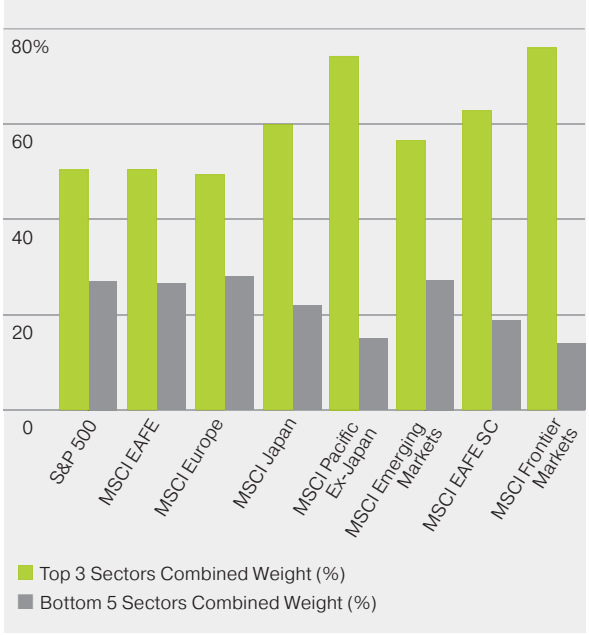
Sector weightings in S&P 500 Index (%)



Source: FactSet (1/30/15).

Exhibit 7

Passive Strategies Carry High Sector Concentration Risk



Source: FactSet (1/30/15).

The Coming Market Environment Could Prove to Be Particularly Favorable for Active Management

If we once again compare the U.S. large-cap equity index, the S&P 500, to the group of mutual funds that invests in that asset class (for this example, we will use the Lipper Large Core Category), we find that over the past three full calendar years of 2012 to 2014, the index's performance, measured by its monthly 3-year rolling returns, beats the category average and lands in the top quartile of performance.

If you extend the analysis further back, however, to 2000 as an example, you will find there were a number of years in which the index's rolling 3-year returns fell below the category average and generally ranked in the third quartile.

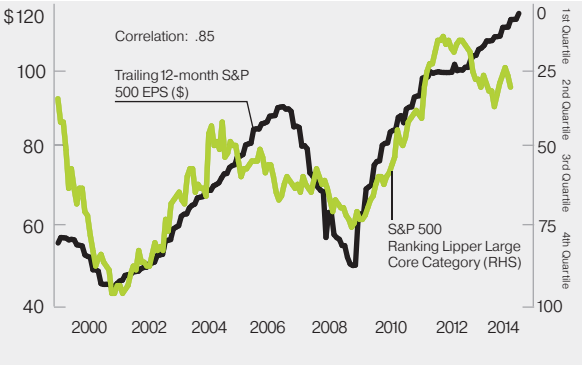
In fact, over that 15-year period, the odds that the index would fall in the top or bottom half are no better than a coin flip—50/50. But the factors driving the index's relative ranking are far less random.

A high historical correlation of .85 exists between the relative performance ranking of the S&P 500 Index in the Lipper Large Core category and U.S. corporate profits as measured by the S&P 500 companies' 12-month, trailing operating earnings per share.[7] The S&P 500's relative ranking tended to rise into the top half, and even the top quartile, of the category during periods of strong, sustained corporate growth such as those of 2003 to 2006 and 2009 to 2011. At times when profits experienced a material decline, such as 2000 to 2002 and 2007 to 2009, the index's ranking dipped into the bottom half of the category. **Exhibit 8** ▼

Exhibit 8

Weakening EPS Momentum Often a Harbinger of Deteriorating Passive Performance

S&P 500 Ranking in Lipper Large Core Category (Rolling 3-Yr) vs. S&P 500 EPS



Sources: Bloomberg, Lipper (12/31/14). The chart depicts the rolling 3-year monthly performance rank of the S&P 500 Index in the Lipper Large Core Category. The S&P 500 Index is a broad-based measure of domestic stock market performance. Indices are unmanaged and cannot be purchased directly by investors. Index performance is for illustrative purposes only and does not predict or depict the performance of any Oppenheimer funds. **Past performance does not guarantee future results.**

Since 2012, aggregate earnings per share of the S&P 500 have continued to climb, but the pace of profit growth has slowed, and that may explain why the S&P 500's ranking in the category has dipped from the first quartile into the second.

While we expect earnings per share to rise modestly this year, we think a number of macroeconomic headwinds could make robust profit growth unlikely. That could portend only middling relative performance for the S&P 500 Index—and the passive products that replicate it.

- Renewed worries about the prospects of recession and deflation in Europe, coupled with weakening growth in other regions of the world, may weigh on U.S. profit growth, given that roughly 40% of the S&P 500 companies' revenues comes from overseas sources.[8]
- While growth in the U.S. economy may outpace other developed nations, two expectations for the second half of 2015—that the Fed will tighten monetary policy and that foreign demand will remain strong for relatively high yielding U.S. bonds—may explain why the U.S. dollar index recently traded at 14% above its average for 2014.[9] That suggests the S&P 500 companies' revenues face a stiff currency headwind in 2015, with the impact compounded by the fact that the index's constituents' foreign earnings per share exposure currently stands at a hefty 33%.[10]
- The collapse in oil prices that began in June 2014 is another major wild card for corporate earnings in 2015. While one might think the negative impact of oil's decline on the energy sector could be offset by the benefits of lower energy prices for other sectors, a look at consensus S&P 500 earnings per share for 2015 reveals more bad news than good. Led by a 44% plunge in energy sector earnings per share, overall S&P 500 estimated profit growth has dropped to just 3.2% from 12.3% in October of 2014, with all 10 sectors experiencing decline. **Exhibit 9** ▼

Exhibit 9

S&P 500 2015 Consensus EPS Forecasts

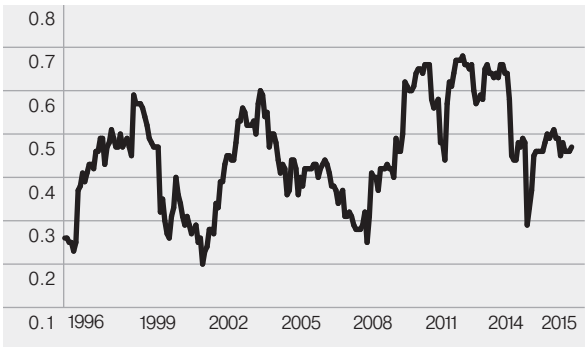
	10/1/14	1/30/15
Cons. Disc.	17.7%	14.8%
Financials	15.1%	12.1%
Healthcare	11.6%	9.8%
I.T.	12.9%	7.6%
Industrials	11.6%	7.6%
Materials	18.6%	6.5%
Cons. Staples	9.2%	5.0%
Telecom	6.1%	4.3%
S&P 500	**12.3%**	**3.2%**
Utilities	3.0%	2.0%
Energy	8.1%	–44.4%

Source: S&P Capital IQ (1/30/15). Forecasts may not be realized.

Investors appear to be taking notice, differentiating between the potential winners and losers. "Pairwise" stock correlations—a measure of the degree to which stock prices move together, recently stood at 0.47, having declined from an all-time high in 2010.[11] Lower correlations suggest that each stock's price is increasingly based on its own fundamentals, rather than on investor sentiment toward the asset class as a whole. Such an environment likely favors active managers—and, in our view, particularly those who have the patience and conviction to be long-term, buy-and-hold investors. **Exhibit 10**

Exhibit 10

Declining Equity Correlation Favors Stock-Pickers
Rolling 12-Month S&P 500 Pairwise Correlation



Source: Strategas Research Partners (1/30/15). Note – Chart shows the rolling 12-month correlation of each S&P 500 constituent to the S&P 500 Index, averaged together to derive the total monthly average. This analysis is based on current index constituents. The S&P 500 Index is a broad-based measure of domestic stock market performance. Indices are unmanaged and cannot be purchased directly by investors. Index performance is for illustrative purposes only and does not predict or depict the performance of any Oppenheimer funds. **Past performance does not guarantee future results.**

Conclusion

Neither active nor passive asset management has a monopoly on helping investors meet a wide variety of investment goals. We believe investors can benefit from hearing why active management continues to warrant core portfolio exposure.

Even net of fees, high conviction, low turnover active strategies have outperformed passive products over various time frames both domestically and globally. Investors should understand this, as well as active management's inherent advantages internationally and the many underappreciated shortcomings of passive investing. Beyond this evergreen superiority, slowing U.S. corporate EPS growth and declining equity correlation are attributes of the current environment that are highly conducive to active management. All told, we believe the attainment of investors' long-term financial goals warrants core portfolio exposure to patient, high conviction active management.

The Case for Fixed Income Active Management

The active vs. passive debate is most frequently waged over the equity markets, with the performance of equity indices generally used to make the case for either side.

Still, the argument for active fixed income investing is just as compelling for a number of reasons.

Issuer-weighted indices are counterintuitive. The weighting of securities in bond indices is driven largely by how much debt a company or government chooses to issue and the size of an individual security issued. If a company issues more debt, it is not fundamentally affecting the aggregate value of the company, yet that issuance adds to the company's weighting in a bond index.

Large size of new issuance market requires active oversight. In 2013, total U.S. corporate bond issuance equaled approximately 19% of the total value of bonds outstanding, according to the Securities Industry and Financial Markets Association (SIFMA). Therefore, active managers who participate in the new issuance market can materially impact their portfolios' performance. Given that new bonds must attract investors and typically come to market at a slight discount to outstanding issues, active managers with a strong presence in the new-issue market can add incremental value through strong and effective credit analysis and relationships with banks.

Predominance of over-the-counter bond transactions requires active oversight. There are hundreds of thousands of U.S.-dollar-denominated fixed income securities. Because of this, the majority of bond purchases and sales are not simple orders, but rather complex negotiations between buyers and sellers. Active management is critical to navigating and optimizing this highly specialized process.

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1. Source: Cremers, K.J. Martijn and Petajisto, Antti, "How Active Is Your Fund Manager? A New Measure That Predicts Performance." *The Review of Financial Studies,* Volume 22, Number 9, 8/6/09.
2. Source: Cremers, K.J. Martijn and Petajisto, Antti, "How Active Is Your Fund Manager? A New Measure That Predicts Performance." *The Review of Financial Studies,* Volume 22, Number 9, 8/6/09.
3. Source: Cremers, K.J. Martijn and Pareek, Ankur, 2014. "Patient Capital Outperformance: The Investment Skill of High Active Share Managers Who Trade Infrequently." Working paper.
4. Source: Strategas Research Partners, 1/30/15.
5. Source: Arora, A., Capp, L., Smith, G., Department of Economics, Pomona College 2014. "The Real Dogs of the Dow."
6. Source: FactSet, 12/31/14.
7. Sources: Bloomberg, Lipper, 12/31/14.
8. Source: S&P Dow Jones Indices, 12/31/13. Latest data available.
9. Source: Bloomberg, 2/28/15.
10. Source: S&P Dow Jones Indices, 12/31/13. Latest data available.
11. Source: Strategas Research Partners, 1/30/15.

The S&P 500 Index is a market capitalization weighted index of the 500 largest domestic U.S. stocks.

The Europe STOXX 600 Index is a broad pan-European equity index with a fixed number of 600 components that represents large-, mid- and small-capitalization companies across 18 countries in the European region.

The Nikkei 225 Index is a leading, price weighted index of Japanese large-cap stocks listed on the Tokyo Stock Exchange.

The MSCI Emerging Markets Index is designed to measure global emerging market equity performance.

The Russell 2000 Index is comprised of small capitalization U.S. stocks.

The S&P Europe 350 Index is a large capitalization, pan-European index comprised of leading European stocks from 16 countries.

The MSCI Japan Index is designed to measure the equity market performance of Japan.

The MSCI All Country World Index is designed to measure the equity market performance of developed and emerging markets. The MSCI ACWI consists of 46 country indices comprising 23 developed and 23 emerging market country indices.

The MSCI World Index is designed to measure the equity market performance of developed markets. It consists of 23 countries.

The MSCI EAFE Index is designed to measure the equity market performance of developed markets excluding the U.S. and Canada. It consists of 21 countries.

The MSCI EAFE Small Cap Index is designed to measure the equity market performance of small capitalization developed markets excluding the U.S. and Canada.

The MSCI Pacific ex. Japan Index is designed to measure the equity market performance of the developed markets in the Pacific region excluding Japan.

The MSCI Frontier Markets Index is designed to measure the equity market performance of frontier markets. It consists of 24 countries.

The U.S. Dollar Index measures the value of the U.S. dollar relative to the majority of its most significant trading partners.

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Foreign investments may be volatile and involve additional expenses and special risks, including currency fluctuations, foreign taxes and geopolitical risks. Emerging and developing markets may be especially volatile. Fixed income investing entails credit risks and interest rate risks. When interest rates rise, bond prices generally fall, and a fund's share prices can fall. Below-investment-grade ("high yield" or "junk") bonds are more at risk of default and are subject to liquidity risk.

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