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# Degrees of Difficulty: Indications of Active Success

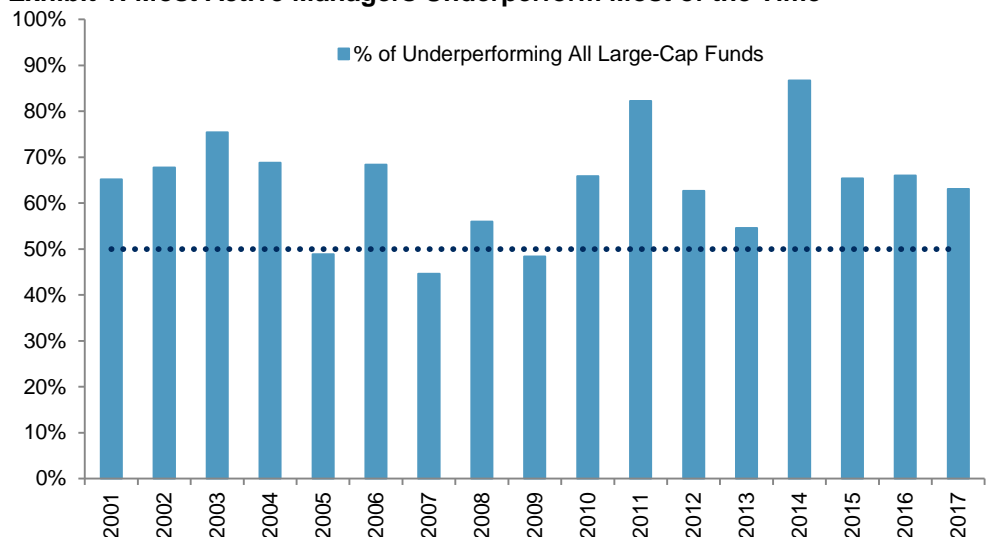
“It is better to be lucky. But I would rather be exact. Then when luck comes you are ready.”

- Ernest Hemingway, *The Old Man and the Sea*

## EXECUTIVE SUMMARY

- Strong theoretical arguments and extensive empirical data support the view that we should expect most active managers to underperform most of the time. But *most of the time* is not *all of the time*, and *most active managers* are not *all active managers*. So it is reasonable to ask whether active performance tends to wax and wane.
- We examined fund performance in various market environments to see whether certain conditions correlate with better active performance. We found that active managers were particularly challenged in periods when dispersion was low, stock prices rose, and market leadership came from extremely large stocks.
- Active managers seemed to perform less poorly in years when the low volatility factor underperformed. This suggests that managers, as a group, have a tilt against low volatility stocks.

### Exhibit 1: Most Active Managers Underperform Most of the Time



Source: S&P Dow Jones Indices LLC, CRSP. Data as of Dec. 31, 2017. Past performance is no guarantee of future results. Chart is provided for illustrative purposes.

## INTRODUCTION: PASSIVE VERSUS ACTIVE

The debate between passive and active investing has a long history, but in recent years it has escalated to the forefront of investor awareness. A summary of the arguments advanced by the advocates of passive investing would include the following.

- Alfred Cowles' (1932) paper on the unimpressive predictive power of stock market forecasters<sup>1</sup>
- William Sharpe's introduction of the Capital Asset Pricing Model (1964)<sup>2</sup> and Eugene Fama's random walk hypothesis (1965),<sup>3</sup> providing a theoretical underpinning for owning the market portfolio rather than relying on active stock selection
- Pleas from Burton Malkiel (1973)<sup>4</sup> and Paul Samuelson (1974)<sup>5</sup> that someone (anyone!) launch a prototype capitalization-weighted index fund
- Charles Ellis' (1975) argument that the professionalization of the investment management business made consistent outperformance unlikely<sup>6</sup>
- Sharpe's (1991) simple demonstration that "after costs, the return on the average actively managed dollar will be less than the return on the average passively managed dollar."<sup>7</sup>

However, while active managers *as a group* cannot outperform, there's no theology to say that *individual* managers cannot outperform, or do so consistently.

In addition, numerous observers, prominently including our own firm, have followed in Cowles' footsteps in accumulating empirical data on the performance of active managers.<sup>8</sup> **The results confirm what theory predicts: most active managers underperform most of the time.**

However, while active managers *as a group* cannot outperform, there's no theology to say that *individual* managers cannot outperform, or do so consistently.<sup>9</sup> Even if we expect that more than half of active managers will

<sup>1</sup> Cowles, Alfred, "[Can Stock Market Forecasters Forecast?](#)" *Econometrica*, 1933, Vol. 1, Issue 3, p. 309-324. See also Edwards, Tim, "[Eighty-one years later...](#)," Dec. 19, 2013.

<sup>2</sup> Sharpe, William F., "[Capital Asset Prices: A Theory of Market Equilibrium under Conditions of Risk](#)," *Journal of Finance*, September 1964, p. 425-42.

<sup>3</sup> Fama, Eugene, "[Random Walks in Stock-Market Prices](#)," *The Journal of Business*, 1965, Vol. 38, No. 1, p. 34-105.

<sup>4</sup> Malkiel, Burton G., "*A Random Walk Down Wall Street*" first edition, 1973, p. 226.

<sup>5</sup> Samuelson, Paul A. "[Challenge to Judgment](#)," *Journal of Portfolio Management*, 1974.1.1: p. 17-19.

<sup>6</sup> Ellis, Charles D., "[The Loser's Game](#)," *Financial Analysts Journal*, July/August 1975.

<sup>7</sup> Sharpe, William F., "[The Arithmetic of Active Management](#)," *Financial Analysts Journal*, January/February 1991.

<sup>8</sup> See, to cite only the most recent example, Soe, Aye M. and Ryan Poirier, "[SPIVA® U.S. Scorecard](#)," Year-End 2017.

<sup>9</sup> Although in practice, consistent outperformance is tough to come by. See Soe, Aye M. and Ryan Poirier, "[Does Past Performance Matter? The Persistence Scorecard](#)," December 2017.

typically underperform, theory doesn't tell us whether the underperformers will be 51% or 81% of the total. It's reasonable to ask if there are some market conditions that are conducive to relatively favorable (or, more precisely, relatively less unfavorable) active results.

The SPIVA database gives us a way to evaluate regimes that might present greater or lesser degrees of difficulty for active managers.

S&P Dow Jones Indices has published its SPIVA® (S&P Indices Versus Active) Scorecard since 2002 for the U.S. market.<sup>10</sup> The 17-year period for which we have SPIVA data has been challenging for active managers; a majority of large-cap U.S. managers outperformed the [S&P 500®](#) in only three years, and an average of 64% of managers underperformed across all 17 years. The SPIVA database gives us a way to evaluate regimes that might present greater or lesser degrees of difficulty for active managers. We'll examine several possible variables along two dimensions:

- Are active managers as a group more likely to outperform (or less likely to underperform)?
- Is the spread between the most and least successful active managers likely to widen?

All of our conclusions should be regarded as indicative rather than definitive. Seventeen years of data are not a lot, and we should be circumspect about drawing too many conclusions from too few observations.

## WHEN MIGHT ACTIVE PERFORMANCE IMPROVE?

“Ability is of little account without opportunity.”

- Napoléon Bonaparte

### Dispersion

Dispersion is a measure of the *spread of returns* within an index. In a high-dispersion environment, there's a large spread among constituent returns; in a low-dispersion environment, the spread is modest.<sup>11</sup> Dispersion is of more than just academic interest. When dispersion is high, e.g., the incremental value added (or lost) by factor indices is much larger than in low-dispersion environments.<sup>12</sup>

Dispersion is relevant to our study because active managers begin with a handicap. Before they can add value for their clients, they must first overcome a set of fixed costs—management fees, research expenses, transaction costs, etc. After these fixed costs are covered, whatever return

<sup>10</sup> See <https://spindices.com/spiva/#/>.

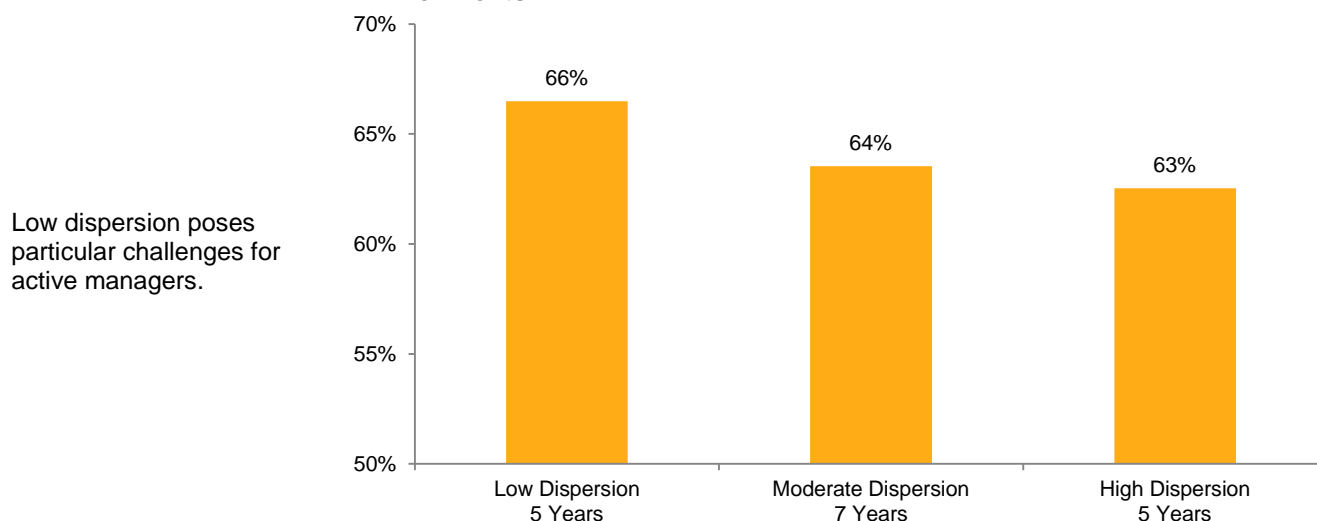
<sup>11</sup> See Edwards, Tim and Craig J. Lazzara, “[Dispersion: Measuring Market Opportunity](#),” December 2013, and “[The Landscape of Risk](#),” December 2014.

<sup>12</sup> Chan, Fei Mei and Craig J. Lazzara, “[Gauging Differential Returns](#),” January 2014.

remains is value added for the client. **In a low-dispersion environment, it is harder to cover the fixed costs.** We might therefore hypothesize that more active managers will underperform when dispersion is low, and that the spread between the best and the worst managers will increase as dispersion rises.

Our SPIVA data validate both of these hypotheses. We divided our 17 yearly observations into three categories: the five lowest-dispersion years, the middle seven years, and the five highest-dispersion years. Exhibit 2a validates our intuition that low dispersion poses particular challenges for active managers. In the low-dispersion years, 66% of active managers underperform, versus 64% and 63% underperformers in the moderate- and high-dispersion categories, respectively.<sup>13</sup>

#### Exhibit 2a: More Active Managers Underperformed in Low-Dispersion Environments



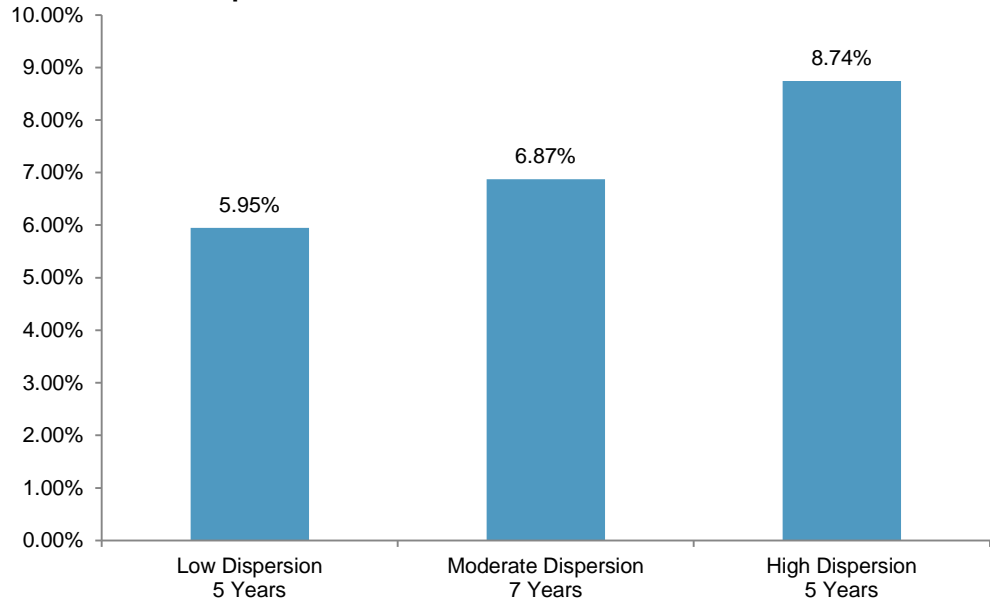
Source: S&P Dow Jones Indices LLC, CRSP. Data from Dec. 31, 2000, through Dec. 31, 2017. Past performance is no guarantee of future results. Chart is provided for illustrative purposes.

The pattern of Exhibit 2a is consistent with our expectations. Low dispersion increases the challenge for active managers, but high dispersion doesn't convey an analogous benefit. A manager's skill is what it is, regardless of the level of dispersion; once fixed costs are covered, there's no reason to expect more managers to outperform.

On the other hand, Exhibit 2b shows that the performance gap between better- and worse-performing managers widens monotonically as dispersion increases.<sup>14</sup> This is what we expected given our understanding of dispersion.

<sup>13</sup> This is an apples-to-apples comparison, or at least apple trees to apple pie. We measure dispersion using the S&P 500 and evaluate its effect on large-cap active U.S. managers.

<sup>14</sup> Specifically, we measure this performance difference by the interquartile range in our large-cap active manager database—the difference between the 25th percentile and the 75th percentile of the distribution.

**Exhibit 2b: Gap Between the Top and Bottom Performance Quartiles Broadened as Dispersion Increased**

Source: S&P Dow Jones Indices LLC, CRSP. Data from Dec. 31, 2000, through Dec. 31, 2017. Past performance is no guarantee of future results. Chart is provided for illustrative purposes.

Correlation, the degree which stocks in an index move together, is cited frequently—and in our view, incorrectly—as a determinant of active management’s success.

### Correlation

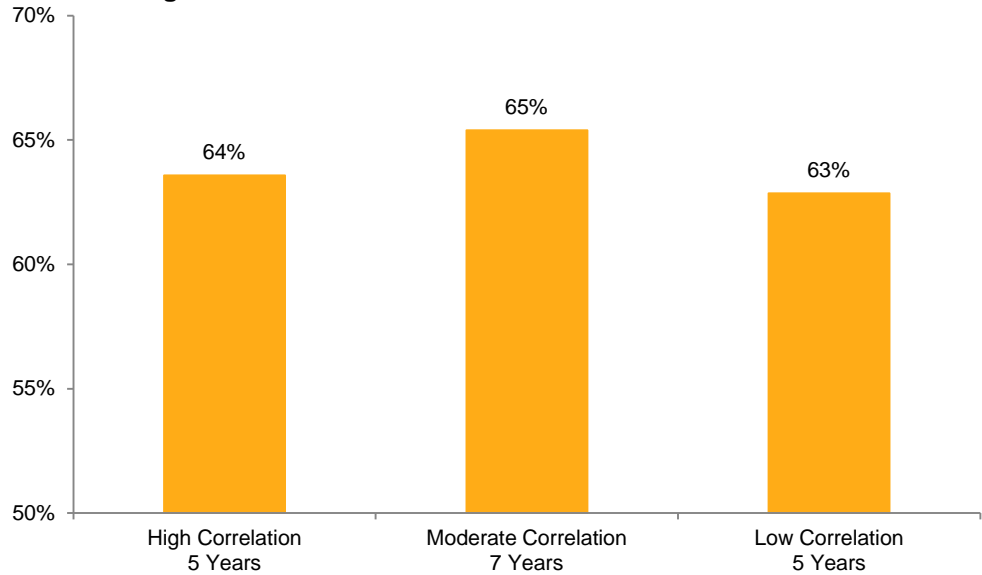
Correlation, the degree which stocks in an index move together, is cited frequently—and in our view, incorrectly—as a determinant of active management’s success.<sup>15</sup> The argument, for those who make it, is that when co-movement is high, stock selection becomes more difficult, so that stock pickers benefit from low correlation. We’ve long argued that dispersion, rather than correlation, is the superior indicator,<sup>16</sup> and the SPIVA database gives us a way to test this view.

Exhibit 3a shows that the percentage of managers underperforming the S&P 500 varies insignificantly as correlation changes, which is in contrast to the relatively large impact of low dispersion.

<sup>15</sup> For a recent example, see Shah, Alap, “[According To One Metric, This Could Be The Best Time For Stock-Picking In A Decade](#),” July 11, 2017.

<sup>16</sup> Lazzara, Craig, “[Dispersion and Correlation: Which is ‘Better?’](#)” Jan. 30, 2014.

**Exhibit 3a: Correlation Had No Significant Influence on the Outcome of Active Manager Performance**

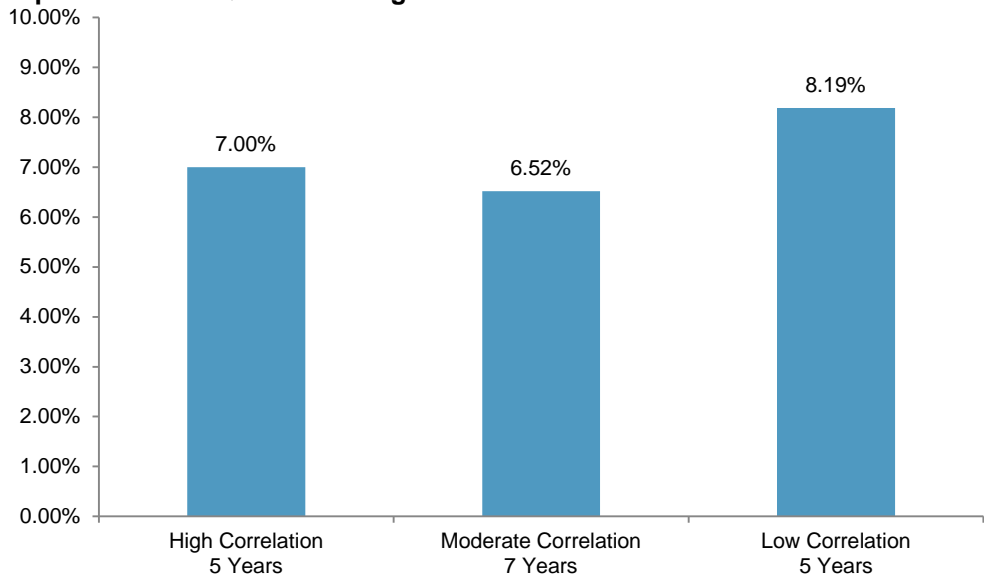


Source: S&P Dow Jones Indices LLC, CRSP. Data from Dec. 31, 2000, through Dec. 31, 2017. Past performance is no guarantee of future results. Chart is provided for illustrative purposes.

Low correlation produces a bigger spread than we find in periods of high correlation—but the relationship is not monotonic and is therefore less persuasive.

Similarly, Exhibit 3b shows a weak relationship between correlation and the spread between top- and bottom-ranked managers. Low correlation produces a bigger spread than we find in periods of high correlation—but the relationship is not monotonic and is therefore less persuasive.

**Exhibit 3b: Correlation Had a Weak Relationship to the Difference Between Top and Bottom Quartile Managers**

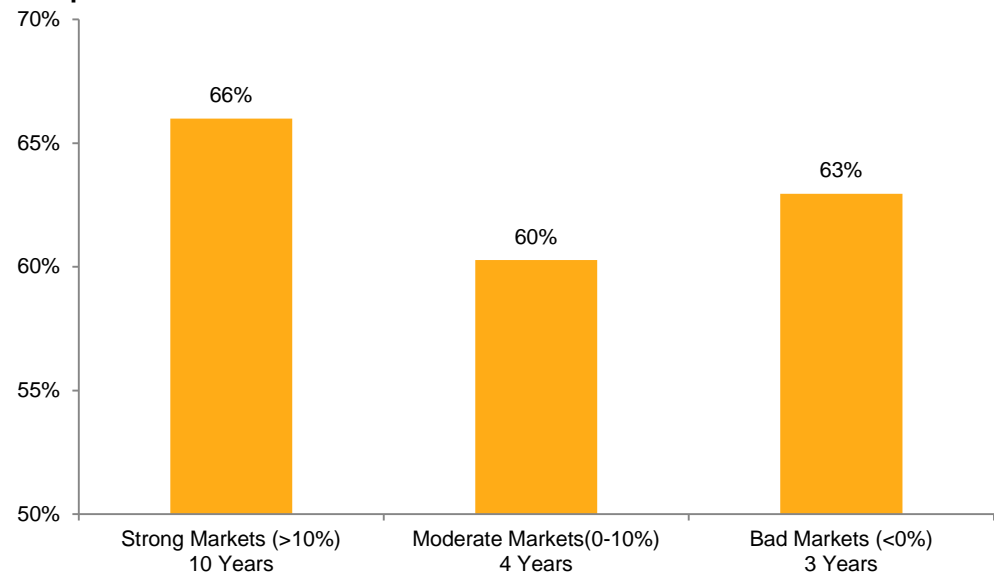


Source: S&P Dow Jones Indices LLC, CRSP. Data from Dec. 31, 2000, through Dec. 31, 2017. Past performance is no guarantee of future results. Chart is provided for illustrative purposes.

### Market Direction

A falling stock market might plausibly augment active managers' performance. If the market declines, active managers can hold cash and thereby gain an advantage over a fully invested index benchmark. Exhibit 4a seems to reflect this, although to a modest and arguably inconsistent degree. Fewer managers underperform when the market declines (63%) than when it's up strongly (66%). But the argument would be more convincing if the relationship between manager performance and the market's direction were monotonic.

**Exhibit 4a: Fewer Active Managers Underperformed in Moderate/Bad Markets Compared to Good Markets**



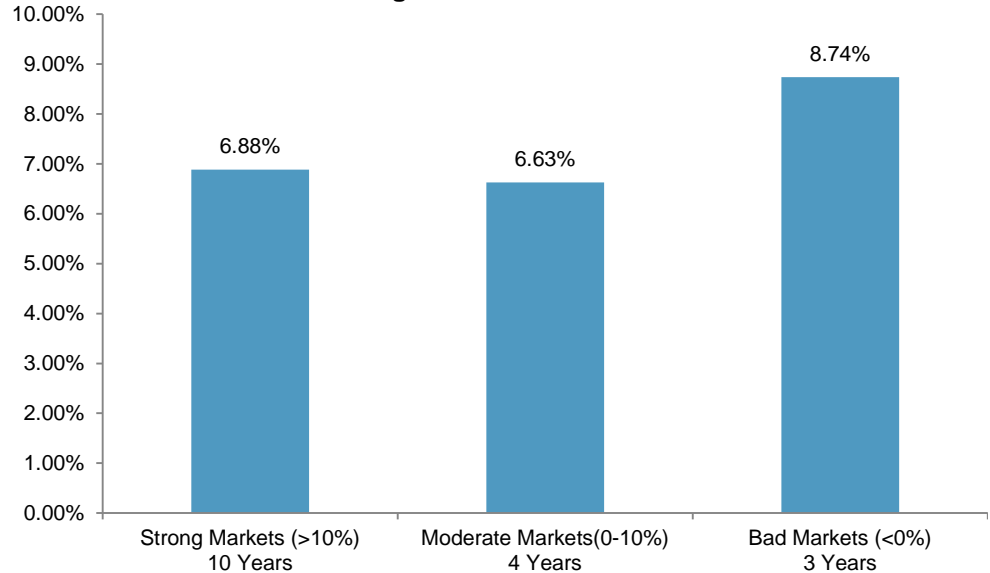
Dispersion tends to rise in bad markets, which also helps explain the range of manager performance when the market declines.

Source: S&P Dow Jones Indices LLC, CRSP. Data from Dec. 31, 2000, through Dec. 31, 2017. Past performance is no guarantee of future results. Chart is provided for illustrative purposes.

Managers who successfully manage their cash levels in declining markets might arguably reap a bigger advantage over their less nimble peers. That's one possible interpretation of Exhibit 4b, which shows that the performance differential between top- and bottom-performers was widest when the market declined. Importantly, however, dispersion tends to rise in bad markets, which may also help explain the range of manager performance when the market declines.<sup>17</sup>

<sup>17</sup> Chan, Fei Mei and Craig J. Lazzara, [“The Best Offense: When Defensive Strategies Win,”](#) March 2015.

#### Exhibit 4b: Gap Between the Top and Bottom Performance Quartiles Was Widest in the Worst-Performing Markets



Source: S&P Dow Jones Indices LLC, CRSP. Data from Dec. 31, 2000, through Dec. 31, 2017. Past performance is no guarantee of future results. Chart is provided for illustrative purposes.

#### Influence of Megacaps

In periods when the megacaps dominate, active management is likely to be more challenged.

Like most capitalization-weighted indices, the S&P 500 is skewed toward its largest members.<sup>18</sup> For purposes of this paper, we defined a “megacap” stock as one that accounts for more than 1% of the total weight of the S&P 500. As of Dec. 31, 2017, there were 15 such stocks making up 25% of the index’s capitalization, which is fairly typical of the years for which we have SPIVA data.<sup>19</sup>

Actively managed funds tend to be closer to equal- than to cap-weighting in their portfolio construction.<sup>20</sup> This means that, other things equal, **a non-megacap stock, if held, is virtually certain to be substantially overweighted.** For a megacap, on the other hand, overweights will typically be smaller, and it’s entirely possible for a megacap to appear in an active portfolio while being underweighted.<sup>21</sup>

If smaller stocks are highly likely to be overweighted in active portfolios, then it follows that when smaller names outperform the megacaps, active manager performance might improve. In periods when the megacaps dominate, active management is likely to be more challenged. Exhibit 5a confirms this—more managers underperform when the megacaps

<sup>18</sup> As of Dec. 31, 2017, the weighted average capitalization of the constituents of the S&P 500 was USD 176 billion. Only 24 stocks were that large.

<sup>19</sup> From 1991 through 2017, there were, on average, 17 megacap stocks totaling 28% of the S&P 500.

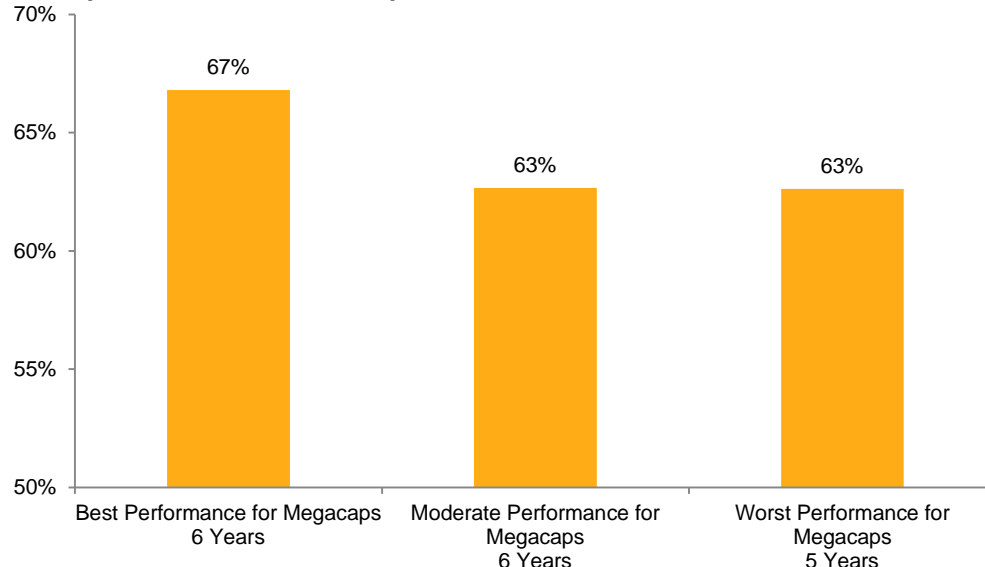
<sup>20</sup> Ganti, Anu, “[Mutual Fund Portfolios: Equal Weight or Cap Weight?](#)” July 27, 2017.

<sup>21</sup> One of the authors is old enough to remember when IBM, at that time the S&P 500’s largest component, accounted for 6% of the index’s value. The stock was widely held in institutional portfolios—and virtually never with a weighting greater than 6%.



outperform—suggesting that active managers as a group are underweight the largest stocks.

**Exhibit 5a: Fewer Active Managers Underperformed When Megacap Stocks Underperformed Smaller Companies**

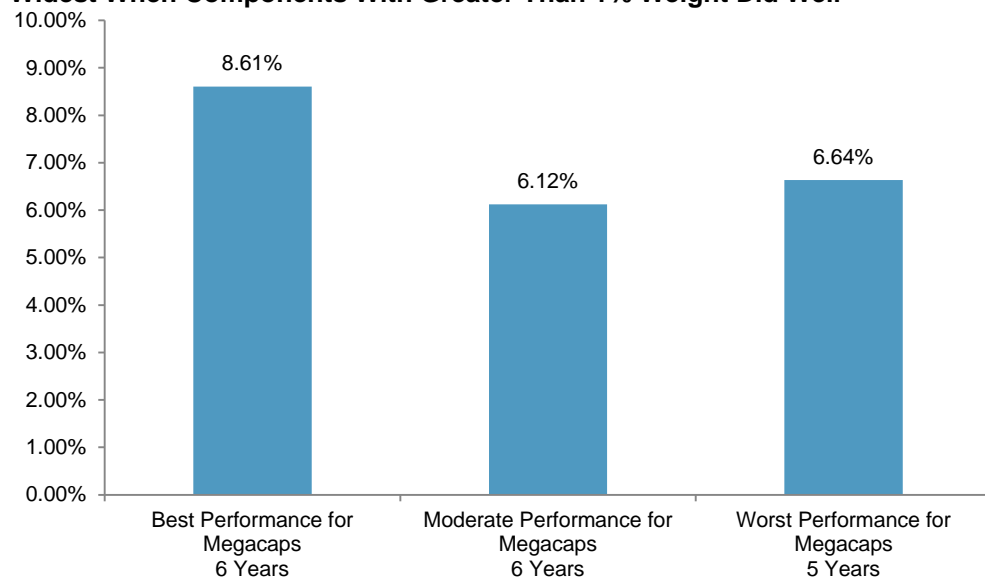


Source: S&P Dow Jones Indices LLC, CRSP. Data from Dec. 31, 2000, through Dec. 31, 2017. Past performance is no guarantee of future results. Chart is provided for illustrative purposes.

More managers underperform when the megacaps outperform—suggesting that active managers as a group are underweight in the largest stocks.

On the other hand, the minority of managers who own a more significant weight in megacap stocks might benefit disproportionately when the megacaps outperform. We see that in Exhibit 5b; the spread between top and bottom quartile managers peaks when the largest companies lead the market.

**Exhibit 5b: Gap Between the Top and Bottom Performance Quartiles Was Widest When Components With Greater Than 1% Weight Did Well**



Source: S&P Dow Jones Indices LLC, CRSP. Data from Dec. 31, 2000, through Dec. 31, 2017. Past performance is no guarantee of future results. Chart is provided for illustrative purposes.

## Factoring in Factors

We also analyzed manager results based on factor performance. We were interested in the performance of five factors, which we captured by reference to the relative performance of five indices.

- **Size.** When the [S&P 500 Equal Weight Index](#)<sup>22</sup> outperforms the cap-weighted S&P 500, smaller companies are outperforming larger.<sup>23</sup> (This is a general statement; our megacap analysis is a more specific instance of the same phenomenon.)
- **Value.** We measure whether the value factor was in or out of favor by measuring the relative returns of the [S&P 500 Enhanced Value Index](#).<sup>24</sup>
- **Low Volatility.** The [S&P 500 Low Volatility Index](#)<sup>25</sup> tells us whether the index's least-volatile stocks are leading the market.
- **Momentum.** The [S&P 500 Momentum Index](#)<sup>26</sup> lets us judge the performance of the momentum factor.
- **Quality.** We measure the performance of high-quality stocks using the [S&P 500 Quality Index](#).<sup>27</sup>

The SPIVA database suggests that active managers did not have a particularly strong tilt to any particular factor with the exception of low volatility.

We examined manager performance as a function of relative factor performance for each of these five factors. Most of the results are uninteresting, suggesting that the active managers in our SPIVA database did not have a particularly strong tilt to any particular factor. The exception is the low volatility factor.

As Exhibit 6a shows, active underperformance was significantly more widespread when the S&P 500 Low Volatility Index's relative performance was strong. In the S&P 500 Low Volatility Index's five best years, an average of 68% of active managers underperformed the market. As the S&P 500 Low Volatility Index's performance worsened, the percentage of underperforming managers declined monotonically with only 57% of managers underperforming in the five worst years for the index.

<sup>22</sup> The index includes the same constituents as the market cap-weighted S&P 500, but each company in the S&P 500 Equal Weight Index is allocated a 0.2% weight. For more details, see the [complete methodology](#).

<sup>23</sup> See Edwards, Tim and Craig J. Lazzara, "[Equal-Weight Benchmarking: Raising the Monkey Bars](#)," May 2014.

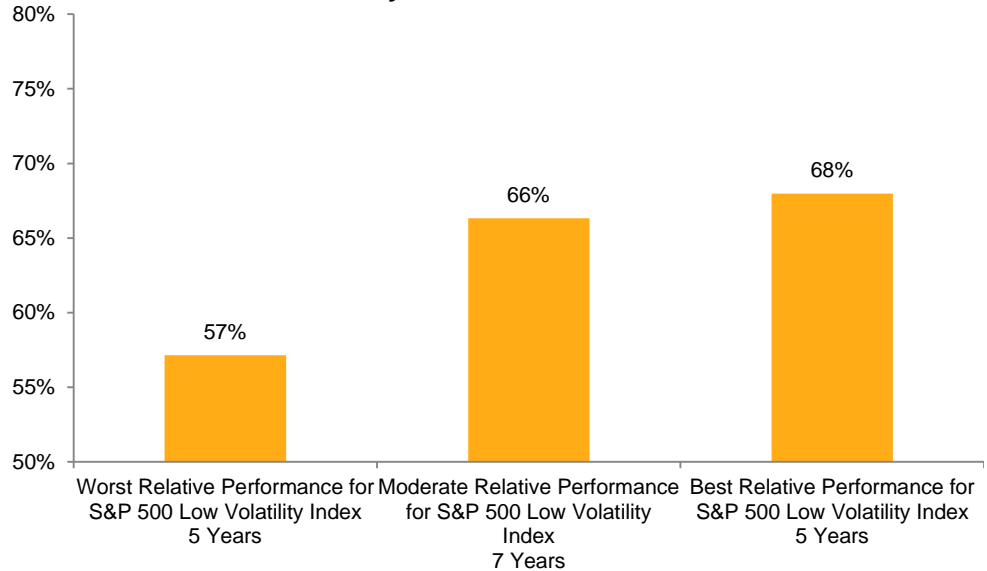
<sup>24</sup> The index is designed to measure the performance of the most undervalued constituents of the S&P 500. Valuations are measured using ratios of book value to price, earnings to price, and sales to price. For more details, see the [complete methodology](#).

<sup>25</sup> The index is designed to track the least-volatile stocks in the S&P 500, as measured by their historical standard deviation. For more details, see the [complete methodology](#).

<sup>26</sup> The index is designed to measure the performance of securities in the S&P 500 universe that exhibit the strongest recent relative performance. For more details, see the [complete methodology](#).

<sup>27</sup> The index is designed to track S&P 500 members with the highest quality scores. The score is calculated based on return on equity, accruals ratio, and financial leverage ratio. For more details, see the [complete methodology](#).

### Exhibit 6a: Fewer Active Managers Underperformed in the Worst Environments for Low Volatility



Source: S&P Dow Jones Indices LLC, CRSP. Data from Dec. 31, 2000, through Dec. 31, 2017. Past performance is no guarantee of future results. Chart is provided for illustrative purposes and reflects hypothetical historical performance. Please see the Performance Disclosure at the end of this document for more information regarding the inherent limitations associated with back-tested performance.

While beta is not synonymous with volatility, higher beta stocks tend to be more volatile.

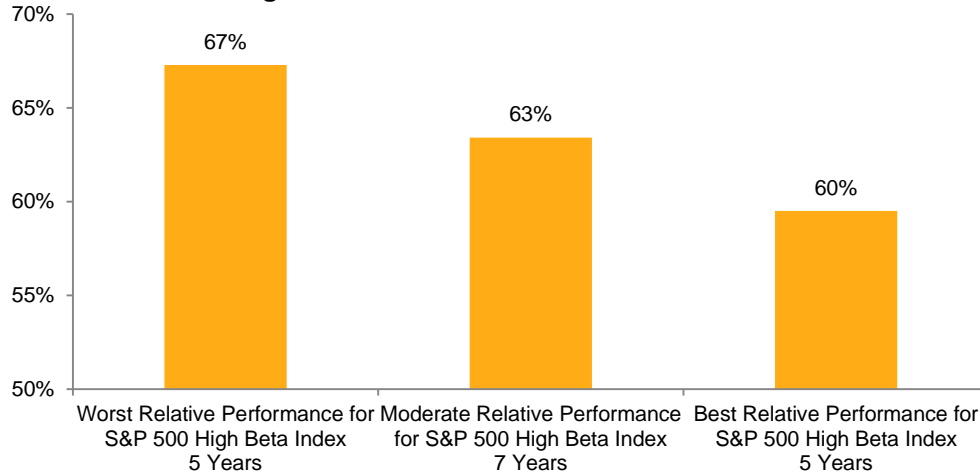
Exhibit 6a suggests that active managers as a group are tilted *against* low volatility. This is not surprising if we posit that most active portfolios have a beta greater than 1.0. While beta is not synonymous with volatility, higher beta stocks tend to be more volatile. Moreover, an active tilt toward higher beta and higher volatility would be consistent with the behavioral explanation for the existence of the so-called low volatility anomaly.<sup>28</sup> This argument—sometimes summarized as the “preference for lotteries”—holds that some investors are willing to buy volatility *for its own sake*, thus bidding up the prices of the market’s most volatile stocks.

Since fewer active managers underperform when the S&P 500 Low Volatility Index underperforms, and since low volatility stocks typically have lower betas, it follows that there might also be a relationship between manager performance and the relative performance of the [S&P 500 High Beta Index](#).<sup>29</sup> Exhibit 6b offers further confirmation of active portfolios’ tilt toward higher beta. More managers underperformed in periods of the worst relative performance for the S&P 500 High Beta Index, and as the index’s performance improved against the benchmark, more managers also outperformed the market.

<sup>28</sup> See Baker, Malcolm, Brendan Bradley, and Jeffrey Wurgler, “[Benchmarks as Limits to Arbitrage: Understanding the Low-Volatility Anomaly](#),” *Financial Analysts Journal*, January/February 2011, pp 40-54.

<sup>29</sup> The index is designed to measure the performance of the 100 constituents in the S&P 500 that are most sensitive to changes in market returns. For more details, see the [complete methodology](#).

**Exhibit 6b: More Active Managers Underperformed in the Worst Environments for High Beta**

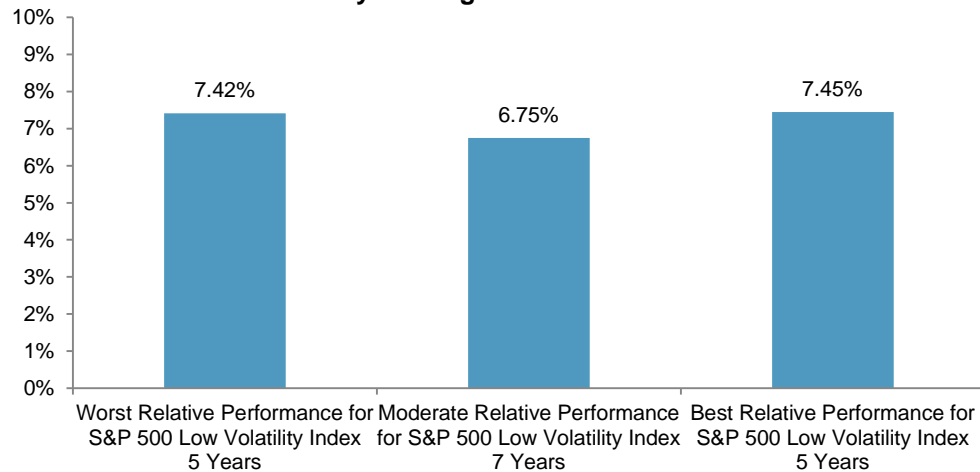


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Exhibits 7a and 7b examine the interquartile range in manager performance spreads. Regardless of whether we sort years by the S&P 500 Low Volatility Index or the S&P 500 High Beta Index, there is a noticeable dip in manager performance spreads in the seven years of moderate relative performance. This is unsurprising—in part because moderate performance spreads correlate with low dispersion environments. It’s also obviously true that if managers as a group are tilted toward a particular factor, in years when the factor doesn’t perform particularly well or particularly poorly, the spreads among manager performance are likely to be subdued.

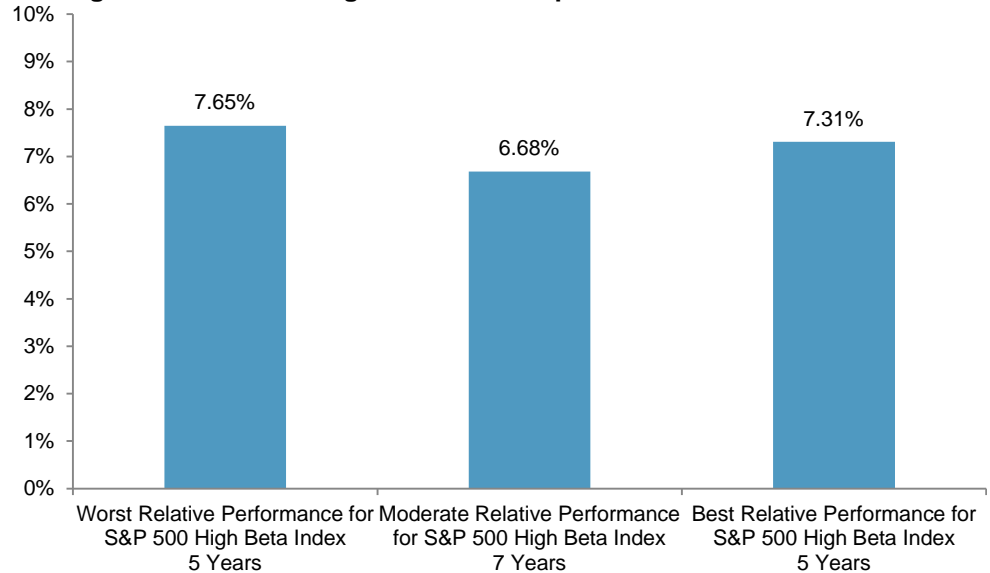
If managers as a group are tilted toward a particular factor, the spreads among manager performance are likely to be subdued in years when the factor’s performance is indifferent.

**Exhibit 7a: Manager Performance Spreads in Moderate Relative Performance Years for Both Low Volatility and High Beta Were Smallest**



Source: S&P Dow Jones Indices LLC, CRSP. Data from Dec. 31, 2000, through Dec. 31, 2017. Past performance is no guarantee of future results. Chart is provided for illustrative purposes and reflects hypothetical historical performance. Please see the Performance Disclosure at the end of this document for more information regarding the inherent limitations associated with back-tested performance.

**Exhibit 7b: The 11 Years of Moderate Performance Spreads for Low Volatility and High Beta Were Among the Lowest Dispersion Years**



Source: S&P Dow Jones Indices LLC, CRSP. Data from Dec. 31, 2000, through Dec. 31, 2017. Past performance is no guarantee of future results. Chart is provided for illustrative purposes and reflects hypothetical historical performance. Please see the Performance Disclosure at the end of this document for more information regarding the inherent limitations associated with back-tested performance.

## CONCLUSION

“We should all work on the assumption that we do not know what will happen next.”

- John Authers, *Financial Times*, Sept. 23, 2017

The years since the global financial crisis have generally been characterized by low dispersion and rising markets—both of which may present particular difficulties for active managers. If those trends reverse in the future, it’s possible that active underperformance will become less prevalent.

Their limited history notwithstanding, the 17 years of SPIVA data give us a way to evaluate active performance through the prism of various investment environments. Higher dispersion was demonstrably more favorable for the skilled (or lucky) subset of active managers. Likewise, markets led by stocks other than those at the top of the capitalization spectrum proved to be auspicious for active funds. Analyzing SPIVA data through the lens of factor performance offered insight into active managers’ possible biases.

**These insights can help market participants frame their expectations of active management.** The years since the global financial crisis, for example, have generally been characterized by low dispersion and rising markets—both of which may present particular difficulties for active managers. If those trends reverse in the future, it’s possible that active underperformance will become less prevalent. That may be cold comfort to the active management community and its customers—but **sometimes cold comfort is all the comfort there is.**

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