

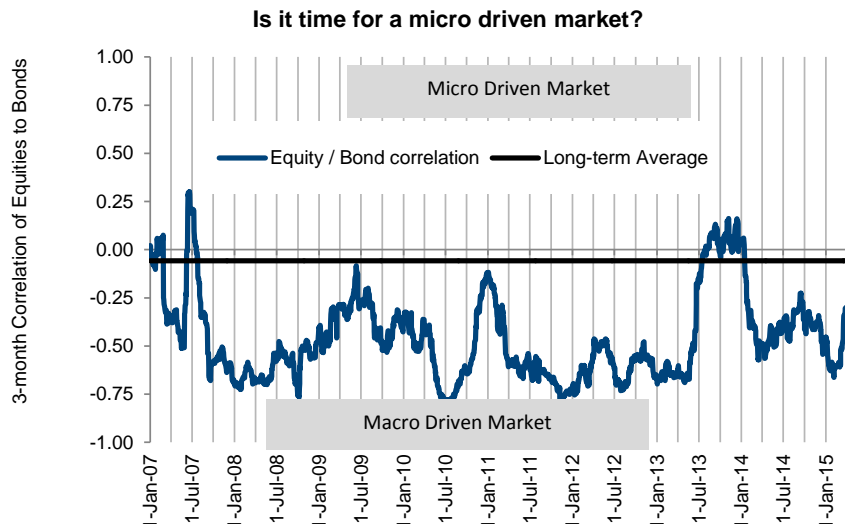
Stock Pickers Comeback?

12 May, 2015

Year 2014 has gone down as perhaps the toughest for actively managed funds. That is of course if we are measuring the success of active management relative to the performance of indexing, because the vast majority of active funds did make money for investors. According to the annual Standard & Poor's Index Versus Active (SPIVA) scorecard report, only 13% of U.S. focused funds outperformed the S&P 500. That is about 1 in 7, not great odds. That is the lowest success rate dating back to 2000 (extent of the data). Worse yet, for large cap core strategies, you could have been top quartile (top 25% of funds) and still underperformed the S&P 500. Turning to the Canadian edition of the report, we had 26% of active funds outperforming the TSX Composite. A little better but clearly not anything to get excited about. Worse yet were Dividend and Income Mandates compared to the S&P/TSX Canadian Dividend Aristocrats index, where only 7% outperformed. This of course begs the question – **should we throw in the towel and simply index away?**

Full disclosure, at Connected Wealth we manage a number of actively invested strategies in both Canada and the U.S. So while we may be a bit biased, we embrace a balanced approach in our asset allocation investor profiles ([HERE](#)). These profiles combine both active management and ETFs, in our view providing some active management with the lower cost passive strategies. So we would recommend a balanced approach and there are some signs that we may be getting closer to tilting our mix a bit more to the active strategies.

Macro driven market for seven years has been tough for active management



Source: Richardson GMP Asset Management, Bloomberg

Connected Wealth Market Ethos posts are market thought pieces from the Richardson GMP Asset Management team. As part of our philosophy for managing money, we believe in providing quality objective advice and services with greater transparency. These reports are designed to provide a deeper look into our current thinking.

Market Ethos - Ethos is defined as the character or disposition of a group. In this case it's the disposition of the market itself.

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Active vs. Passive

We believe there are two critical factors that determine which investment style has the upper hand. But before we discuss these, our underlying contention is that neither is necessarily superior and to be honest, you can't prove one over the other. After a year in the U.S. that saw six out of seven funds trail the benchmark, one may argue the verdict is in. However, the pendulum swings both ways, and even though the recent history has seen passive as a better strategy, this pendulum can, and will, swing the other way. Just like a fund that returns 50% will not likely repeat such a feat, and studies show there is a larger probability this outperformance will be followed by underperformance. The most widely stated disclaimer in this industry is 'past returns are not indicative of future performance', for good reason as it is true. We believe the relative performance of active vs. passive management is a more cyclical relationship and there are times to be more active and there are times to be more passive. The key two drivers of this are index construction and the market environment.

Index Construction – As the active vs. passive debate is all relative to a benchmark, how that benchmark (passive option) is constructed is critical. Some indices are better balanced and some are not. We believe those that are not well balanced or constructed are easier for active managers to outperform or add value.

The vast majority of indices are market capitalization weighted, meaning bigger cap companies carry bigger weights. But they are also constructed based on the companies trading on an exchange(s) or in a specific country. The index simply becomes the residual of the companies trading in a country. This creates distortions when compared to the economy. Consumer stocks represent 10% of the TSX but a far greater portion of the economy. It can be distorted by a few mega companies. Nortel did this to the TSX years ago. What if Apple moved to Canada to enjoy our lower corporate tax rates or more interesting weather? Without constraints it would be over 1/3 of our index, yet nothing has really changed. Valeant carries almost a 5% weight in the TSX, yet it is now a U.S. company based in New Jersey with 5% of sales in Canada.

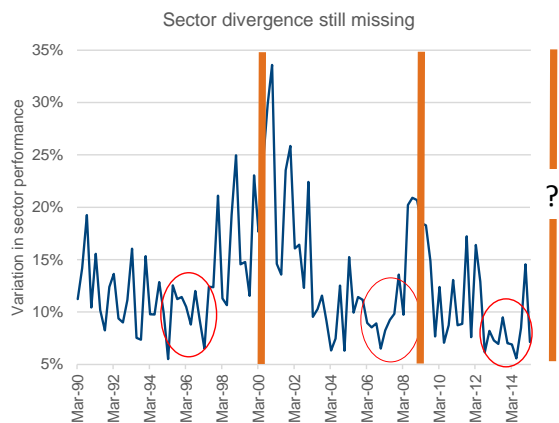
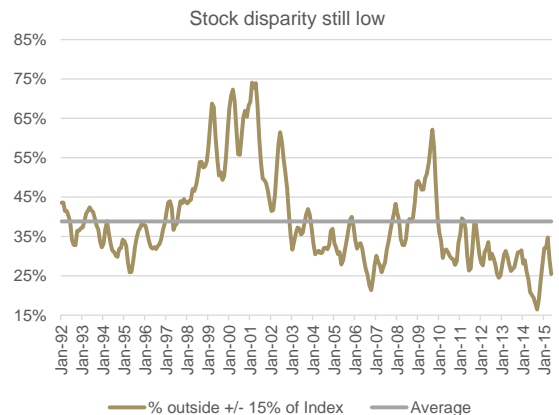
Some indices are better balanced or constructed than others. Those that are poorly diversified should be easier to outperform using active management. Or at the very least, should be easier to better diversify the embedded risks built into the index. From our experience the TSX is easier to outperform than the S&P 500, which is arguably better diversified.

Market Environment – This is the bigger driver and we believe it has a more dramatic impact on the relative performance or success of active vs. passive. And it is cyclical. We believe there are two kinds of markets, macro driven and micro driven. Macro driven markets are those where big data points, such as central bank policy, economic data or other broad reaching forces are the bigger driver of performance. Conversely, micro driven markets tend to have individual company or fundamental data as the bigger driver of performance.

The chart at the bottom of page 1 is one of our models that attempts to capture the type of market by the rolling correlation between equities and bonds. The premise is in a macro driven market that experiences periods of risk-on and risk-off, this correlation will be strongly negative. If this correlation is weak or positive, it is more of a micro driven market. The long term average is actually pretty close to zero or no correlation but the trend over the past seven years has been strongly negative. This makes stock picking very difficult.

While our Macro vs. Micro model may be starting to favour active management, we have two more models that are not. Stock disparity measures the variation in returns within the index. Using the S&P 500, it tracks the percentage of companies that are either outperforming or underperforming the index by 15% or more. If the index is disperse, an active manager has a better chance of outperforming by picking winners or avoiding big losers. When disparity is low, the stock picking skill will have a lesser impact on performance, and perhaps not enough to overcome fees. Of course the skill has to be good, but that is another article. Note that disparity (top chart) has been very low over the past few years as the market has been more homogeneous.

Disparity & Leadership models still favour passive



Source: Richardson GMP Asset Management, Bloomberg

The 2nd chart is sector leadership or divergence and measures the variance between sector performance. Essentially, when this is high there are clearly winning sectors and losing sectors that a good manager can identify and weight appropriately. Currently the variance is very low as we have been in a leaderless market. Or more accurately, we have seen leadership rotate around sectors very quickly. Again, a tough environment for active management.

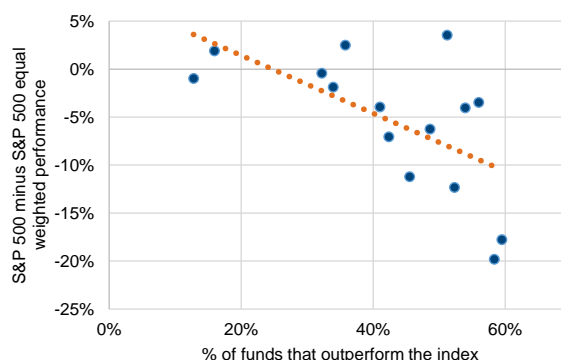
The Cycle

Even though our market environment models are mixed or even favouring passive management at the moment, in the late phase of a bull market we tend to see an environment that is friendlier for active managers. In the later phase of a bull market, we often see fundamentals as a bigger driver of performance as the need for central bank stimulus fades and the economy is on a more self-sustainable trajectory. This can also see leadership develop and become more stable, which may favour active management.

One additional indicator we monitor is the relative performance of the S&P 500 and S&P 500 equal weighted. The latter gives each company the same weight, hence Apple would have a 0.2% weight. This measurement does capture a bit of a smaller firm effect. In years when the equal weighted has outperformed the market cap weighted, we have seen active managers have more success at beating the index.

In the accompanying chart, we have plotted the S&P 500 cap weighted minus equal weighted performance (lower means equal weighted outperformed) vs. the percentage of funds beating the index. The correlation is about -0.6. Currently both indices are up about 3% so far in 2015, so again this favours passive. But it is one of the indicators we will monitor for any change in trend.

When equal weighted outperforms, active does better



Source: Richardson GMP Asset Management, Bloomberg

Conclusions

- ▶ The past few years have been a very tough environment for active management relative to passive. Currently, most of our indicators continue to point to a market environment that favours passive.
- ▶ At present, our investor profiles have passive allocations of 59% for Conservative, 45% for Balanced and 41% for Growth. We will be maintaining these allocations between active and passive for the time being.
- ▶ If we see greater market leadership, greater disparity and/or S&P equal weighted outperforming cap weighted, we will revisit these allocations with a bias towards increasing the active component.

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