The Growing Tailwind for Active Managers

Many U.S. active equity managers have struggled during the past few years with market conditions that have made it difficult to outperform benchmarks. In this podcast supplementing our latest white paper The Growing Tailwind for Active Managers, Investment Analyst Brad Neuman discusses why Alger believes that conditions for active management are improving and that portfolio managers will be more likely to outperform in the foreseeable future.

Brad Neuman: This podcast is meant to be a supplement to our new whitepaper, *The Growing Tailwind for Active Managers* which is available at www.alger.com. There you can see all the underlying data and charts supporting this discussion.

Is this a difficult environment for active managers? Well, unfortunately the answer is yes. It's been very difficult. Many U.S. active equity managers have struggled during the past few years with market conditions that have made it difficult to outperform benchmarks. However, we think that conditions for active managers are improving, and that portfolio managers will be more likely to outperform in the foreseeable future.

For the past five-year period that ended at the end of 2014, only 11 percent of active U.S. large cap managers have outperformed the S&P 500. 2014 was also discouraging with only 14 percent of active large cap managers outperforming the market. This was the worst showing in the past 15 years.

What are the primary causes of manager underperformance? Well, there are several factors. Extremely low return dispersion of stocks, investors favoring bond-like equities while placing less emphasis on the relationship of corporate fundamentals and on valuations, underperformance of small cap stocks and weak performance of international stocks.

What is return dispersion? Return dispersion measures the difference in return amongst a group of stocks. Think of it this way. If a portfolio of three stocks are all up exactly 10 percent, there is no return dispersion because there is no variation amongst the different returns. But if another equally weighted portfolio of three stocks is up 10 percent with one stock down 10 percent, another being flat and the third up 40 percent, that portfolio has a much wider return dispersion.

Think about a weather man predicting the weather. If the weather's really going to be sunny every day for the next two weeks and you have a bunch of weathermen trying to predict the weather, they all say it's sunny. You can't really tell who's a good weatherman and who’s not. But if you have some variation, some so to speak dispersion or change in the weather like maybe a big storm is coming Some weathermen predict that – and some weatherman don’t predict it accurately, and you can kind of tell who is doing a good job, but there has to be some opportunity for the weatherman to distinguish himself there. There clearly is no opportunity if it’s 80 degrees and sunny every day. Everyone’s going to be saying the same thing. That's low return dispersion.

Why should we expect a brighter outlook for active managers? Well, higher interest rates for one. We think that will create a move away from bond-like equities which active managers have been underweight typically. There’s good precedence for this. In the summer of 2013 when Ben Bernanke, chairman of the Federal Reserve, talked about potentially tapering quantitative easing, interest rates went up and active managers did better as investors deemphasized bond-like equities and focused more on dynamic earnings growth and other fundamentals.

Importantly, interest rates don’t actually have to go up for active managers to do better. Rather, the expectation of rising interest rates may help active managers. Expectations are really everything in the stock market. If investors think rates will rise, they’ll incorporate those assumptions into their discounted cash flow estimates.
In fact, in the paper we show that low interest rates and the focus on bond-like equities has caused investors to buy these types of securities even at the expense of fundamentals, and as interest rates rise and the focus returns to fundamentals, we think active managers should be well positioned.

Another reason for a brighter outlook for active managers is improved performance of small international stocks. And another reason for active managers doing better is the maturation of the business cycle. Active managers tend to do better when there’s modest increases in the stock market rather than a large bull market as seen in the beginning of an economic expansion when macro economic factors are driving the market. In those types of markets, stocks are well correlated, and there’s little opportunity for stock pickers. But as the business cycle matures and growth slows a bit, the market returns more modestly, stock pickers tend to shine as return dispersion increases and active managers out perform. There’s good precedence for this. At the end of the last economic expansion, 2005 to 2007, active managers outperformed in that period.

It’s been nearly a perfect storm with various factors going against active managers over the past several years, and we see all those factors really reversing and going from headwinds to becoming tailwinds. In fact we’re seeing evidence of that year to date with interest rates, international stocks and small cap stocks all reversing direction and now moving favorably for active managers, producing a really favorable effect with active managers outperforming for the first time in quite some time.

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stocks tend to be more volatile than other stocks as the price of growth stocks tends to be higher in relation to their companies´ earnings and may be more sensitive to market, political and economic developments.

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