INVESTMENT STRATEGY RESEARCH

RBC Capital Markets

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November 29, 2016

Make Active Management Great Again

Extraordinary central bank policy, ETF flows, and a craze for low vol stocks have all been blamed for the poor performance of active management throughout the recovery. Our research challenges these assertions, pointing instead to the impacts of sub-par growth and below-normal interest rates. We expect a much more favorable operating environment for portfolio managers under the types of economic policies likely with a Trump presidency.

The data suggests that active managers consistently apply a set of portfolio tilts, such as a tendency to equal-weight holdings. While over the long-run, these biases go in-and-out of favor, the post-crisis environment has been particularly unkind to portfolio managers. Put differently, many of these tilts that have detracted from active manager returns throughout the recovery should become tailwinds given proposed pro-growth, reflationary policies.

Our thesis around the cyclicality of alpha generation was first presented in In Defense of Active Management, published earlier this year. In our recent note A Whole New World, we laid out likely market behavior under a Trump presidency.

Equal-Weighting: Active managers tend to equal-weight their portfolios, leading to an overweight in small- and mid-cap stocks. While larger names have led over the past several years, smaller stocks have outperformed since the election given their greater leverage to an improving economy and less dollar exposure. See exhibits 3-4 on page 3.

Bond Proxies: With the exception of dedicated income strategies, managers tend to underweight high yielding stocks such as Utilities, Telcos & REITs. This has been painful for many investors given the strong performance of these groups in recent years. Rising inflation expectations and interest rates over the past several months — and since the election in particular — have caused bond proxies to lag and Financials to lead (active manager's largest overweight). Further upside to inflation and interest rates, and a less onerous regulatory environment, should continue to reward this positioning. See exhibits 5-6 on page 4.

Fundamentals: Active managers tend to emphasize stock fundamentals over market sentiment, resulting in a bias toward low P/E stocks. Over the past several years, the market has rewarded yield and stability over such fundamental drivers. The data suggests that this is a direct result of weaker economic growth and below-normal yields. Should growth return to more normal levels, this trend is likely to reverse. Since the election, the market has rewarded such fundamentals. See exhibits 7-8 on page 5.

Correlations & Volatility: Over the past 10-15 years, portfolio tracking error (the deviation of returns between active portfolios and their benchmarks) has collapsed. While many blame benchmark-hugging, the data suggests otherwise. More specifically, low volatility and high correlation between stocks appear to be the primary culprits. We would expect a Trump presidency to result in a more volatile market environment with greater dispersion between stocks, contributing to a more favorable backdrop for active managers. While both volatility and correlations have plummeted since the election, we would expect volatility to rise from here. This is typical in periods of faster growth and rising rates. See exhibits 9-10 on page 6.

All values in USD unless otherwise noted.

Priced as of November 25, 2016 (unless otherwise stated).

For Required Conflicts Disclosures, please see page 7.

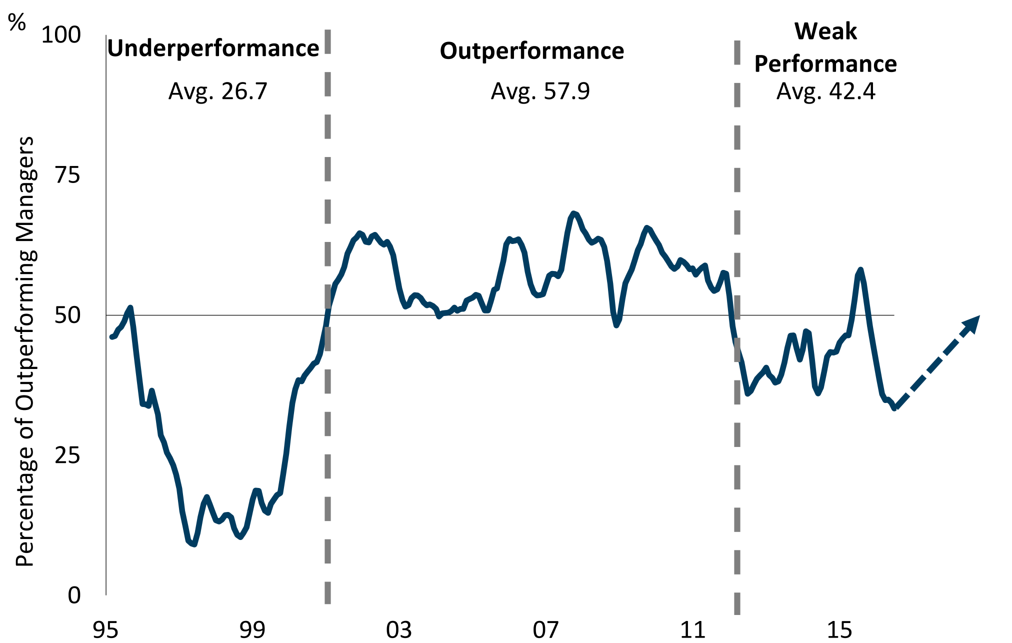
Disseminated: November 29, 2016 00:45ET; Produced: November 28, 2016 17:50ET

Large Cap Manager Performance

Manager performance tends to be quiet cyclical

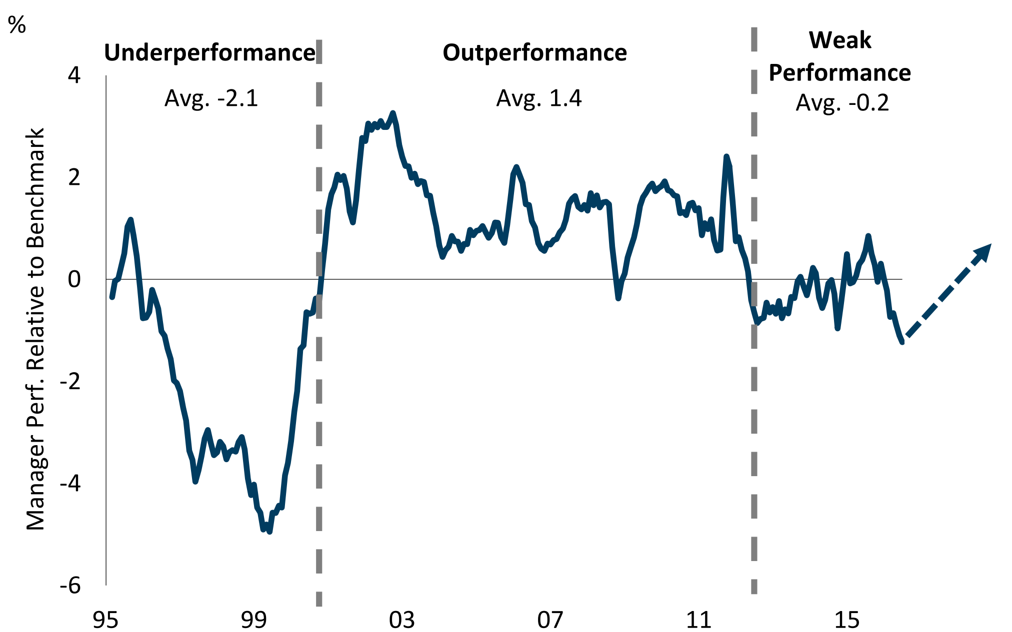
The post-election backdrop should be more favorable for alpha generation

Exhibit 1: Percentage of Managers Beating the S&P 500



Note: Gross performance; rolling 3-year annualized total return; Large cap managers defined by Morningstar
Source: S&P, Morningstar, FactSet, and RBC Capital Markets

Exhibit 2: Large Cap Manager Alpha

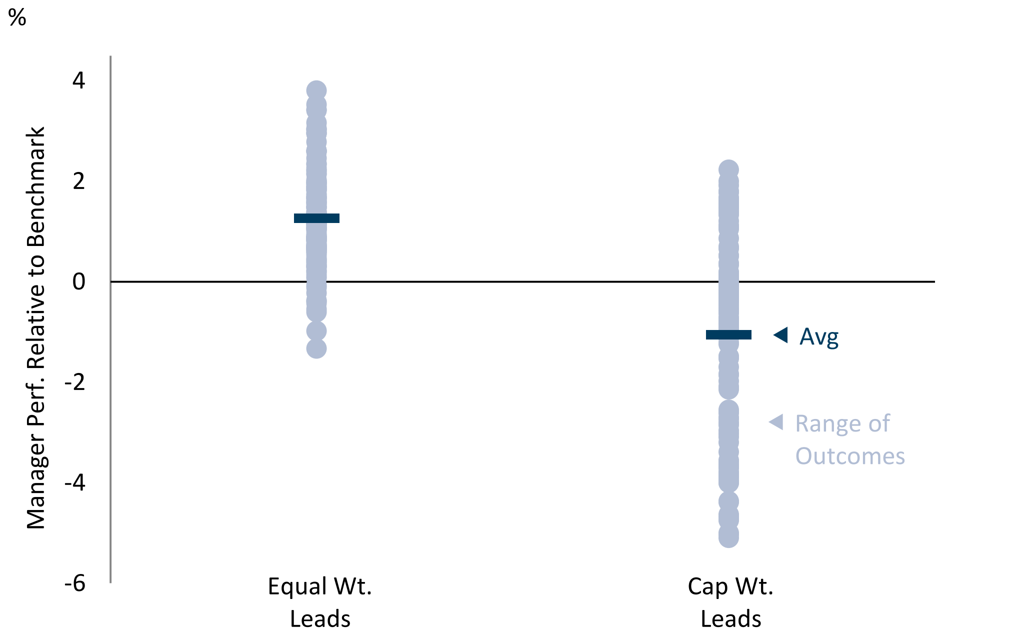


Note: Gross performance; rolling 3-year annualized total return; Large cap managers defined by Morningstar
Source: S&P, Morningstar, FactSet, and RBC Capital Markets

Equal Weighting

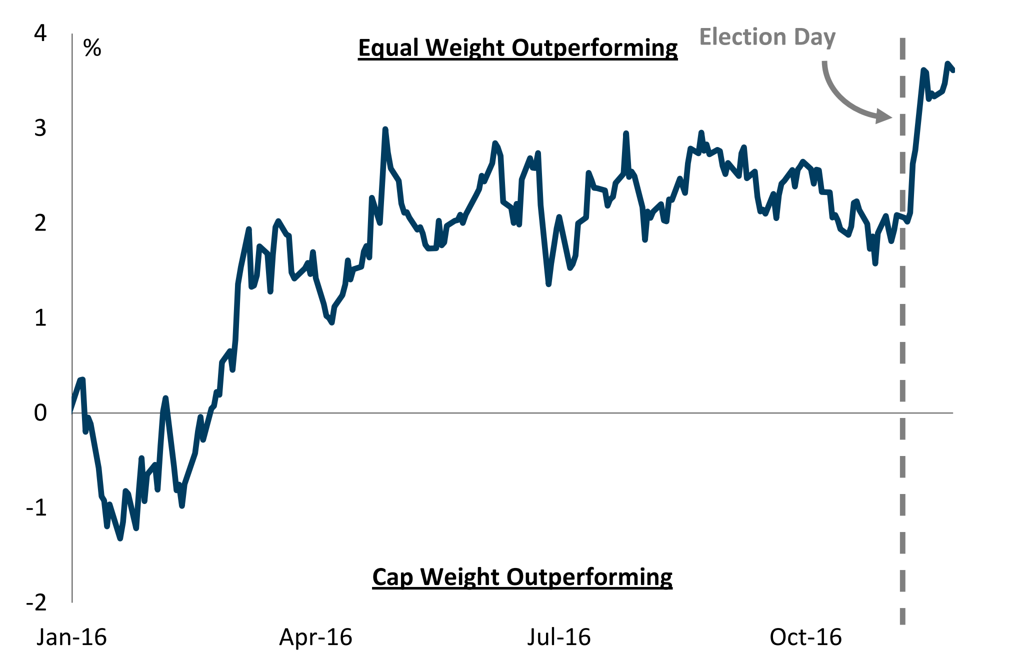
Greater market breadth would be favorable for active management

Exhibit 3: Manager Alpha – Equal Weighted vs. Cap Weighted Benchmark



Note: S&P 500 Total Return Benchmark; Gross Performance; Rolling 3-year annualized total return; Large cap managers defined by Morningstar
Source: S&P, Morningstar, FactSet, and RBC Capital Markets Note: Since 1/31/1995

Exhibit 4: S&P 500 Relative Performance – Equal Weight vs. Cap Weight

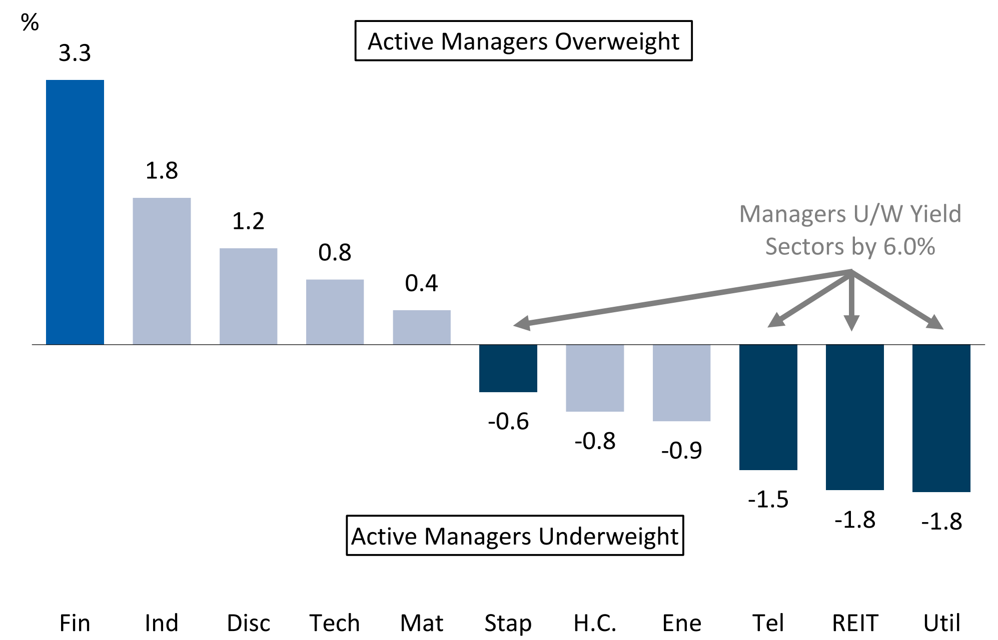


Source: S&P, FactSet, and RBC Capital Markets

Bond Proxies

Historically, active managers have been underweight bond-proxies

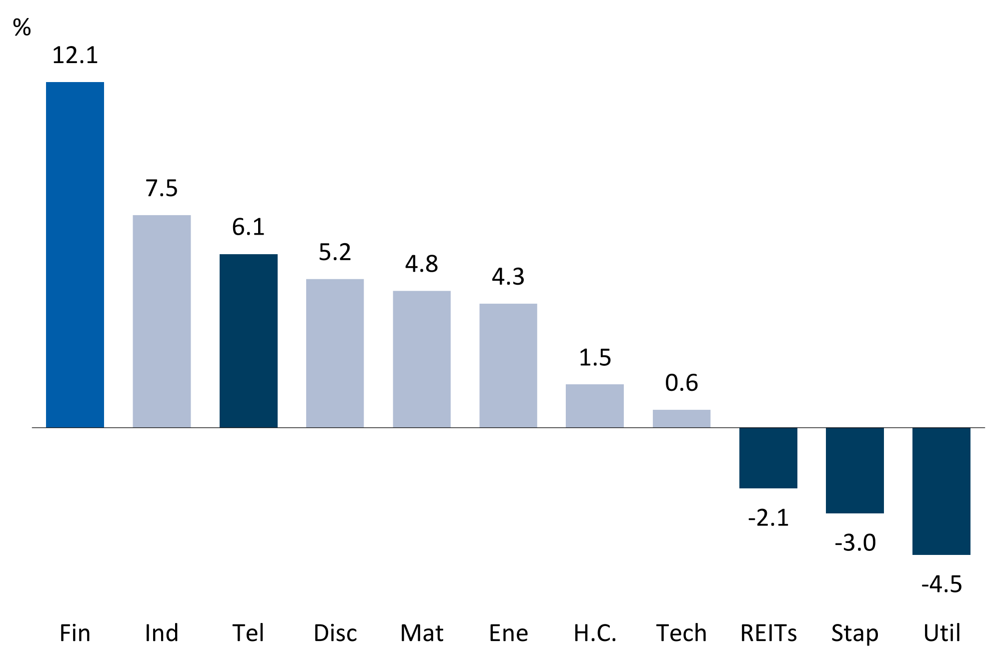
Exhibit 5: Sector Weights – Large Cap Blend Mutual Funds vs. S&P 500



Note: 25 Largest U.S. Large Cap Blend Mutual Funds by AUM as defined by Morningstar; Adjusted for cash & non-equity holdings
Source: S&P, Morningstar, Thomson Financial, FactSet, and RBC Capital Markets

Bond-proxies have lagged Financials since the election

Exhibit 6: Post-Election Performance – S&P 500 Sectors

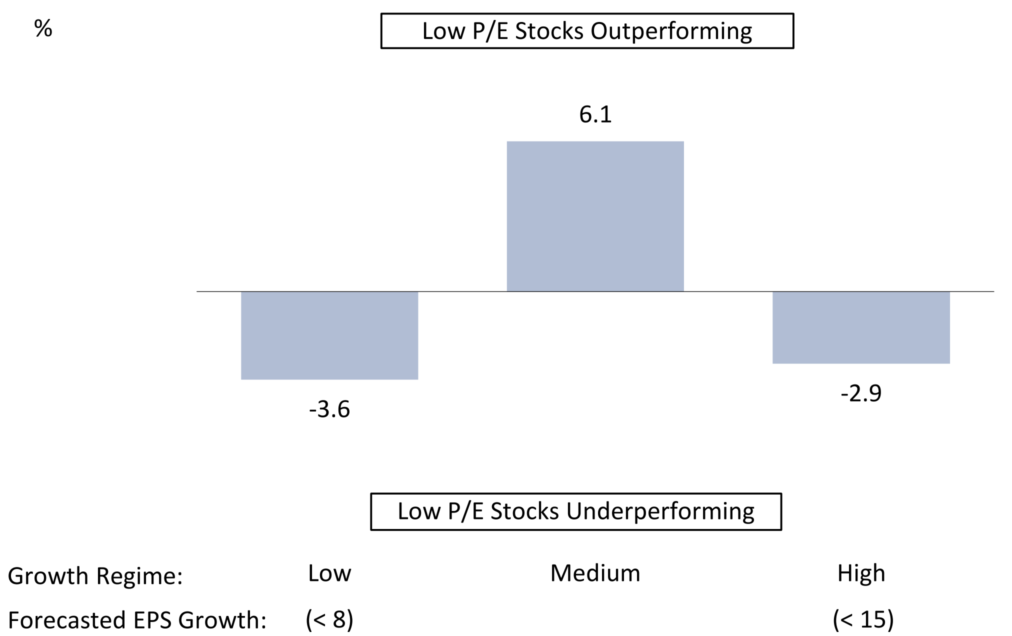


Source: S&P, FactSet, and RBC Capital Markets

Fundamentals

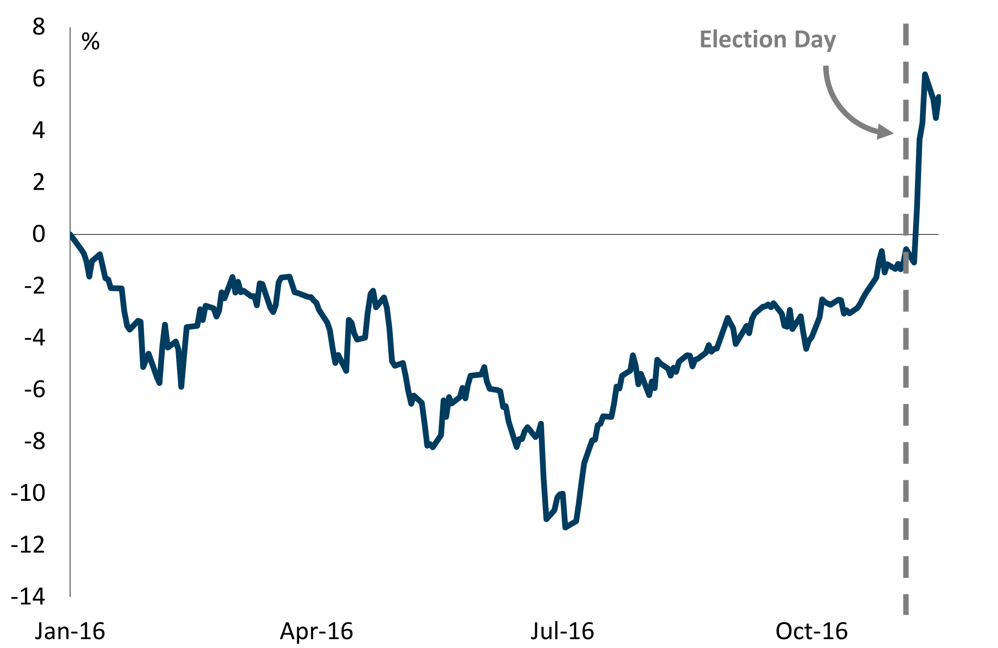
The return to a more normal growth environment should benefit stock fundamentals such as P/E

Exhibit 7: Low P/E Factor Performance by Earnings Growth Environment



Note: Growth environment based on average NTM earnings growth over rolling 12-month period; Industry group neutral low vs. high NTM P/E tertiled factor; Rolling 12-month performance
Source: S&P, Compustat, Thomson Financial, FactSet, and RBC Capital Markets

Exhibit 8: Low P/E Factor Performance

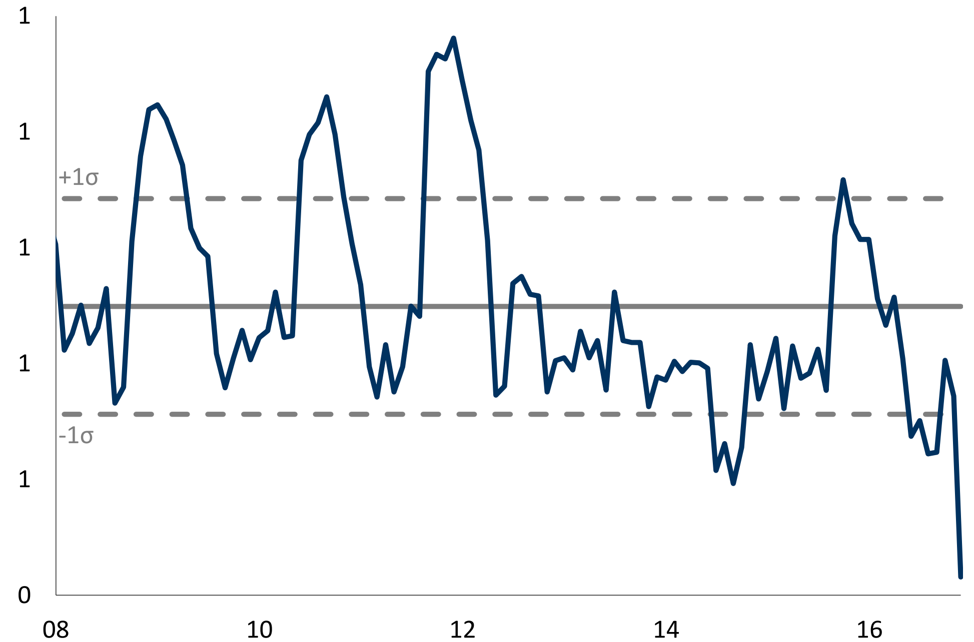


Note: Cumulative performance of unconstrained low vs. high NTM P/E tertiled factor
Source: S&P, Thomson Financial, Compustat, FactSet, and RBC Capital Markets

Correlation & Volatility

Correlation among stocks fell following the election

Exhibit 9: S&P 500 Industry Group Correlation

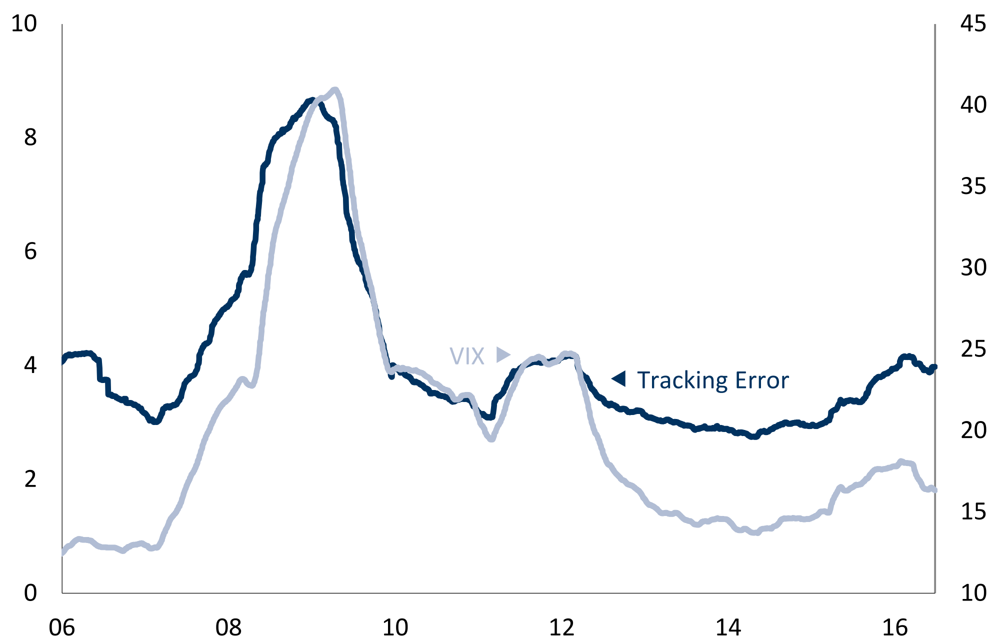


Source: S&P, Compustat, FactSet, and RBC Capital Markets

Note: IG Pairwise trailing 90 day correlation

Tracking error is driven by volatility and correlations more so than active share

Exhibit 10: Large Cap Fund Tracking Error vs. VIX



Note: 1-Year Daily Tracking Error of 25 Largest U.S. Large Cap Blend Mutual Funds by AUM as defined by Morningstar; 1-Year Moving Average of VIX
Source: CBOE, Morningstar, FactSet, and RBC Capital Markets

Required disclosures

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