



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 cyclicity 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.

RBC Capital Markets, LLC

### Jonathan Golub, CFA

Chief Equity Strategist

(212) 618-7634

[jonathan.golub@rbccm.com](mailto:jonathan.golub@rbccm.com)

### Josh Jamner, CFA

Associate Strategist

(212) 618-3312

[josh.jamner@rbccm.com](mailto:josh.jamner@rbccm.com)

### Patrick Palfrey

Associate Strategist

(212) 618-7507

[patrick.palfrey@rbccm.com](mailto:patrick.palfrey@rbccm.com)

All values in USD unless otherwise noted.

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

**For Required Conflicts Disclosures, please see page 7.**

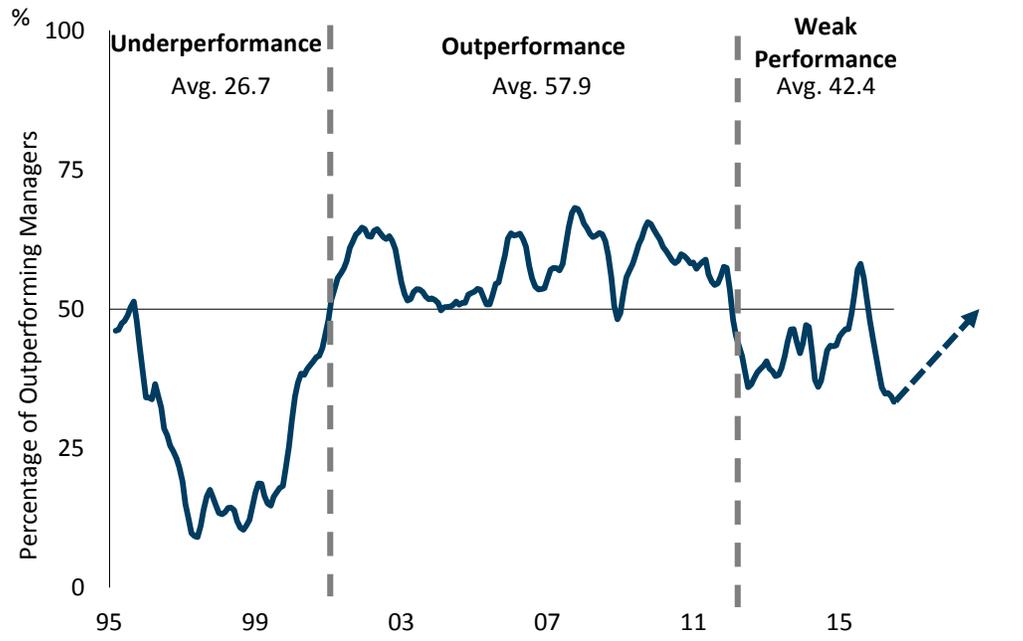


# Large Cap Manager Performance

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

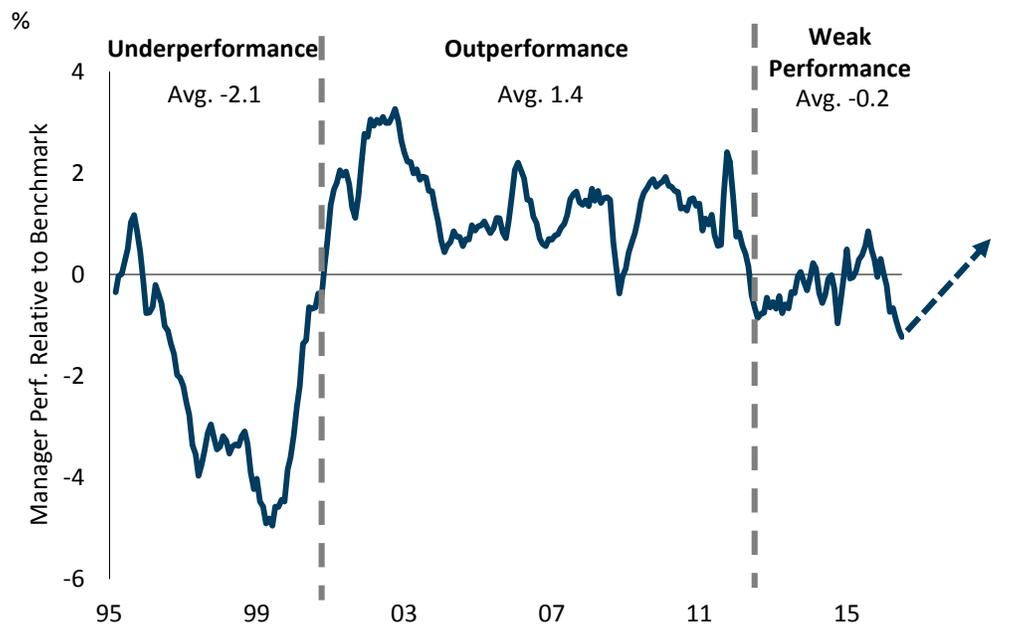
*Manager performance tends to be quiet cyclical*

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



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



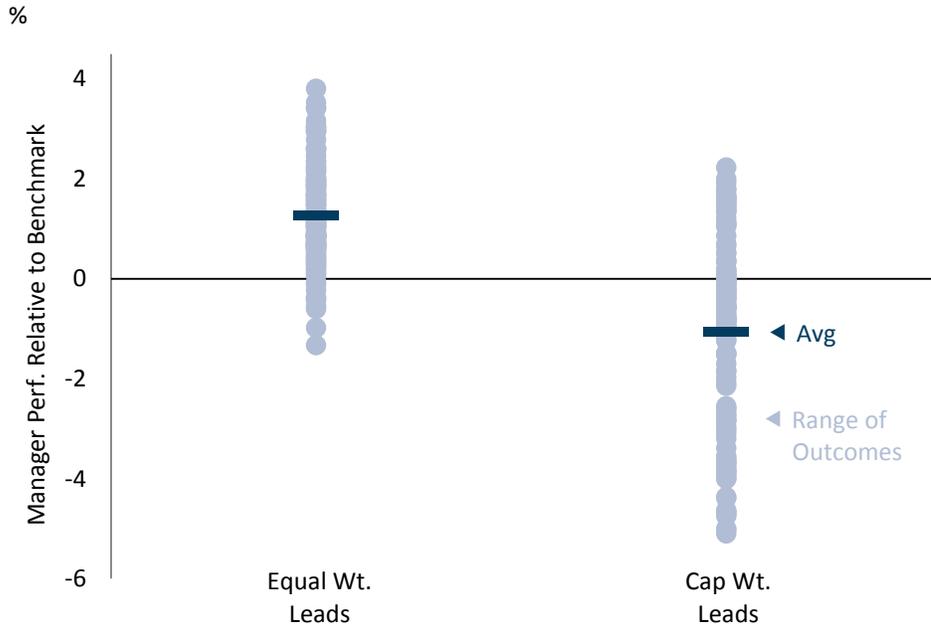
Note: Gross performance; rolling 3-year annualized total return; Large cap managers defined by Morningstar  
Source: S&P, Morningstar, FactSet, and RBC Capital Markets



# Equal Weighting

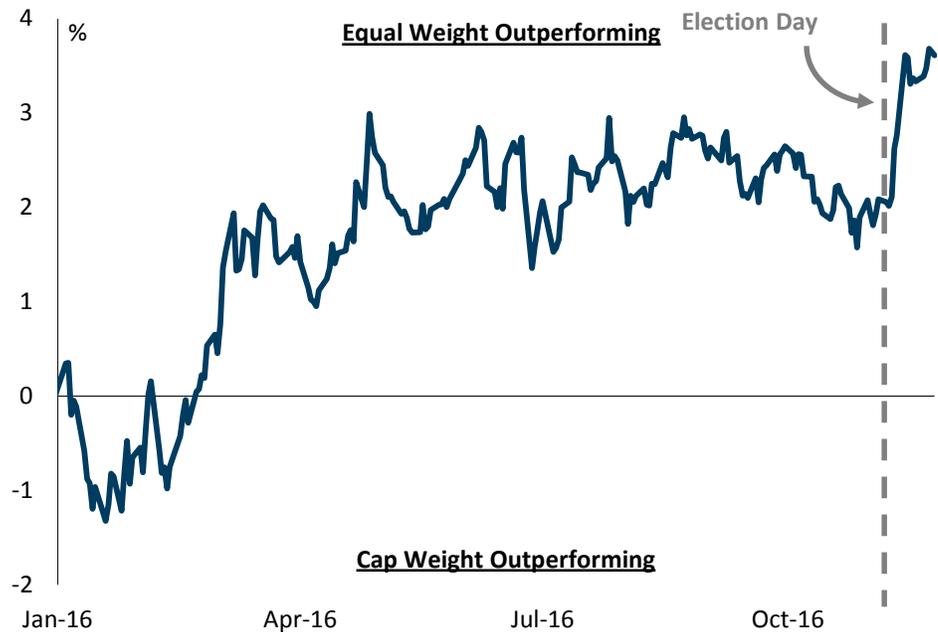
*Greater market breadth would be favorable for active management*

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



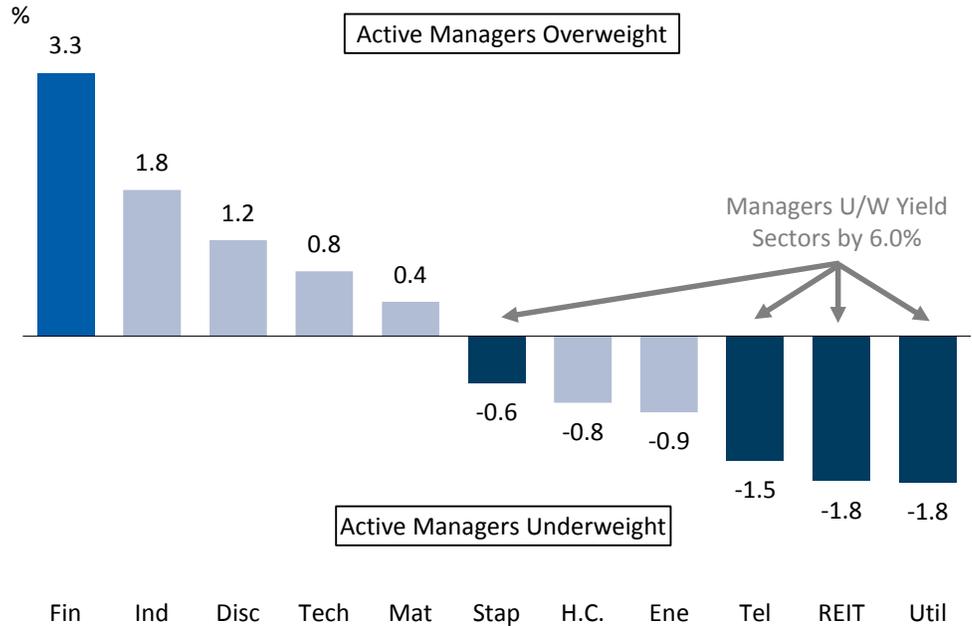
Source: S&P, FactSet, and RBC Capital Markets



Bond Proxies

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

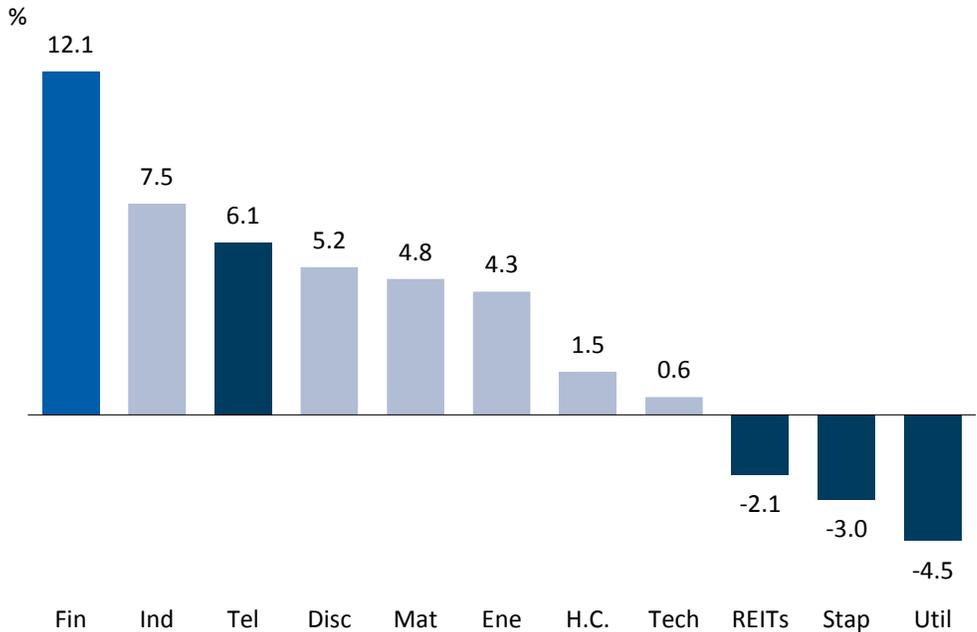
Historically, active managers have been underweight bond-proxies



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

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

Bond-proxies have lagged Financials since the election



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

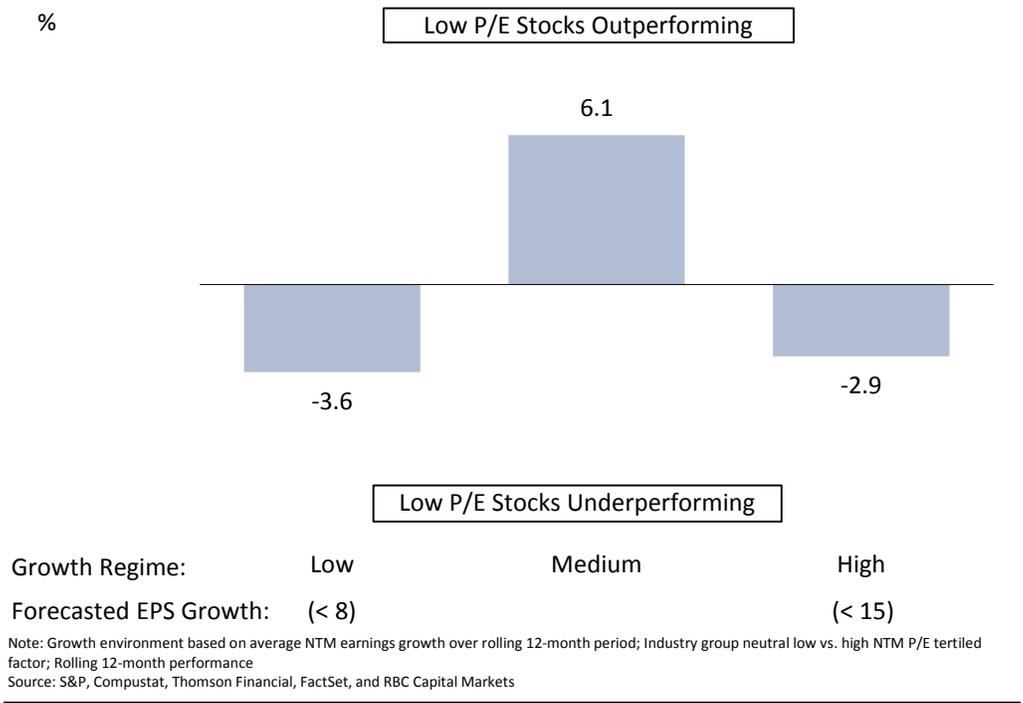
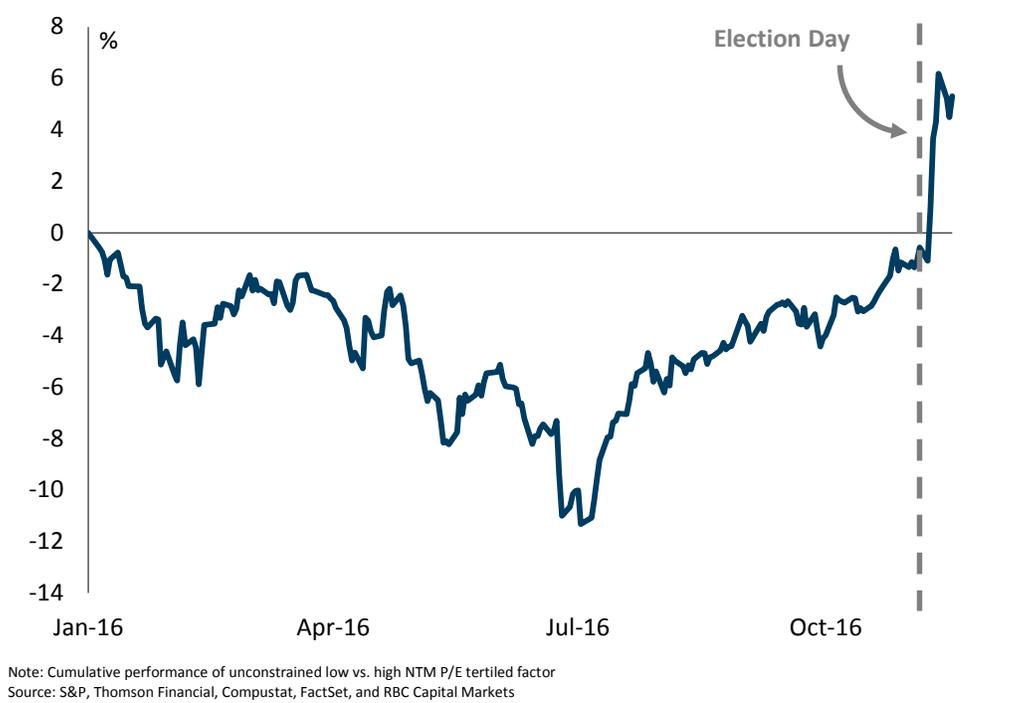


Exhibit 8: Low P/E Factor Performance

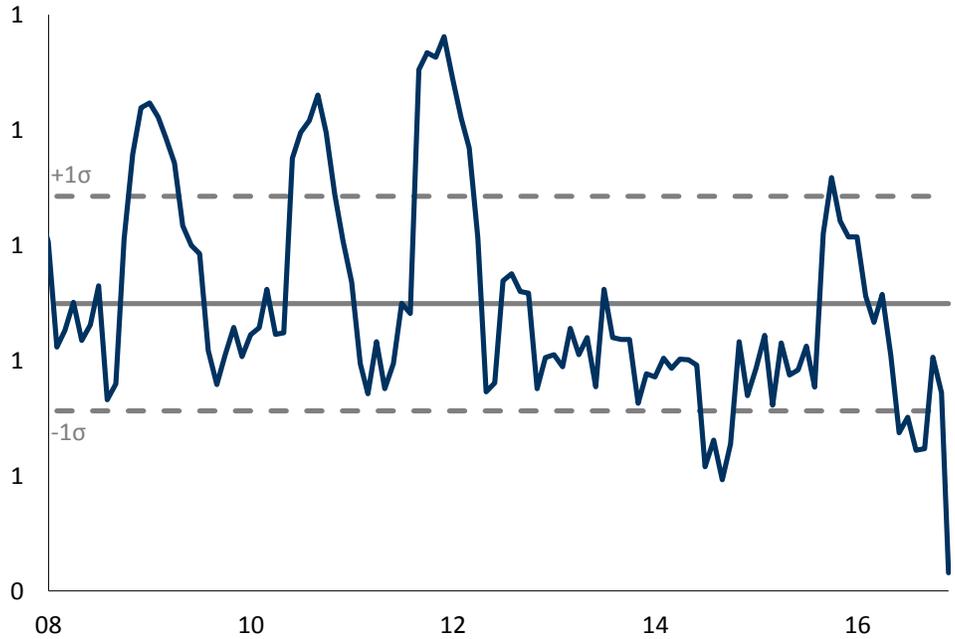




# Correlation & Volatility

Exhibit 9: S&P 500 Industry Group Correlation

*Correlation among stocks fell following the election*

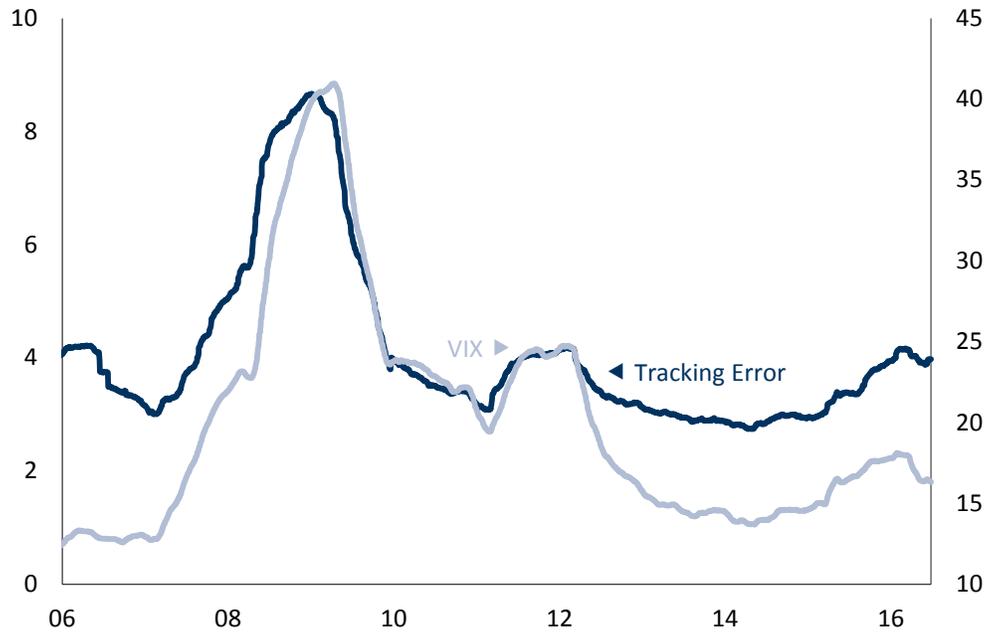


Source: S&P, Compustat, FactSet, and RBC Capital Markets

Note: IG Pairwise trailing 90 day correlation

Exhibit 10: Large Cap Fund Tracking Error vs. VIX

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



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



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