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Market Conditions and the Active-Passive Debate

Jurrien Timmer
Director of Global Macro,
Fidelity Global Asset Allocation Division

KEY TAKEAWAYS

- The active vs. passive debate is not a simple "either-or" proposition, and the strategy in favor during any given period hinges in part on the prevailing market conditions of the time.
- A host of factors come into play in determining when an active manager is more or less likely to beat an index, including the dispersion and correlation of returns, as well as market breadth.
- All else being equal, history has shown that market regimes in which leadership is broad and equity returns are less correlated tend to lend themselves well to active management.
- There is a case to be made for both active and passive strategies, and both may have a place in a long-term investment portfolio.

The debate over active vs. passive strategies for equity investors has been raging for years, with compelling arguments being made on both sides of the issue. Regardless of which side you hear from—active managers or index providers—the answer is more complicated than the simple headlines and assumptions that are grabbing our attention. The skill of the manager, the fees of the provider (whether active or passive), and prevailing market conditions all raise or lower the odds of active strategies finding success relative to indexing. Fees can be screened, while finding skilled managers may take skill. Since market conditions are handed to us and since I believe we are experiencing what could be an interesting climate change, I would like to focus my comments here.

Market Internals

Market internals are attributes that, at the market level (not the individual security level), tend to enhance the likelihood that an active strategy will outperform its respective benchmark. They tend to define what kind of market regime we are operating in. As discussed in our Thought Leadership paper *"Active Investing: The Cyclicality of Performance in the U.S. Large-Cap Equity Market"* (June 2014), two market internals that play a large role in determining the effectiveness of active strategies are the dispersion of returns within an index and the correlation of those returns. One can also consider the dispersion of earnings growth and valuations to indicate how homogenous or heterogeneous the market is.

Simply put, when the dispersion of equity returns (or earnings growth and valuation) is high, there is more differentiation among the equities in an index. When dispersion is low, there is less differentiation among the equities in an index, which creates a less favorable environment for stock pickers. When correlations are low, the chances of an active strategy adding alpha are higher, and vice versa, all else being equal. So, what an active manager wants to see is a market environment of high dispersion and low correlation.

Market Breadth

Closely related to dispersion, market breadth is another consideration in the active-passive discussion. Breadth can be defined simply as the number of stocks that are advancing versus the number of decliners. The concept is pretty straightforward: If a majority of stocks are outperforming their index, then statistically the odds of picking winning stocks are higher. Conversely, if only a few stocks are outperforming, then the active manager has to pick from just those few stocks to add alpha. Think of it as fishing in a pond: The fewer fish in the pond, the harder it will be to catch something.

Market breadth is by definition related to the market's capital structure. Given that the major indices like the S&P 500 or Russell 3000 are capitalization-weighted, if only a small percentage of stocks are leading the market higher, then by definition those stocks will have large capitalizations. Otherwise they wouldn't be able to impact the index very much. In the small-cap universe, however, most indices cover a wider range of stocks with a vast selection of company-specific characteristics, offering a greater number of independent investment decisions. Although also cap-weighted, they are much "flatter" and not as top-heavy in their weighting scheme. This greater breadth of opportunities partially explains why active managers on average have been more successful in the relatively less efficient U.S. small-cap equity segment than in the large-cap space, which is discussed in the aforementioned *Active Investing: The Cyclicality of Performance* paper.

The Link between Breadth and Active-Passive

The following statistics illustrate the link between the relative breadth of the stock market and the relative performance between active and passive strategies. Going back to 1991 (as far back as industry-wide data on active vs. passive goes using Morningstar data), we see that on average the percentage of stocks outperforming the S&P 500 on a 12-month basis is 50%. That makes sense, of course. It is positive (above 50%) 53% of the time and negative 47% of the time. When relative breadth is positive, the median three-year excess return of active strategies over passive is +0.04%.

But it gets more interesting. When the market gets broader and relative breadth gets more positive, say at 55%, active outperforms passive by +0.99% on a three-year rolling basis, and it does so 78% of the time. When relative breadth gets very positive, say at 60%, then active beats passive by +2.35% and does so 100% of the time. How often does this happen? Relative breadth above 55% has happened 32% of the time since 1991 and 23% of the time since the start of our breadth data in 1927. Relative breadth above 60% has happened 11% of the time since 1991 and 8% since 1927.

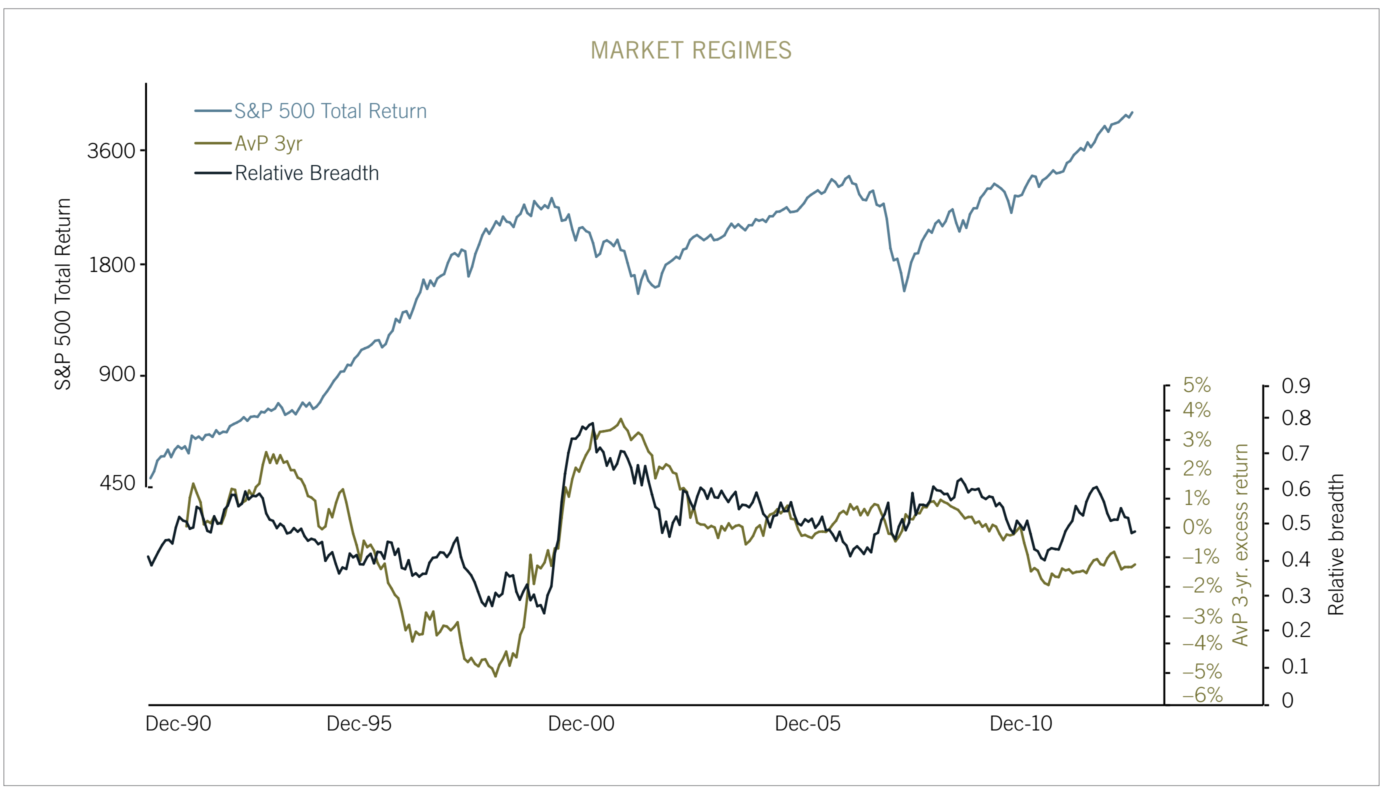
Conversely, when the market gets narrower and relative breadth falls to 45% or below, active underperforms passive by -2.05% on a three-year basis and does so 79% of the time. When breadth gets even more narrow and falls to 40% or below, active underperforms passive by -2.8% and does so 97% of the time. How often does this happen? Relative breadth below 45% has happened 31% of the time since 1991 and 41% of the time since the start of our breadth data in 1927. Relative breadth below 40% has happened 16% of the time since 1991 and 20% since 1927.

Exhibit 1 (below) shows the relationship between relative breadth and the excess return of active over passive. Since 1991, the R-squared (a statistical measure that represents the percentage of a variable's movements that can be explained by movements in another factor) of the two series is 0.52.

Market Regimes

If we go back in history, we can identify several important market regimes that were favorable to either active strategies or indexing. Basically, when the market leadership is broad (as discussed earlier) and equity returns are less correlated, that's a macro backdrop that tends to lend itself well to active management (i.e., the ability of the manager to pick winning stocks), all else being equal. For instance, the early to mid-1990s was a period during which classic GARP (growth at a reasonable price) investing

EXHIBIT 1: The higher the percentage of relative breadth, the greater the tendency for active to outperform passive.



AvP 3yr = excess return of active over passive during rolling 3-year periods. Source: Haver Analytics, Morningstar, Fidelity Investments, as of Jul. 31, 2014.

worked well (see Exhibit 2, right). That regime lent itself very well to active management.

Then, during the late 1990s, we had the tech bubble, during which the major indices were lifted higher by literally only a handful of mega-cap stocks, causing valuations to soar and leadership to narrow. That was when indexing became very popular, which ironically compounded the market's overvaluation. Then the bubble burst, and while the major indices fell significantly, the majority of equities outperformed the market, and this environment lent itself well to active strategies once again.

The middle 2000s was a "neither-here-nor-there" period. That was the era of globalization and low volatility. Then came the credit crisis in 2008. That environment, as we all remember, was one of extreme systemic risk, ultra-easy monetary policy, and extreme high correlations within the stock market—and also among all risk markets. As the saying goes, in times of crisis all correlations go to 1, and that was certainly true in 2008 and 2009.

The financial crisis and its aftermath was a period of binary risk-on or risk-off investing. If you were risk-on, it really didn't matter much which stocks you owned, because every risk asset was highly correlated to every other risk asset. You were either on the right side of the risk trade or on the wrong side, and nothing much mattered beyond that. It was all macro and binary. In short, when the market leadership gets narrow as it did in 1999, the investing environment lends itself more to indexing.

Extreme Breadth: The Tech Bubble

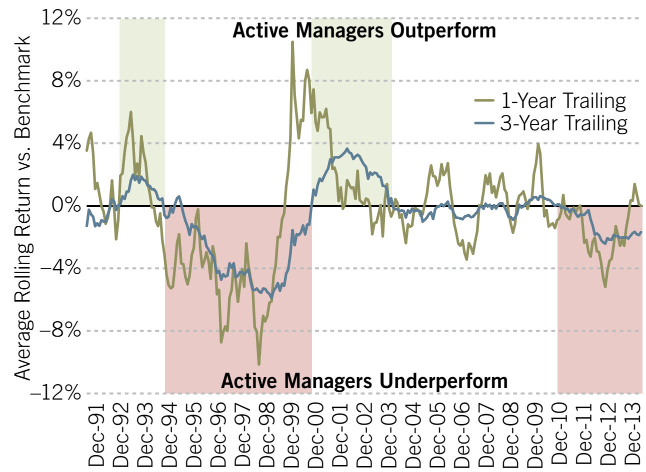
For the most part, the dispersion of returns and the breadth of the market tend to ebb and flow together and are key attributes that define what market regime we're in. Generally, when the dispersion of returns is above average, so is breadth, and vice versa. However, there was one period where the dispersion spiked significantly higher while breadth plummeted. That was the tech bubble.

The dot-com bubble was one of the most extreme periods of relative breadth in history. The major averages peaked in March 2000, but by that time only 25% of the constituents within the S&P 500 were outperforming the index on a 12-month trailing basis. This was a peculiar indexing phenomenon during which a parabolic rise in the stock market (especially the NASDAQ Composite Index) was driven by just a handful of mega-cap stocks. Since most equity indices are cap-weighted, a huge move by only a few very large companies was all it took to push the indices to bubble-like levels, even though the majority of stocks barely participated.

By February 2000, the NASDAQ was up 100% in just 12 months, yet only 38% of stocks in the benchmark were higher than a year earlier. That is extremely narrow leadership, and many active managers underperformed their benchmarks during the period leading up to the bubble peak. Once the bubble burst, however, the opposite happened. Even though the S&P 500 declined more

EXHIBIT 2: Looking back across more than 20 years, there have been distinctive multiyear periods when active managers of U.S. large-cap equity strategies have either out- or underperformed their respective passive benchmarks, on average.

AVERAGE ROLLING RETURNS OF ACTIVELY MANAGED U.S. LARGE-CAP EQUITY FUNDS VS. RESPECTIVE BENCHMARKS 1991–2013



Fund performance reflects three-year and one-year rolling returns on average for the universe of actively managed funds in Morningstar's large-cap categorization relative to each fund's primary benchmark. Fund performance is net of total operating expenses charged by the respective investment management companies. Shaded areas identify cycles by three-year returns: Green areas indicate active manager outperformance; red areas indicate underperformance. Past performance is no guarantee of future results. This chart does not represent actual or future performance of any individual investment option. See the complete methodology on page 5. Source: Morningstar, as of Dec. 31, 2013.

than 50% from the March 2000 high to the October 2002 low, breadth shot up, with more than 75% of constituent stocks outperforming the index. By July 2001 the S&P 500 was down 15% year-over-year, yet 68% of the stocks within the index were actually higher than a year earlier in absolute terms. As a result, active beat passive by a considerable margin during that time frame.[1]

As mentioned, the market's leadership became extremely narrow during the height of the tech bubble, making it very difficult for active managers to outperform. Ironically, during this same period the dispersion of returns spiked to one of the highest levels on record. This is a departure from the normal course of events, when the two attributes tend to behave more alike. But in this period it was large-cap technology and Internet stocks driving the market higher, with literally everything else lagging behind. As a result, breadth was poor and the dispersion was high.

What Drives Market Conditions?

So, we have seen that breadth, dispersion, and correlation are important attributes of market regimes, and that they can enhance or detract from the probability of success for an active or passive strategy. The question then becomes: What creates these regimes in the first place? What causes breadth to broaden or narrow, or correlations to spike higher or descend lower?

This is where the business cycle, monetary policy, and systemic risk come into play. Take monetary policy for a moment. In a typical business cycle, when the economy overheats, the Fed will eventually tighten policy by raising short rates. Since short rates typically move faster than long rates, when the Fed tightens, the yield curve tends to flatten and eventually invert as a result.

Where we are in the business cycle also helps determine market conditions, whether it be early cycle, mid cycle, late cycle, or down cycle. It is, after all, the business cycle that tends to drive the Fed. Typically, it is the early cycle that lifts all boats, as the economy recovers from a recession and the stock market recovers from a bear market. When a new rally begins, breadth is usually very strong. Then when the bull market ages and becomes more mature, the market's leadership (and therefore breadth) tends to become narrower.

Then there are the structural forces, such as the degree of leverage and systemic risk. As mentioned before, we only need to go back to the credit crisis and its aftermath to see what high degrees of systemic risk do to correlations within and among asset classes.

Bottom Line

We know that active strategies tend to have a greater chance of outperforming indexing when breadth and dispersion are high and correlations are low—conditions that are more likely to occur when the business cycle is fresh and when systemic risk is low or at least receding. What does that suggest for the future? The Great Recession ended in 2009, so that means the business cycle is now more mature at five years. On the surface, that might make me less inclined to favor active strategies at this time. But then again, this has been anything but a normal business cycle, coming on the heels of a global systemic crisis and a resulting lack of resource utilization and inflation. So chances are that this business cycle will last longer (and perhaps much longer) than the average cycle.

In this sense, it is worth remembering that it's typically the Fed that tips the scale from late cycle expansion into recession or slowdown, and so far the Fed has been extremely careful to not take the punchbowl away before it absolutely has to. With that in mind, it is important to note that the Fed remains extremely accommodative, despite signaling it will likely start to normalize rates by mid-2015. But with inflation well behaved, the proposed path toward rate normalization is likely to be very gradual and is expected to terminate at a lower "neutral" rate than in past cycles (see my July commentary *"Could Inflation Upset the Markets' Low-Volatility, Low-Yield Equilibrium?"*).

The bottom line is that there have been distinctive, multiyear periods when active management has outperformed. Given the cyclicality of market conditions, investors with only passive equity strategies in their portfolios may want to consider maintaining some exposure to active strategies to maximize their return potential.

Author

Jurrien Timmer
Director of Global Macro, Fidelity Global Asset Allocation Division

Jurrien Timmer is the director of Global Macro for the Global Asset Allocation Division of Fidelity Investments, specializing in global macro strategy and tactical asset allocation. He joined Fidelity in 1995 as a technical research analyst.

Fidelity Thought Leadership Vice President and Senior Investment Writer Matt Bennett provided editorial direction for this commentary.

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Methodology

Data and sources: Morningstar (Morningstar Direct) – full list of actively managed funds with fund absolute and excess returns (monthly and net of total operating expenses) in the U.S. large-cap growth, U.S. large-cap blend, and U.S. large-cap value categories, along with the funds' associated primary large-cap benchmarks if they were one of the following large-cap indexes: Standard & Poor's 500 Index, Russell 1000 Index, Russell 1000 Value Index, Russell 1000 Growth Index, Russell 3000 Index, Russell 3000 Growth Index, Russell 3000 Value Index. ***Morningstar explanation of net total return calculated for actively managed U.S. large-cap equity funds:*** Expressed in percentage terms, Morningstar's calculation of total return is determined by taking the change in price, reinvesting, if applicable, all income and capital-gains distributions during that month, and dividing by the starting price. Reinvestments are made using the actual reinvestment price, and daily payoffs are reinvested monthly. Unless otherwise noted, Morningstar does not adjust total returns for sales charges (such as front-end loads, deferred loads and redemption fees), preferring to give a clearer picture of performance. The total returns do account for management, administrative, 12b-1 fees, and other costs taken out of assets (i.e., total operating expenses). The dataset ranged monthly from Jan. 1991 to Dec. 2013. Funds that stopped reporting returns between those dates are included in the dataset, to reduce survivorship bias. Rolling three-year and one-year returns of the large-cap categorized funds in the universe mentioned earlier were calculated by taking a simple average of all the funds' net returns relative to their benchmarks (net of total operating expenses). ***Active manager performance cycle start dates:*** Given the overlapping nature of 3-year rolling return calculations, the cycle start dates were determined to be 18 months (half the 3-year period) prior to when a cycle moved from a positive value to a negative value, or vice versa. See cycle start and end dates in Exhibit 2.

Endnote:

[1] Source of all data in the footnoted paragraph is Haver Analytics, as of Sep. 30, 2014.

Index definitions

Standard & Poor's 500 Index (S&P 500®) is an unmanaged market capitalization-weighted index of 500 widely held U.S. stocks and includes reinvestment of dividends.

Russell 3000® Index is a market capitalization-weighted index of performance of the 3,000 largest companies in the U.S. equity market.

The NASDAQ Composite Index is a market capitalization-weighted index that is designed to represent the performance of NASDAQ stocks.

It is not possible to invest directly in an index. All indices are unmanaged.

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