MEKETA
INVESTMENT GROUP

Signals for Active Management

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In our first paper, *Is the Performance of Active Managers Still Cyclical*, we highlighted how there are cycles in active management and that certain market regimes (e.g., negative markets, markets with more breadth) tend to provide more fertile ground for potential active manager outperformance.

As a follow-up, we decided to search for potential leading indicators that could signal favorable regimes for active managers. These indicators could theoretically be used as guideposts when making decisions on allocating between active managers and passive indices. While these signals would not represent the totality of decision inputs on active versus passive allocations, they could theoretically help stack the odds in one's favor.

We tested a number of potential indicators. Some of the hypotheses were more intuition-based while others were aimed at identifying possible leading signals of down markets based on data from our first paper that demonstrated the downside protection that active management has tended to provide in declining markets.

Our conclusion is that, outside the well-known leading indicators of recessions, the hypotheses were either proven false or exhibited too much noise to be considered reliable. In this paper, we review a sub-set of the tested hypotheses, their results, and the inherent challenges in drawing definitive conclusions on timing allocations between active and passive management.

Intuitive hypotheses

There are a number of intuitive hypotheses around the conditions that provide the most fertile ground for active management outperformance. One such hypothesis is that periods of narrow sector contribution to index returns present headwinds for active managers. In markets where fewer sectors have an outsized impact on returns, active managers will likely struggle versus their respective indices. One reason for the poor relative performance could include risk parameters that mandate diversification across sectors. Another might be valuation disciplines that often steer managers away from what they perceive as overvalued sectors that have had an immense impact on positive index performance. Given that most indices are market capitalization weighted, there is an inherent momentum bias in benchmarks that can present headwinds for active managers who incorporate valuation into their investment processes.

However, the data paints a picture that runs counter to this intuition. A larger percentage of large cap and small cap active managers have outperformed their respective indices in periods of narrow sector contribution. Charts 1 and 2 below show that when a smaller number of sectors have more of an outsized impact on both the large cap (Russell 1000) and small cap (Russell 2000) universe returns, a greater percentage of active managers outperformed. In addition, for the most part, fewer active managers outperformed their indices as breadth increased (i.e., as contribution to index returns became more diversified across sectors).

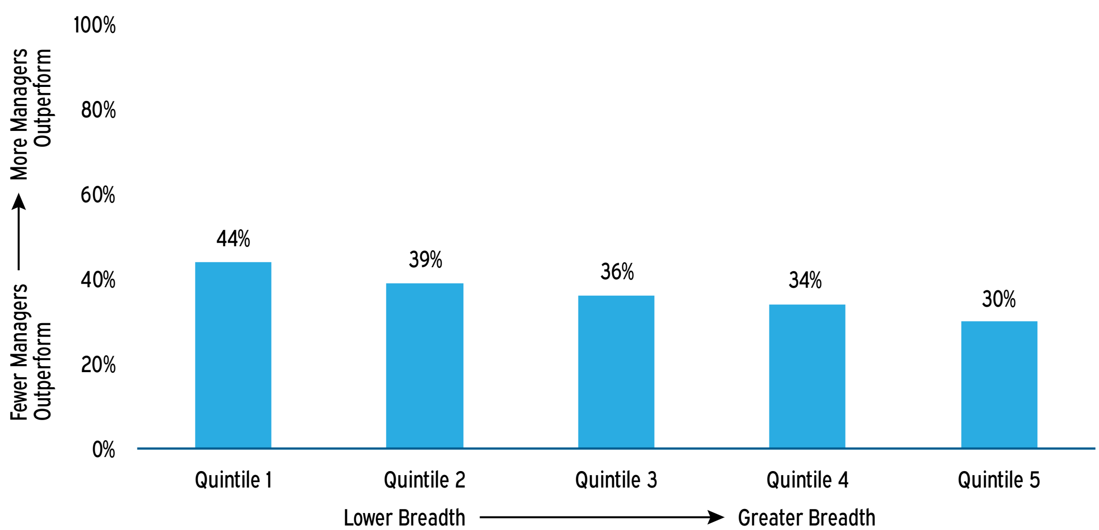

CHART 1

% of Large Cap Core Managers Outperforming R1000 by Sector Contribution Breadth Quintile[1]

(Rolling One-Year Returns April 1985-September 2019)

[1] Source: FactSet and Morningstar Direct

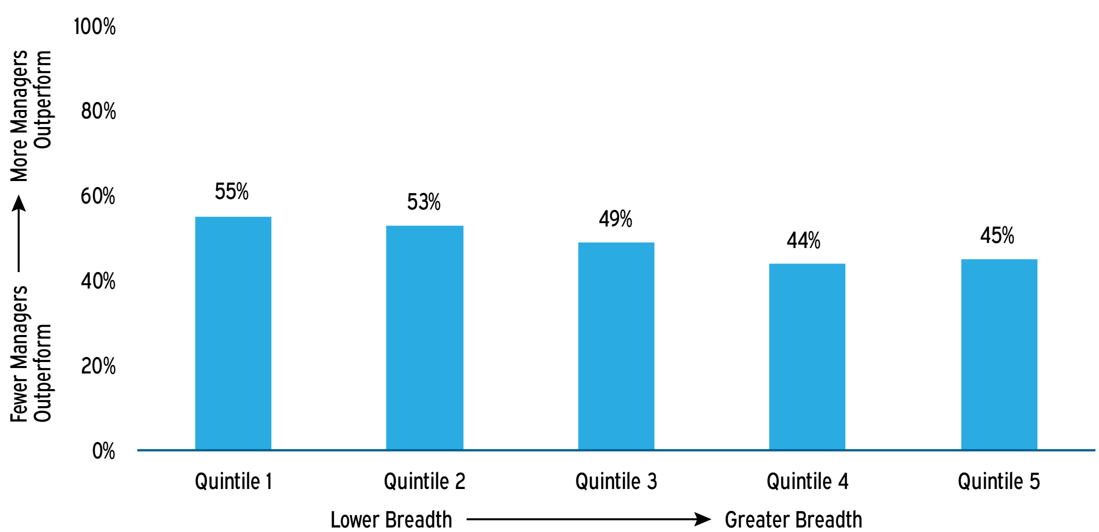

CHART 2

% of Small Cap Core Managers Outperforming R2000 by Sector Contribution Breadth Quintile

(Rolling One-Year Returns February 1990-September 2019)

Another hypothesis we tested is that in periods of low or decreasing interest rates, more highly levered companies tend to outperform more lowly leveraged companies, since lower interest rates make it easier for companies with more debt to fund their operations and/or to take on more debt to fund their operations. We also hypothesized that more active managers would underperform their indices in this environment, given that many active managers seem to lean toward companies with less debt. However, Chart 3 shows that while there might be some directional relationship between declining interest rates and the outperformance of highly leveraged companies versus the least leveraged companies, the relationship is not particularly clear. Further, noise pervades this relationship given that other factors are likely at play that affect the direction of interest rates and the relative performance of high versus low leverage companies. Lastly, when reviewing Morningstar large cap core manager data, there were not meaningful differences in the debt to capital ratio of the average active manager versus the S&P 500 Index, indicating that active managers are not taking on incrementally more or less leverage risk than the benchmark (see Chart 7 in Appendix).

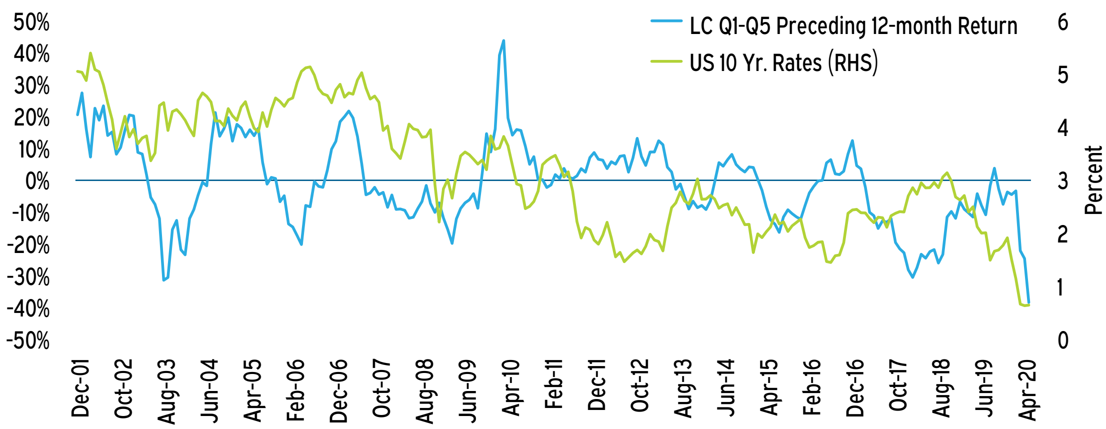

CHART 3
Rolling 12-month High Leverage Minus Low Leverage Large Cap Companies versus 10-year US Rates
(December 2001-May 2020)

Recessionary environmental/declining market indicators

The other hypotheses we tested fell in the category of common leading indicators of recessionary environments and negative equity markets. As demonstrated in our first paper, active managers have tended to outperform when the market inflects downward. Chart 4 below, taken from our first paper, shows that the Russell 1000 Index tends to rank higher (i.e., fewer active managers outperform) in the large cap core universe during sharp upward markets. Conversely, the benchmark ranks lower (i.e., more active managers outperform) in significant market declines.

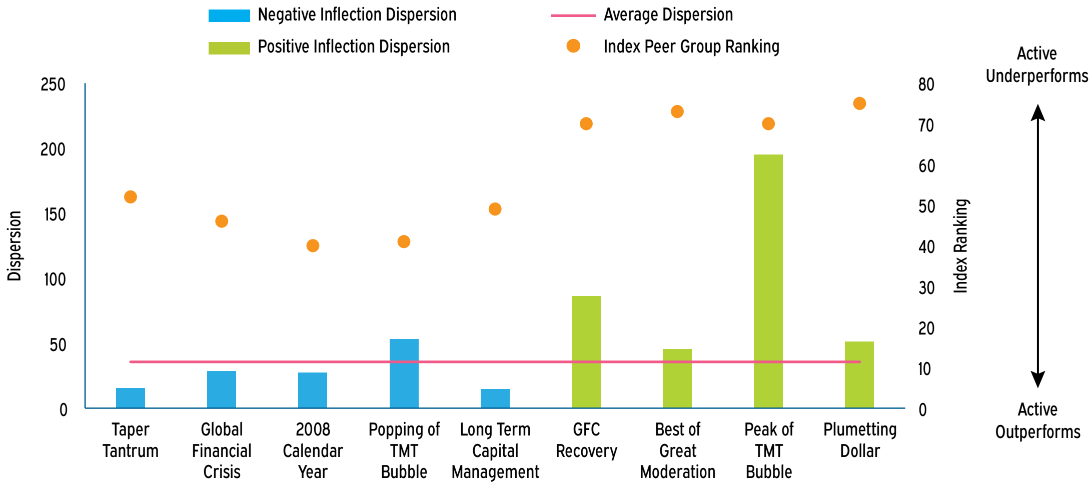

CHART 4
Russell 1000 Stock Dispersion and Ranking During Market Inflections

Markets tend to decline just before and during recessions. However, relatively precise timing is required to take full advantage of such opportunities, potentially rendering them too challenging to capture. The fact that market declines happen both before and during recessions means that if an investor waits for a recession to occur, then by definition some of the outperformance has already come to fruition. Hence an investor would need to look for leading indicators rather than coincident indicators of a downturn.

One such leading indicator of recessions is the difference between the Conference Board's[2] Leading and Coincident Economic Indicators. Chart 4 shows that the difference between the LEI and CEI has turned negative prior to each of the six recessionary periods during the period measured. Chart 5 demonstrates that typically, at some point during or preceding the recessionary period, the subsequent rolling 12-month return of the S&P 500 turns negative as indicated by the downward sloping blue line. Generally speaking, more active managers outperform the S&P 500 Index over these rolling one-year periods when the S&P 500 declines, as indicated by the downward sloping red line that generally coincides with the downward sloping blue line. Therefore, using the LEI-CEI signal could potentially indicate an opportune time to shift toward active.

[2] The Conference Board is a non-profit business membership and research organization that includes approximately 1,200 public and private corporations and other organizations as members. Among the copious research produced by this organization are composite indices of leading, coincident, and lagging economic indicators. The Leading Economic Index ("LEI") is used to gauge future economic activity while the Coincident Economic Index ("CEI") measures current economic activity.

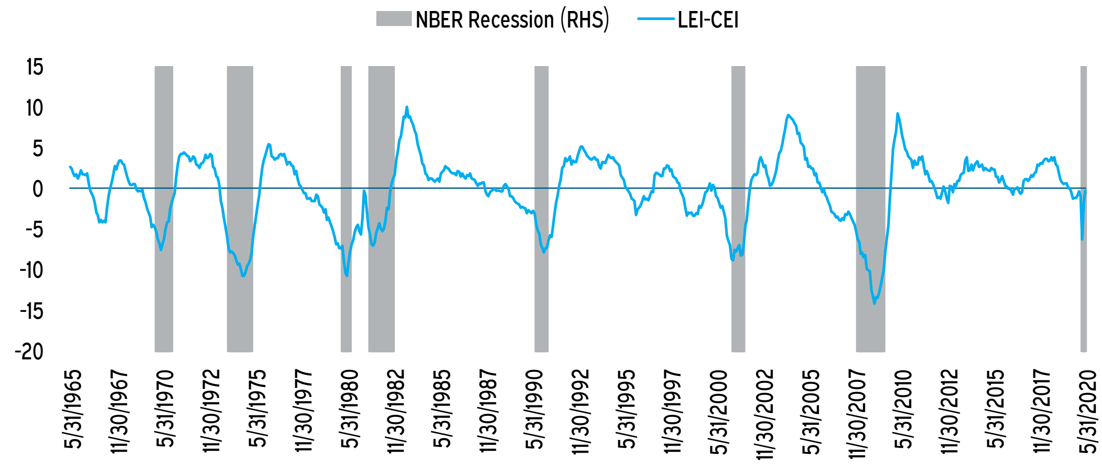

CHART 5

Conference Board LEI-CEI versus NBER Recession Definition

(Monthly, June 1965 – May 2020)

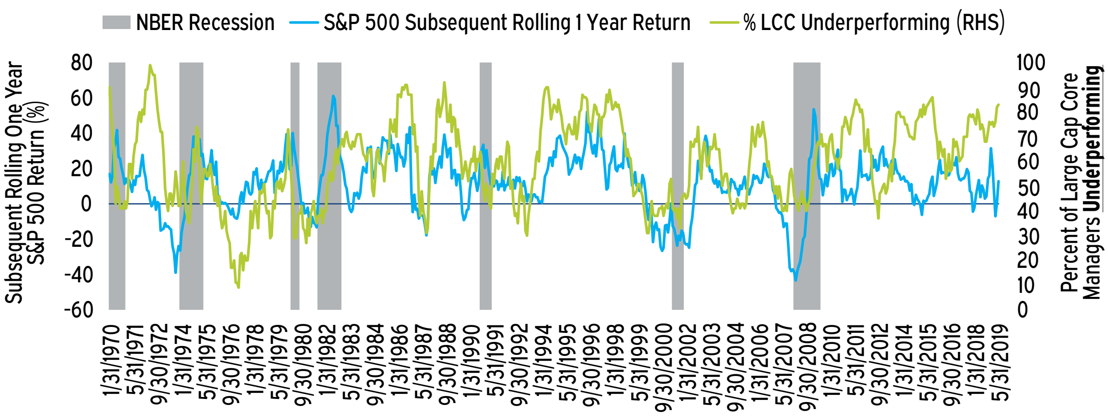

CHART 6

Monthly NBER Recession versus Subsequent Rolling One-Year S&P 500 Return and % of Large Cap Core Managers Outperforming S&P 500

(Monthly, January 1970 – May 2020)

However, this indicator is fraught with issues around timing and manager selection. First, in some instances, the market turned negative prior to the LEI-CEI inversion and ensuing recession, meaning that use of the LEI-CEI signal alone would have resulted in the investor's missing some of the initial protection provided by active managers in down markets. The market itself is, after all, a leading indicator of recessions, sometimes *more* leading than the LEI-CEI inversion. That said, the investor would likely still benefit from some downside protection in instances when the market continued to decline during the recession.

Second, and somewhat related, is that there is no particular pattern or trend as to how many months set apart the LEI-CEI inversion, the S&P 500 decline (and active management outperformance), and the recession. In some instances, the S&P 500 decline happened before, right around, or after the LEI-CEI inversion. All we know is that these directional patterns somewhat coincide, but timing precision would likely prove an exercise in futility. Further, the costs of such turnover could be significant and could potentially offset any benefit even if an investor's timing was accurate.

Lastly, on the timing issue, is that this analysis relies on the tenet that the investor is willing and able to shift back toward passive investments once the S&P 500 rebound occurs, given that passive allocations tend to outperform more often in positive markets, particularly at inflection points. That assumption is likely a far leap. Ill-timed shifts back to passive could negate, or more than offset, the positive benefits from shifting into active management for the market decline. In addition, none of this analysis speaks to potential offsetting effects of benefitting from, and/or being penalized by, strong or weak active manager selection and any given active manager's ability to outperform in either positive or negative markets.

An investor could be better-served to leverage leading indicators of market declines and/or recessions by moving capital to cash as opposed to active managers. Having cash would likely better position the investor to shift more seamlessly to passive investments to take advantage of eventual market rebounds. It also limits the variability of outcomes an investor could potentially experience by allocating to active management, where the range of performance is much wider.

Conclusions

In conclusion, we believe that timing investments in active versus passive strategies is as challenging as any other type of market timing. Perhaps this is why there are no well-known indicators to time such decisions. Further, implementation lags in tilting portfolios between active and passive strategies present additional challenges that could render any potential benefit of such tilts obsolete.

Appendix

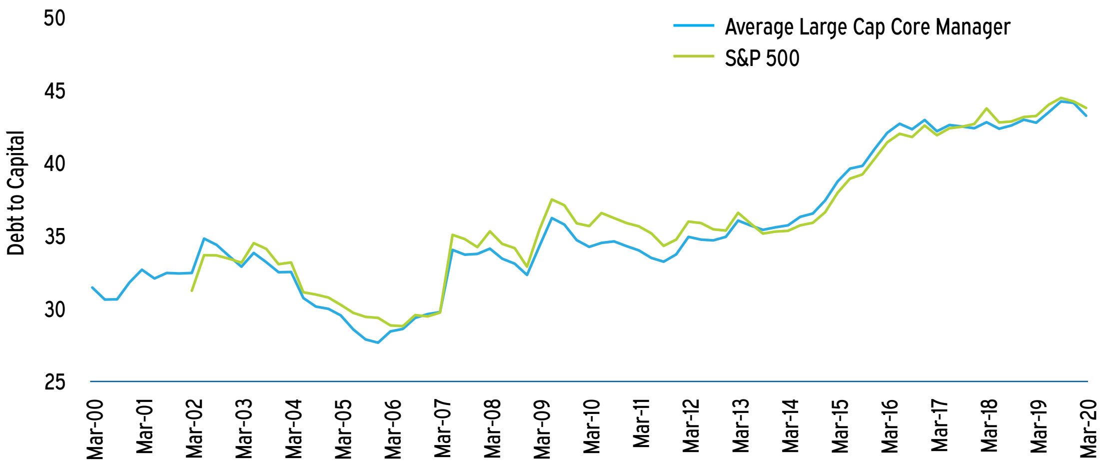

CHART 7

Long-term Debt to Total Capital: Average Large Cap Core Manager versus S&P 500

(Quarterly, March 2000 – March 2020)

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