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Reports of the death of active fund management are greatly exaggerated. In fact, it's likely to do quite well again if interest rates go up.

Return of The Stockpickers

By Sarah Max

When John Templeton said, "The time of maximum pessimism is the best time to buy," he probably wasn't thinking that his tenet might one day refer to his own industry. Yet, for active mutual fund managers, 2014 was a point of maximum pessimism.

While the Standard & Poor's 500 returned 13.7% for the year, stockpickers struggled to keep up. Just 19.9% of U.S. equity fund managers bested their benchmarks, according to Morningstar but those who did managed an advantage of 1.8 percentage points, on average. Specialists, such as sector and alternative funds, also struggled, with 33% and 25%, respectively, beating their benchmarks.

"It was one of those years where everything went against them," says John Rekenthaler, vice president of research at Morningstar. "It's just been a clobbering."

Indeed, last year's sorry showing would appear to be proof positive that even the best active managers can't add enough additional return to justify their higher fees. With so many index and exchange-traded funds at their disposal, many investors figure, why gamble on humans?

Before you write off active management just yet, consider the backdrop of the past, oh, three decades. A closer look at the economic environment and how it's changing offers some perspective on the challenges and, yes, advantages of active management. Perhaps the news of its death has been greatly exaggerated.

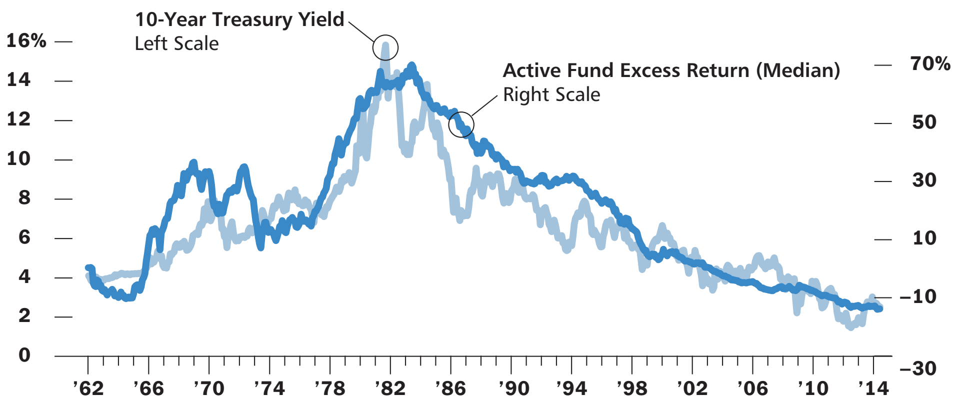
The primary distinguishing economic trend of the past 30 years is, of course, a steady decline in interest rates, until the federal-funds rate sank to about zero and stayed there for five years. When rates fall, the markets typically do well. But there's a surprising connection between rates and active management: When rates rise, active managers beat their benchmarks. Joe Mezrich, head of quantitative investment strategy at Nomura Securities, first noticed this connection when he saw a chart plotting the performance of active managers relative to the market over a long period.

From 1962 to 1981, when the 10-year Treasury yield more than tripled, from 3.85% to 15.8%, the median cumulative return for large-company mutual funds (including those that have since closed) was more than 62 percentage points better than the S&P 500, or an average of 3.2 percentage points per year. In other words, $10,000 invested in an active fund

Outperformance of Active Funds vs. Interest Rates

As interest rates rise, the stock market on the whole often suffers—and that's when active managers shine. As rates fall, the average outperformance of active funds declines, and indexing looks better.

U.S. Active Fund Excess Return vs. Rate Environment



Source: Nomura Securities

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that earned the median return in that stretch would have $13,000 more than the same investment in an S&P 500 index fund. That lead reached 70 percentage points in 1983, then steadily eroded as interest rates headed down.

Active managers have since given up that lead and then some. All told, active managers have underperformed the index by 14 percentage points since the numbers were first tallied in 1962. This trend also plays out on an annual basis, with active managers beating the index by 1.5 percentage points in the years in which rates moved higher and trailing it by two percentage points in those in which rates fell.

How the 10 Largest Actively Managed Funds Fared in 2014

The largest funds all had trouble beating their benchmarks last year–some by an alarming amount. The larger a fund gets, the harder it can be to make enough large, meaningful bets to vault returns beyond that of the index.

	12/31/14	1-Yr*		10-Yr*		
Fund / Ticker	**AUM** (bil)	**Fund**	**Benchmark**	**Fund**	**Benchmark**	**Benchmark**
Pimco Total Return / PTTRX	$162.8	4.7%	6.0%	6.0%	4.7%	Barclays US Agg Bond
Amer Funds Growth Fund of Amer / AGTHX	143.1	9.3	13.7	8.1	7.7	S&P 500
Amer Funds EuroPacific Growth / AEPGX	121.4	-2.6	-3.9	6.7	5.1	MSCI ACWI Ex USA
Fidelity Contrafund /FCNTX	109.8	9.6	13.7	9.7	7.7	S&P 500
Amer Funds Income Fund of Amer / AMECX	96.7	8.4	13.7	6.9	7.7	S&P 500
Amer Funds Capital Inc Bldr / CAIBX	96.5	6.6	13.7	6.2	7.7	S&P 500
Franklin Income / FKINX	94.2	4.1	13.7	6.5	7.7	S&P 500
Vanguard Wellington /VWELX	89.5	9.8	13.7	8.0	7.7	S&P 500
Amer Funds Capital World Growth & Inc / CWGIX	86.5	4.0	4.9	7.6	6.0	MSCI World
Amer Funds American Balanced / ABALX	79.6	8.9	13.7	7.0	7.7	S&P 500

*Total return as of 12/31/14. Ten-year returns are annualized. AUM=Assets under management.

Source: Morningstar

"If rates falling were part of this backdrop [of underperformance], then active managers should get their lead back when rates move higher," says Mezrich, who used data from the University of Chicago's Center for Research in Security Prices.

In 2013, investors got a reminder of what rising rates could mean for stockpickers. "Go back to April 2013, when Ben Bernanke talked about the need for quantitative easing to come to an end," says Brian Hogan, head of equities and high-yield investing at Fidelity. "The bond market sold off a little, yields moved up, and it became fertile ground for active managers." Fidelity and many of its competitors, he says, had "terrific performance" relative to their benchmarks for much of that year. Every dollar invested in a Fidelity fund in 2013 beat its respective benchmark by 1.3 percentage points. Yet, as interest rates reversed course last year sending the 10-year Treasury from 3% to 2% at one point active management again fell from favor.

There are a few reasons for this phenomenon. For starters, rising rates go hand-in-hand with outperformance of smaller stocks, which active managers tend to favor. Last year wasn't kind to smaller companies. Double-digit returns for the S&P were driven by its largest components, such as Apple (ticker: AAPL), which makes up about 3.5% of the index, and which rose 40%. The bellwether for small stocks, the Russell 2000, was up just 4.9% even as small-cap earnings grew by nearly twice that rate.

Also, few fund managers foresaw that oil would sink below $50 a barrel, or that the U.S. market would trounce most of the world. Managers "needed to be really right on some specific things that are more idiosyncratic than they have been in the past," says Frank Porcelli, head of U.S. wealth advisory at BlackRock. All the while, dispersion the difference between the best- and worst-performing stocks was historically low. In fact, the dispersion in one-year returns for the stocks in the Russell 1000 through October was at its lowest level since 1979, which is as far back as Nomura data go. "When rates go up, you see lower correlations and higher dispersions, both important factors for active management," says Mezrich.

Ann Holcomb, manager of the $700 million T. Rowe Price Capital Opportunity (PRCOX) fund believes that helped drop her fund 1.5 percentage points behind the index. "If there's not a lot of dispersion between stocks in a given sector, it's difficult to add value," she says. She keeps sector weightings close to the S&P 500's but looks to pick the best stocks within those sectors. "Last year, spreads were smaller than we've ever seen, but one calendar year doesn't negate a thesis. When you have periods of volatility, corrections, mispricing that's when active management really shines."

Here is where anyone squarely in the passive camp would rightly argue that active managers always seem to have excuses. Isn't the whole point of active management to anticipate idiosyncrasies and adjust accordingly? Hogan, for his part, says recent market conditions are reasons, not excuses. "We expect our managers to beat their benchmarks," he observes.

Investors expect better-than-index returns but aren't willing to suffer bigger-than-index losses, notes Rob Isbitts, founder and chief investment strategist at Sungarden Investment Research in Weston, Fla. "Most people should be more concerned with how to get a realistic target return," he maintains.

The comparison between a fund and its benchmark doesn't entirely reflect the investor experience. A more accurate comparison is against the relevant index fund or exchange-traded funds. Even index funds trail their benchmarks because of fees. Case in point: Only 38% of Vanguard's passive funds beat their benchmarks in 2014, according to Morningstar, while 61% of its active funds did.

Nevertheless, it's hard to argue with the efficiency of indexing especially when the market is going up. And there's no question that passive strategies have a place in most portfolios, which is why investors have been exiting actively managed U.S. stock funds for nine straight years. Last year, they pulled nearly $94 billion out of active domestic equity funds through November, says the Investment Company Institute, and put more than $100 billion into domestic equity-index funds and exchange-traded funds. "In my view, the industry is evolving quickly to index funds, ETFs, and a small cadre of active managers in some areas," adds Rekenthaler. "For an industry this old and mature, the change has been very rapid."

The fund industry has responded by rolling out more concentrated, high-conviction strategies, as well as absolute return and multi-asset funds, "basically strategies that aren't easy to replicate in a passive product," says Cindy Zarker, the director of asset-management research for Cerulli Associates.

As more money moves into the indexes, it could create more opportunity for stockpickers. “It becomes a self-fulfilling prophecy,” says Arik Ahitov, co-manager of $1.2 billion FPA Capital (FPPTX). Ahitov says more than a quarter of the companies in his bogey, the Russell 2500, have net negative income. “You have all of these unprofitable companies going up, and nobody seems to care. An index fund doesn’t distinguish between what is and isn’t profitable. Everything moves together.” His fund has averaged 14.4% annual gains since 1984, versus 11.9% for its benchmark. But, like many deep-value funds with large cash positions recently 28% of assets it has lagged behind lately, last year by nearly six percentage points.

“If you simply invest in the index, it can lead you down alleys with dead ends,” adds J.B. Taylor, co-manager of Wasatch Core Growth (WGROX). “We like having some control of our destiny.” His small-company fund trailed its benchmark in 2013, when investors flocked to small stocks, sometimes indiscriminately, and drove the index up 38.8%; Taylor’s fund was up a more modest 30% that year. No matter, over the past 15 years, it has averaged 10.9% annually, dwarfing the index’s 7.6% return.

In fact, even as they embrace passive investing, more than 60% of financial advisors surveyed by Cerulli think active and passive management can be complementary, and nearly half said active managers can consistently add value. “You might be hard-pressed to find a large-cap-blend manager that beat the S&P, but there are still places where good managers can run circles around the index,” says Leon LaBrecque, a financial advisor in Troy, Mich., who has about half of client assets in passive funds, but favors active management for such areas as real estate and emerging markets.

“We don’t talk about active versus passive but how to blend them together,” says BlackRock’s Porcelli, whose parent company has a stake in both camps.

The model portfolio for many investors now resembles an hourglass, with inexpensive, broad market exposure on the bottom and high-alpha strategies, like asset-allocation funds, concentrated funds, and alternative strategies, at the top. The middle ground, once taken by funds that checked off each of the “style boxes” growth, value, size, etc. now has a considerably slimmer role. The net effect: Investors trim the overall costs of their portfolios, but still get the benefits of active management.

The Best-Performing Active Funds of 2014

Fully half of the 25 top performers were tiny funds that didn’t have even a three-year track record, reflecting the mercurial nature of some outperformance.

Fund / Ticker	12/31/14 AUM (mil)	1-Yr*	10-Yr*
Glenmede Large Cap Growth / GTLLX	$860.7	20.0%	9.7%
Vanguard Primecap Core / VPCCX	7,348.2	19.3	10.4
Vanguard Capital Opportunity / VHCOX	13,778.3	18.9	10.3
Vanguard Primecap / VPMCX	46,696.5	18.7	10.1
Parnassus Endeavor Fund / PARWX	768.3	18.5	NA
Lazard US Equity Concentrated / LEVOX	337.9	18.3	NA
Eventide Gilead / ETGLX	986.6	17.9	NA
Janus Contrarian / JACNX	4,429.0	17.5	8.9
Goldman Sachs Lg Cap Growth Insights / GLCGX	495.9	17.4	6.7
JPMorgan Intrepid Growth / JGIRX	916.7	16.7	NA
S&P 500		**13.7**	**7.7**

*Total return as of 12/31/14. Ten-year returns are annualized. Top 10 active U.S. equity mutual funds with at least $200 million in assets and a three-year history. AUM=Assets under management. NA=Not Applicable. Source: Morningstar

Of course, to get active management, you need funds that are truly active. That’s where “active share” the percent of holdings that differ from a benchmark comes in. According to economist Martijn Cremers’ research, funds with at least 90% active share beat their benchmarks by 0.81 percentage points, after fees, from 1990 to 2013. Those with active share below 60% consistently underperformed by 1.01 percentage points annually, after fees. And, he notes, the proliferation of passive products has encouraged active managers to distinguish themselves by becoming more active.

Cost is, of course, a major reason many active managers don’t outperform. Firms that keep their costs low tend to do best over the longer term. Dodge & Cox, for example, has fees hovering around 0.5%, and its three funds with 15-year track records (out of six in total) have beaten their benchmarks over that period, on an annualized basis. (See “The Minimalist Next Door,” page L10.) More than 60% of American Funds’ portfolios have done better than their benchmarks over that same period, due in part to their low expense ratios.

For truly active managers, down years are inevitable. “When you concentrate a portfolio with your best ideas, you aren’t always going to be in favor,” says James Hamel, who runs the $1.2 billion Artisan Global Opportunities (ARTRX), which has 46 holdings and more than half its assets in its top 20 stocks. “But that’s the only way to create alpha.”

Stockpickers, such as C.T. Fitzpatrick of the $1.5 billion Vulcan Value Partners fund (VVPLX), are nonplussed by talk of active management’s obsolescence. Not only did he launch two mutual funds in 2010, but he himself also invests in active managers. Franklin Resources (BEN) and United Kingdom based Aberdeen Asset Management (ADN.UK) are among the top 10 holdings of Vulcan Value, which is up 23.5% over three years, four percentage points better than the S&P 500 annually.

Is active management dead? “It’s a good headline,” he says. “Usually, people say that right before everything turns around.” ■

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	As of December 31, 2014			
Inception Date: December 30, 2009	Current Quarter	YTD	1 Year	Annualized Since Inception
Vulcan Value Partners Fund	**7.27%**	**13.74%**	**13.74%**	**17.14%**
Russell 1000 Value Index	4.98%	13.45%	13.45%	15.19%
S&P 500 Index	4.93%	13.69%	13.69%	15.20%
*Total Expense Ratio: 1.09%				

The performance numbers show the fund's historical performance. Past performance is not indicative of future results. Investment return and value of shares will fluctuate. Upon redemption, shares may be worth more or less than their original cost. The current performance may be higher or lower than the quoted performance. Vulcan Value Partners does not have a sales charge. Please call 1-877-421-5078, or visit our website, www.vulcanvaluepartners.com, for the most recent month-end performance results.

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Definitions:

Alpha - a measure of the difference between a fund’s actual returns and its expected performance, given its level of risk as measured by beta.

The Russell 1000® Value Index - measures the performance of the large-cap value segment of the U.S. equity universe. It includes those Russell 1000® companies with lower price-to-book ratios and lower expected growth values.

The Russell 2000® Value Index - measures the performance of those Russell 2000® companies with lower price-to-book ratios and lower forecasted growth values. The Russell 2000 Value Index figures do not reflect any fees, expenses, or taxes.

The Russell 2500™ Value Index - measures the performance of the small to mid-cap value segment of the U.S. equity universe. It includes those Russell 2500 companies that are considered more value oriented relative to the overall market as defined by Russell’s leading style methodology.

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An investment cannot be made directly into an index.

The holdings referenced in the article, Apple (AAPL), Franklin Resources (BEN), and Aberdeen Asset Management (ADN.UK), had the following percentage of total net assets in the Vulcan Value Partners Fund as of December 31, 2014, respectively: 2.48%, 3.87%, and 3.64%.

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