Active Versus Passive Return Drivers: A Year-End Update

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Our July special report "Active Vs. Passive: A Three-Club Headwind" studied the recent performance advantage of passive indexes over actively managed funds. We hypothesized, and our research confirmed, that market conditions play a significant role in determining which side comes out on top. We examined nine metrics and found a strong relationship between the prevailing market environment and the relative performance of active managers. **We concluded that, just as market conditions cycle, so does the active/passive return spread. Investors are wise not to chase the winning style but to diversify their portfolios using both types of funds.**

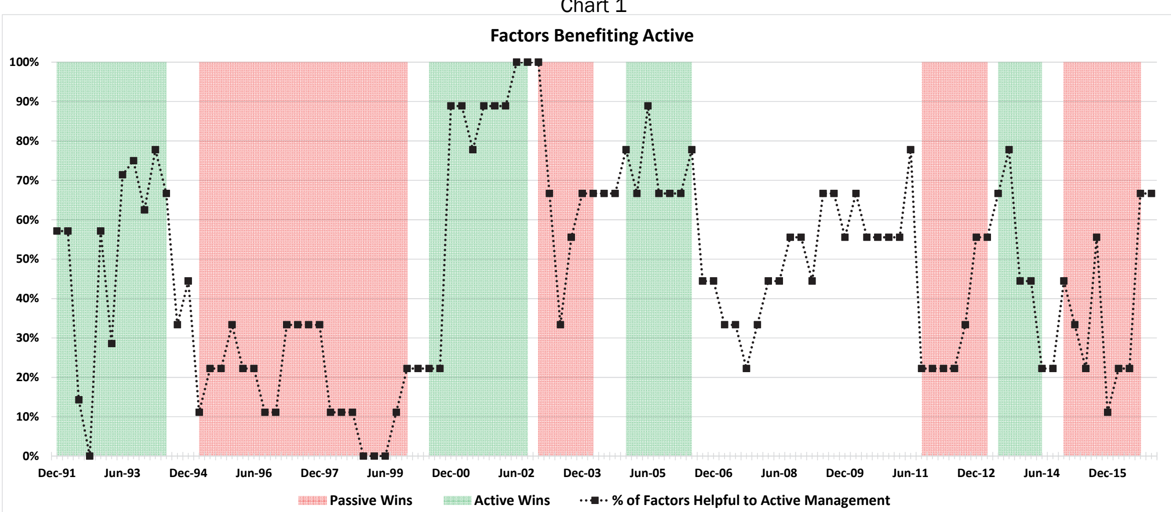
Herein we provide a year-end update on the factors we determined were important to the active/passive relationship. **We found that the market environment and the success of active managers changed significantly in late 2016.** The three-club headwind facing active managers has calmed and is even showing signs of becoming a tailwind, a welcome relief to active managers looking to make up some ground in 2017.

Our original study evaluated the nine metrics shown in Table 1 and classified them as either "favorable to active" or "favorable to passive." Back in March 2016, only two of nine factors were "favorable to active," but by the end of 2016 the count had risen to six of nine as seen in Chart 1. (Refer to our July report for metric definitions and the rationale behind each.) *Note that the recent "passive winning" window closed in the fourth quarter, which scored as a "draw" under our methodology.*

Table 1: Current Conditions

Favorable to Active	Favorable to Passive
Small Cap beating Large Cap	Cash losing to S&P 500
Value beating Growth	**EAFE losing to S&P 500**
Equal Weighted beating Cap Weighted	"The Rest" losing to Negative Earners
% of S&P 1500 outperforming S&P 500	
"The Rest" beating Largest 25 Companies	
"The Rest" beating P/E > 40	

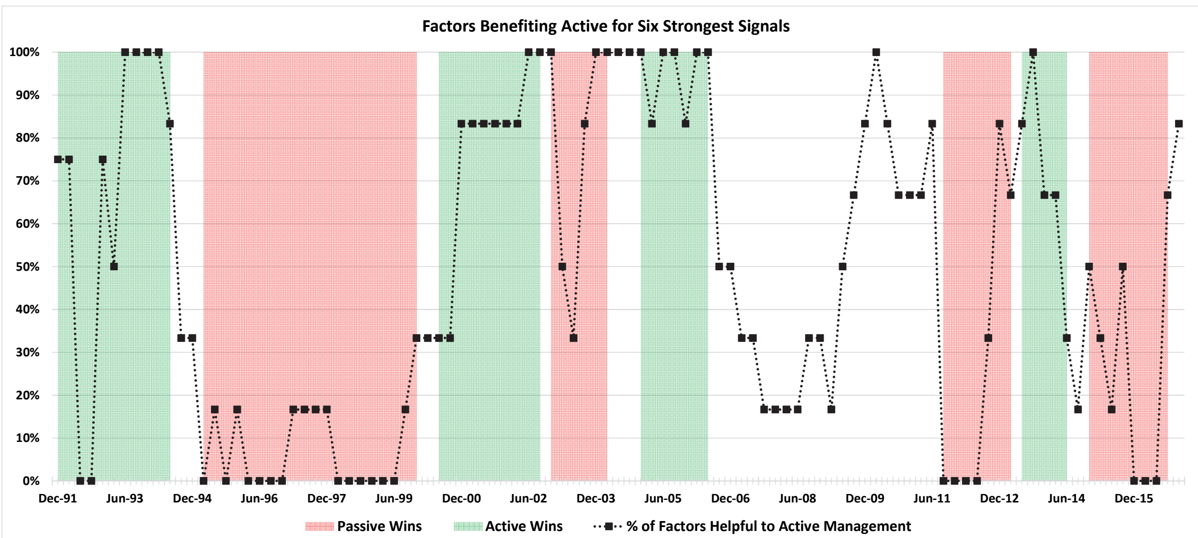
Chart 1



Our original research identified three factors that seemed to have lower explanatory power, so we created Chart 2 using just the six strongest signals; this tally was zero-for-six in March 2016, but rallied to a robust five-out-of-six by year end. The six strongest metrics are identified in bold in Table 1. We would again point out the robust relationship between market factors and the active/passive performance derby.

Six of the nine signals switched signs during the latter half of 2016. The three signals relating to "size" changed to favor active management, as Small Caps excelled in the fourth quarter; the Russell 2000 outpaced the S&P 500 by 5%. Mega Cap tech companies such as Alphabet, Amazon, and Facebook lagged badly, and the S&P 500's "Largest 25" underperformance extended to non-tech stalwarts including J&J, Visa, Wal-Mart, and Coca Cola. Two of the three valuation signals also favor active management; in fact, Value outperformed across the size spectrum in the fourth quarter, allowing the Value vs. Growth metric to turn toward cheaper stocks for the first time since late 2013.

Chart 2



Today, the only strong signal *not* favoring active management is EAFE vs. the S&P 500. International equities lagged throughout 2016 and didn't participate in the Trump rally, leaving them 11% behind domestic stocks for the year. Meanwhile, the only factor switching from pro-active management to pro-passive was "The Rest" vs. *companies with negative earnings*. The short roster of negative earners is populated by Energy companies, and their rally flipped this indicator in favor of passive. Needless to say, cash was once again a millstone in active portfolios.

To this author's relief, the rally in active-favorable factors was accompanied by concurrent improvement in the performance of actively managed funds over the second half of 2016. Our original study left off in a period when our factor count favored passive, and just 20% of active managers were outperforming on a one-year trailing basis. That ratio held in the third quarter but improved to 43% in the fourth quarter. Looking at just the fourth quarter, 55% of active managers outperformed the index. It appears that the strength and direction of the market-environment wind is having the expected effect on the active/passive comparison.

Perhaps to some readers' dismay, we are not going to close this update with a market environment forecast for 2017. However, our view is that **the shift in the metrics began with the February 2016 lows and was reinforced by an oil price recovery, the bottoming of interest rates, and the Trump rally late in the year.** These forces could easily run well into 2017 and, absent a narrow run in the Mega Caps, we would not be surprised to find our metrics continuing strong in favor off "active," and perhaps even experience a shift to a green "active wins" regime on our chart.

As the snow falls outside, we eagerly look forward to providing another update this summer.