

Has Value's Run Just Begun?

Part 4: Active-Passive Reaches a Tipping Point

JUNE 2021



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Snapshot

- › We anticipate that the rotation to value leadership will spur a favourable period for active management.
- › Traditional cap-weighted index strategies are extremely expensive based on our historical research.
- › We expect a shift in the types of actively managed strategies that could lead in the coming years.

The nascent rotation to value that we began to explore in the first three papers of this series has implications for the active-versus-passive strategy debate. Based on history, and the extreme valuations of traditional passive strategies, we believe that value's turn in the driver's seat will spur a favourable period for active management. Looking at the past also provides a window into the types of active strategies that will most likely prevail as value takes the lead.

Active versus passive: Sometimes it's a size issue

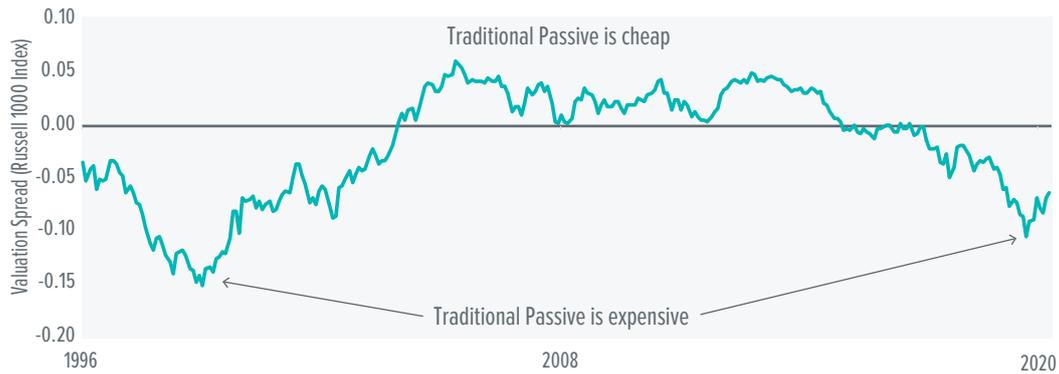
Active management comprises an entire universe of investment strategies. In aggregate, however, they tend to be more diversified than traditional passive indexes. Recall that traditional passive indexes are market-capitalisation-weighted (cap-weighted), which means that the largest publically traded companies (as measured by the total value of their stock prices) account for the greatest portions of a given index. For example, five companies accounted for a 23.6% share of S&P 500 Index market capitalisation as of 7 May 2021¹. Those same five companies accounted for only 14.8% of the S&P 500's expected earnings over the next year, showing how a top-heavy index can become inefficient from a profitability standpoint¹.

Indexes can also be calculated using different weighting methods for each stock. We have found that comparing a traditional cap-weighted index to its so-called diversity-weighted counterpart can reveal whether traditional passive portfolios are cheap or expensive at a given point in time. Diversity-weighted indexes limit the size of the largest stocks to ensure they don't dominate index performance.

Traditional passive is not only expensive right now—it is extremely so from a historical perspective (Exhibit 1 on the next page).

¹"Stock Market Briefing:FAANGMs." Yardeni Research, Inc. 7 May 2021.

Exhibit 1: Diversity-Weighted vs. Capitalisation-Weighted Valuations



Source: SEI, using data from Lipper, FactSet, and Russell. Valuation spread represents a difference in valuation between diversity-weighted and capitalisation-weighted index and is measured by SEI's composite value family scores. The metrics are composites of underlying ratios that SEI has determined to be appropriate measures of each factor. Updated to March 2021. SEI's diversity-weighting methodology limits the maximum weight to 50 basis points. Index returns are for illustrative purposes only and do not represent actual performance of an SEI Fund. Index returns do not reflect any management fees, transaction costs or expenses. Indexes are unmanaged and one cannot invest directly in an index.

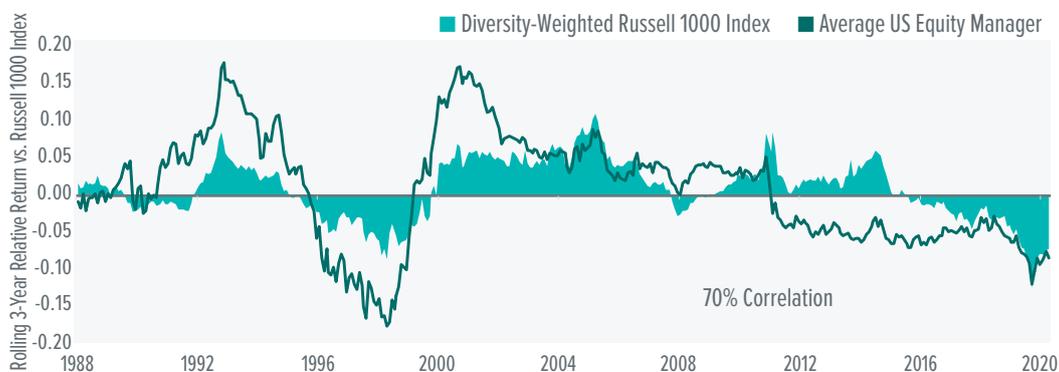
There's no getting away from the fact that active management as a whole is intertwined with the valuation cycle that we presented in Exhibit 1. History tells us that as indexes become more concentrated—that is, the top-weighted names grow larger while the smaller names shrink—their performance and valuations move further away from those of actively managed strategies.

This is especially clear if you think about active management in terms of deviation from a benchmark index. Market cap is the dominant metric for creating traditional passive strategies, so we can expect a great deal of their performance difference versus the average active manager to be driven by active preferences for companies other than those at the top of the index.

Put another way, we can use diversity versus concentration as a proxy for the tension between active and passive strategies. Exhibit 2 depicts the historically tight relationship between the average US equity manager and a diversity-weighted US equity index when comparing each against a traditional cap-weighted US equity index. These two sets of relative performance (that is, the average equity manager vs. a cap-weighted index and a diversity-weighted index vs. a cap-weighted index) have a 70% correlation.

Perhaps unsurprisingly, periods in which traditional passive has grown extremely expensive have historically been followed by superior performance from active strategies (Exhibit 2).

Exhibit 2: When Passive is Expensive, Active Has Performed Well



Source: SEI, using data from Lipper, FactSet, and Russell. Diversity-weighted index is constructed by SEI by limiting the maximum weight to the largest constituents of Russell 1000 Index. Index returns are for illustrative purposes only and do not represent actual performance of an SEI Fund. Index returns do not reflect any management fees, transaction costs or expenses. Indexes are unmanaged and one cannot invest directly in an index. Average US Equity Manager represents the average gross return of all US equity mutual funds on Lipper database. Updated to 31 March 2021. Past performance is not a reliable indicator of future results.

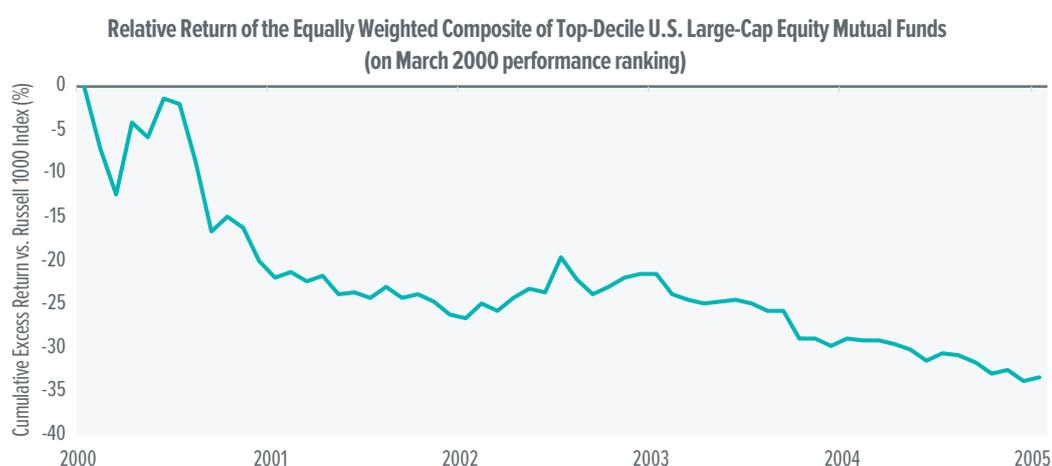
All references to performance are in U.S. dollar terms unless otherwise noted.

Active versus active: Lessons from the last great rotation to value

History tells us that as traditional passive leadership continues to give way to more diversified strategies, we should expect a shift in the types of active strategies that could lead in the coming years.

During the last strong rotation to value at the end of the dot-com bubble, active management was completely upended: US equity mutual funds that had produced top-decile performance in the three-year period through March 2000 proceeded to lag the broad US equity market during the subsequent five years (Exhibit 3).

Exhibit 3: Top Active Funds Lagged After the Last Great Value Rotation



Source: SEI, using data from Lipper; Period: 31 March 2000 to 31 March 2005. Universe definition and methodology: All large-, mid- and all-cap US equity funds as per US Mutual Fund Lipper Classification that had at least a 3-year track record as of March 2000, excluding index-tracking (passive) funds. The defined universe included 990 funds. Top Decile is defined as the best-performing 99 funds over the prior three years. Aggregate relative return is based on an equally weighted composite constructed as of 31 March 2000. The performance is measured relative to Russell 1000 Index (total return). Past performance is not a reliable indicator of future results.

Our View

Passive equity strategies surged in popularity over the recent historically long bull market, and now account for more assets under management than active equity strategies². Yet the entire premise of passive investing—which is that passive investors can benefit from the market efficiency produced by the allocation decisions of active investors—has begun to reveal its inherent limitations as traditional passive has outgrown active. And history shows that this is not an isolated phenomenon. The concept continues to be self-defeating on a cyclical basis as passive strategies gravitate toward inefficient concentration and grow top-heavy and expensive. Active strategies, meanwhile, can still make efficient decisions about where to invest their capital.

The final entry in this series—**Has Value’s Run Just Begun? Part 5: The Value in Rising Rates**—explores how the history of rising interest rates has impacted value and other factors.

²Source: Morningstar. Passive U.S. equity assets equaled approximately \$5.7 trillion as at 31 December 2020 while active U.S. equity assets equaled approximately \$5.2 trillion.

Glossary

Active management: Active managers aim to outperform a specific index, or benchmark. An active manager will continuously monitor and make changes to investments in an attempt to maximise returns.

Bull market: A bull market refers to a market environment in which prices are generally rising (or are expected to rise) and investor confidence is high.

Dot-com bubble: The dot-com bubble was a period during the late 1990s that coincided with the rapid growth and adoption of the internet. Speculation in the shares of internet-related companies resulted in a stock-market bubble that ultimately began to collapse in early 2000.

Passive index strategy: A passive index investment strategy generally uses the constituents of an index to dictate the investment portfolio's composition. Market-capitalisation-weighted indexes served as the basis for the first passive strategies and remain the most popular type.

Rotation: Rotation is the movement of capital from one group of shares, sectors or investment styles to another as investors anticipate the next stage of the economic cycle.

Value: Value stocks are those that are considered to be cheap and are trading for less than they are worth.

Index Definitions

Russell 1000 Index: The Russell 1000 Index includes 1,000 of the largest U.S. equity securities based on market cap and current index membership; it is used to measure the activity of the U.S. large-cap equity market.

S&P 500 Index: The S&P 500 Index is an unmanaged market-capitalization-weighted index comprising 500 of the largest publicly traded U.S. companies and is considered representative of the broad US stock market.

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