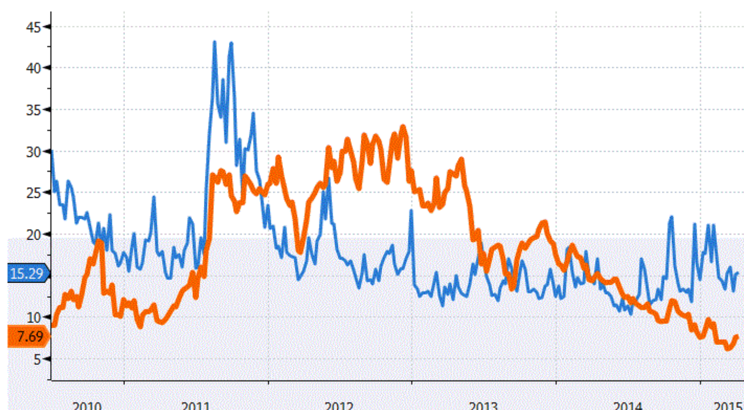
An Improving Environment for Active Equity Management?

In a December 2014 white paper entitled, "The Quest for Alpha," Chris Moore, Massey Quick's Chief Investment Officer, explored the dynamics of active vs. passive exposure in client portfolios and highlighted the impact that the increased popularity of passive ETFs has had on the markets. In short, as discussed in the below excerpt from said strategy piece, lower levels of volatility and increased use of passive investments has led to lower levels of differentiation among company returns:

"Macro events have been driving capital in or out of certain pockets of the market rather than fundamental changes at the company level....High correlation [between equity securities] means that both the good companies and the bad companies are generally moving in tandem. Flows into ETFs work to perpetuate this phenomenon. When market participants buy the whole index, all index constituents benefit from positive asset flows; this increases correlation between individual securities."

However, market volatility increased markedly during the fourth quarter of 2014 and early months of 2015 as a result of divergent central bank policies, continued commodity price volatility and political unrest around the globe. The below chart highlights the recent swings in the popular VIX index (blue line) relative to the expected months until the first interest rate hike by the US Federal Reserve (orange line)[1]:



Not only has equity volatility been increasing after an extended period of persistent lows, but movements in volatility have also been quite pronounced over short intervals of time. For example, in eight of the first thirteen weeks of 2015, the VIX index posted weekly gains or losses in excess of fifteen percent in eight observations with three of these observations representing a weekly move of greater than twenty percent. For context, there were only eight such moves of fifteen percent or

[1] Source: Bloomberg

greater in the entirety of 2013.[2] This means that volatility levels are generally increasing and swings in volatility are also potentially increasing. It would stand to reason that these movements in volatility indicate increased investor uncertainty throughout the second half of 2014 and early 2015.

However, we believe this increased volatility creates opportunities for active management as the market provides attractive entry points and companies begin to demonstrate return dispersion based on fundamentals. This may be especially true in the US as the Fed looks poised to become the first major global central bank to begin policy tightening while other central bankers continue to step on the proverbial monetary policy gas pedal in an effort to spur growth and inflation. One of Massey Quick's core long/short equity allocators recently opined on the impact of varying monetary policies around the world in his quarterly letter to investors:

"Finally, there has also been a modest improvement in the behavior of stocks relative to company fundamentals (i.e. stock prices are more appropriately reflecting changes in fundamentals) which we believe will continue under the 'normalization' scenario. Simply put, it seems as if the macro funds that have been effectively frontrunning central bank activity have now shifted their focus to Europe and Japan. This has created a somewhat improved environment for long/short stock picking that we think should persist absent a dislocation in the U.S. economic growth outlook."

As we recently read in Lateef Investment Management's Q1 2015 commentary, data that considers returns based on company "quality" seems to corroborate the above assertion by our long/short equity manager. The often-cited Dartmouth Professor of finance, Kenneth French publishes return data for portfolios formed based on various fundamental company characteristics such as size and book value. One of French's data sets is constructed based on operating profitability which can function as a crude measure of performance by company quality.[3] In evaluating the opportunity set available to active management, it is also important to evaluate the degree to which high and low quality companies demonstrate similar directionality of returns. To do so, consider the following chart, which utilizes French's data and compares the rolling twelve month correlation between top decile portfolios formed on operating profitability (i.e. the "highest quality" companies) and bottom decile portfolios formed on operating profitability (i.e. the "lowest quality" companies):[4,5]

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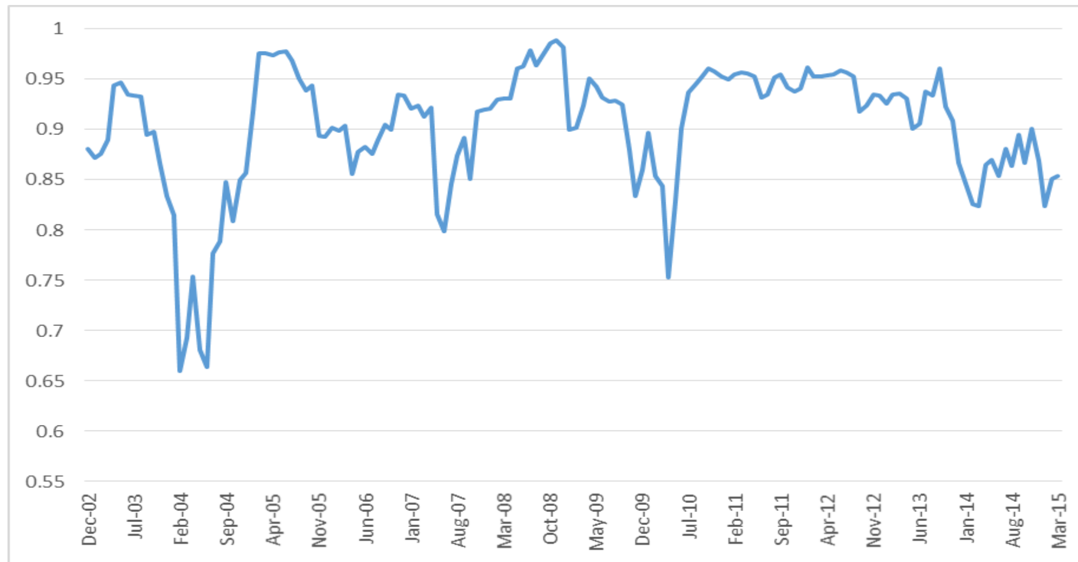
[2] Ibid.

[3] French defines operating profitability as "operating profits (sales minus cost of goods sold, minus selling, general, and, administrative expenses, minus interest expense) divided by book equity at the last fiscal year end of the prior calendar year." Source: http://mba.tuck.dartmouth.edu/pages/faculty/ken.french/data_library.html

[4] Ibid.

[5] Chart originally created using French's data by Lateef Investment Management and recreated/modified by Massey Quick to show an extended time frame



One can see that the period from 2011 to 2014 saw persistently high levels of correlation (in excess of 0.9 for the duration of said period) between high and low profitability companies. This period of heightened correlation indicates low dispersion of returns between profitable and unprofitable companies. In essence, companies with lower profitability were not necessarily performing in line with fundamentals. That this period of increased correlation and relatively strong performance by lower quality companies is concurrent with the Federal Reserve's initiation of various quantitative easing measures is not surprising considering that investors readily bid up risk asset exposure against the backdrop of an accommodative central bank. As noted above, ETF flows can represent a key driving force behind this phenomenon of higher correlation. In seeking to attain cost-effective exposure to the market, investors may utilize passive ETFs, which, in turn, direct capital to to all underlying ETF constituent securities, regardless of "quality." This period of heightened correlation further frames the well-documented and oft-criticized performance of active management in the period following the 2008 financial crisis. If active managers strive to identify "the best" investment opportunities (using French's measure of quality as a proxy), it would make sense that their performance might lag during periods when there is little differentiation between high and low quality companies.[6]

Nevertheless, the chart above seems to be demonstrating an encouraging trend in the period from 2014 to the present as the correlation between high and low quality companies has broken down from previous highs. What does this mean for active management? As Lateef also noted in the aforementioned commentary, periods of lower correlation can facilitate returns for active managers that can effectively identify quality investment opportunities while avoiding lower quality companies; Massey Quick agrees with this sentiment. As dispersion between high quality and low quality

[6] This notion is also referenced by Lateef in their first quarter commentary (http://www.lateef.com/Webcast/2015_Q1/MultiCap/Lateef_Commentary_MultiCap.pdf)

securities increases, the potential rewards for managers that invest in only a select subset of the market (rather than the entire market as is the case via an ETF) are potentially increased. In support of this theory, please consider the below data from Factset; this data reviews the trailing four earnings seasons and documents the average performance of S&P 500 companies two days prior to earnings announcements through two days after announcements:[7]

Earnings Quarter	Upside Surprise	Downside Surprise	Data as Of
Q2 2014	-0.10%	-3.00%	8/1/2014
Q3 2014	2.50%	-1.20%	11/28/2014
Q4 2014	0.90%	-1.90%	3/6/2015
Q1 2015	0.90%	-1.90%	5/1/2015
5 Year Average	1.00%	-2.30%	5/1/2015

This data helps to quantify the downside risk for companies that miss on fundamentals and shows the value that active management can potentially add through selective portfolio construction. In a near term validation of this phenomenon, the first quarter of 2015 saw active management (and many alternative strategies in particular) outperform the broader markets. While one quarter is an admittedly small sample of data, the underlying drivers of increased volatility in the market remain largely intact. For example, macro trends such as increased commodity price volatility and the appreciation of the dollar have fundamental impacts on operating profitability for many companies. Moreover, the specter of rate increases has a longer-term, tangible impact on companies' cost of capital after a multi-year period of easy financing conditions. Both of these factors likely explain some component of this declining correlation between high and low quality companies. To the extent that these factors (and others) persist points to an attractive hunting ground for active management in the coming months, particularly as markets get closer to an eventual Federal Reserve "liftoff." Massey Quick is optimistic that our approach to asset allocation, which emphasizes mixing efficient passive exposure with active exposure in less efficient market arenas (e.g. small cap), will yield attractive returns over the long-term should the opportunity set for active management continue to bear fruit.

As always, we welcome your questions or comments at any time. Please do not hesitate to contact us.

[7] Source: Factset (http://www.factset.com/websitefiles/PDFs/earningsinsight)

IMPORTANT DISCLOSURE INFORMATION

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