What Makes Active Equity Management Successful?

NUVEEN ASSET MANAGEMENT

MARKET COMMENTARY

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KEY POINTS

- Although active equity managers have struggled in recent years, we believe the market environment is shifting to one that should help active management.
- A combination of rising interest rates, a shift from growth to value styles, lower correlations among individual stocks and other factors suggest the environment for active management may be improving.
- We furthermore believe that certain active management characteristics may provide a greater potential for managers to outperform their benchmarks.

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The active versus passive management question has been long debated. Passive management has been winning over the past few years, as most active U.S. large cap equity managers (meaning those who invest in the sort of large, U.S. companies that can be found in such indexes as the S&P 500® or the Russell 1000®) underperformed their benchmarks and flows moved out of actively managed equities. We believe there is room for both approaches in a portfolio, but the pendulum may have swung too far toward passive investing. In the following pages, we discuss why many active managers have underperformed in recent years and why those factors may be changing. And, more importantly, we suggest the qualities we think investors should seek in an active manager.

It's Been Challenging for Active Managers

Active managers have had a rough ride in recent years. The environment has been difficult, and flows have been moving out of actively managed equity mutual funds. Only 32% of active equity managers outperformed their benchmarks in 2016, according to a recent report from JP Morgan.[1] At the same time, investors withdrew $200 billion from active equity funds.[1] To be sure, not all active managers underperformed over the last few years (which speaks to the importance of choosing the right manager — a topic we discuss at the end of this paper). But the broad trend of managers underperforming has certainly been evident.

To some extent, these trends in active versus passive flows and performance seem to be cyclical. As seen in Exhibit 1, active managers lagged during the late 1990s, enjoyed a period of strong relative performance through most of the 2000s and have struggled over the past five or six years. We think the years-long trend of underperformance may be coming to an end.

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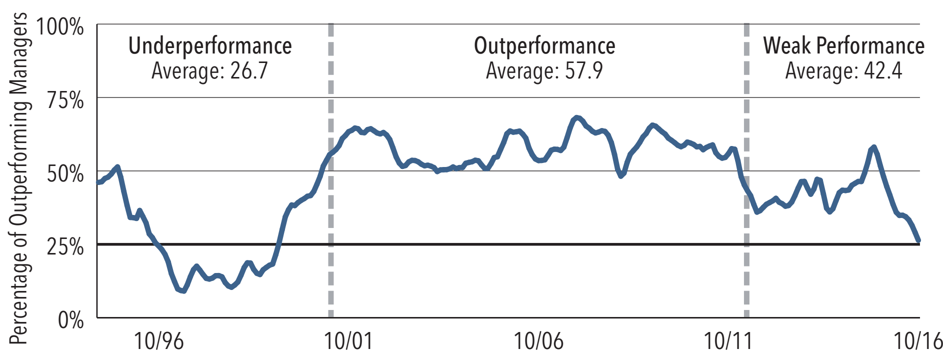
Exhibit 1: On the Cusp of Active Management Outperformance?
Active Large Cap Managers Outperforming the S&P 500 Index



Source: RBC Capital Markets. Past performance is no guarantee of future results. Returns are based on gross performance on a 3-year annualized basis. Large cap managers are as those classified as large cap by Morningstar.

When Do Active Managers Typically Outperform?

The obvious question to ask, then, is why active managers collectively tend to outperform or underperform during different times. Based on our experience, we believe certain market environments benefit active large cap equity managers. Or, put another way, during certain times, we think it is easier for active managers to add value than others. There are a number of factors that contribute to a better environment for active managers. And the good news for portfolio managers like us is that we think many of these factors should emerge or continue in 2017 and beyond.

Exhibit 2: Factors That May Help Active Managers to Outperform

	Our Expectation for 2017
Small Caps Outperform Large Caps	Yes
International Over U.S. Equities	????
Value Outperforms Growth	Yes
Equal Weight Over Cap Weight	Yes
Correlations Low	Yes
Interest Rates Rise	Yes
Credit Spreads Fall	Yes

Source: Nuveen Asset Management

Let's review each factor and discuss why we believe they offer better prospects for large cap equity managers:

Small caps outperforming large caps: Large cap equity benchmarks like the S&P 500 Index or Russell 1000 Index are cap weighted, meaning larger companies represent a larger percentage of the index and thus have an outsized influence on index performance. As a result, when larger stocks outperform, index performance improves and it is harder for active managers to add value. In contrast, when smaller capitalization stocks (meaning the relatively smaller companies within large cap universes) outperform larger caps (as we expect will happen this year), there is greater opportunity for differentiation between individual companies and thus more opportunities for active managers.

International outperforming domestic stocks: Many (if not most) large cap active managers hold at least some international stocks in their portfolios. When international markets outperform, those managers may benefit from a possible performance tailwind. U.S. equities have generally outperformed in recent years, creating headwinds for active managers. We are ambivalent about this trend reversing. U.S. stocks have several relative advantages, including better economic and earnings growth. But those advantages are largely already baked into valuations.

Value outperforming growth: Almost all active managers have a valuation component of their investment process, since a key part of active management is identifying undervalued companies. As such, active managers are usually biased toward companies with lower price-to-earnings measures. Over the past several years, growth styles have generally outperformed as investors sought growth in a relatively weak economic environment. We expect economic growth to accelerate modestly, which should help value styles perform better and possibly create a better environment for active managers.

Equal weight outperforming cap weight: This is a corollary to the small caps outperforming large caps factor. Many active managers tend to (or at least have the opportunity to) equal weight their portfolios, which generally leads to a down-cap bias in portfolio construction. If an equal weighted index outperforms a cap weighted index, active managers should have more opportunities.

Low Correlations: This may be the most critical factor. Despite periodic market disruptions, market volatility has been relatively low over the last several years. This environment compresses the performance spread between the best-performing and worst-performing stocks, making it more challenging for stock pickers.

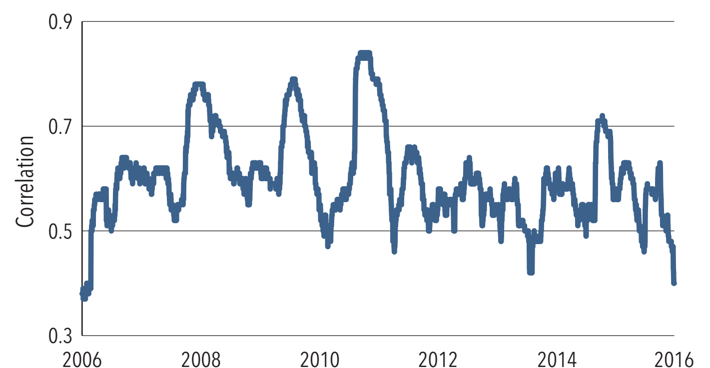
Even if an active manager picks the "best" stocks, it makes less of a difference when correlations are high. Conversely, more dispersion between winners and losers creates a better environment for stock pickers. Since mid-2016, stock correlations have fallen, plummeting to their lowest level in 10 years after the elections (see Exhibit 3). We expect correlations to remain relatively low, which should provide solid opportunities for active managers.

Rising Interest Rates: Generally speaking, when interest rates fall, valuations drive equity returns. When rates are rising, earnings become more important. Put another way, company fundamentals matter more in a rising interest rate environment. Think of valuations as a measure of how much investors will pay for a given level of corporate earnings. When interest rates fall, equity dividend yields look comparatively more attractive.

Essentially, investors will pay more for a given level of earnings when rates are falling and low. When rates are rising, investors become more selective about how much they will pay for earnings, meaning earnings fundamentals become more important. Since active managers by definition pay attention to quality of earnings, this presents more opportunities. We seem to be in a rising interest-rate environment. The yield on the 10-year U.S. Treasury bottomed at 1.37% on July 8, 2016, and we expect rates to rise slowly and unevenly for some time.[2]

Falling credit spreads: Related to rising interest rates, falling credit spreads signal an improving economy. Earnings growth typically thrives in an environment in which economic growth accelerates, interest rates rise and credit spreads fall. When earnings improve, active managers can generally be more selective.

Exhibit 3: Falling Correlation May Signal a Stock-Picker's Market: Stock-to-Stock Correlation of the S&P 500 Index



Source: Strategas Research Partners, Bloomberg, 12/29/06 – 12/16/16. **Past performance is no guarantee of future results.** Correlation is a statistical measure of how two securities move in relation to each other. Perfect positive correlation (a correlation co-efficient of +1) implies that as one security moves the other security will move in lockstep, in the same direction. Alternatively, perfect negative correlation (a correlation co-efficient of –1) means that securities will move by an equal amount in the opposite direction. If the correlation is 0, the movements of the securities are said to have no correlation; their movements in relation to one another are completely random. Index performance is shown for illustrative purposes only. It is not possible to invest directly in an index.

A Shift Toward Active Management?

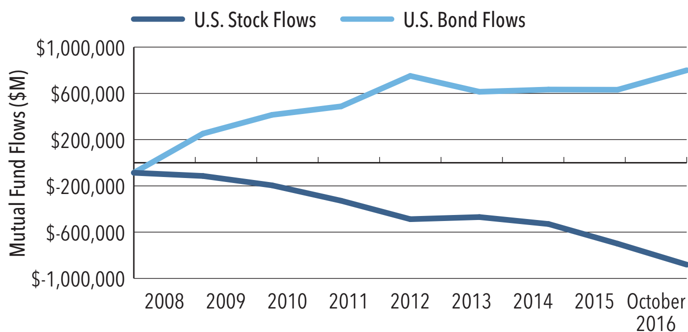
We think it is early, but markets appear to be moving toward an environment in which active managers may be better able to outperform. Since the middle of last year, economic data has strengthened, corporate earnings prospects have improved, interest rates have risen and stock correlations have fallen. These trends

accelerated sharply after the election, and we expect they will persist (if unevenly) for the coming years.

In the admittedly short time period since the election, we have seen evidence that active managers have improved performance. From that time through mid-January, 58% of fundamental managers have beaten their indexes. At the same time, we have seen $52 billion in inflows into actively managed equity funds.[1]

This is likely the beginning of a long-term trend, not a one-year phenomenon. It will take time for investors to become convinced that active managers are performing better and it will take even longer for equity mutual fund flows to turn positive. Since the financial crisis, investors have transferred massive amounts of money from equity funds into bond funds (see Exhibit 4). We don't expect equity fund flows to turn positive any time soon, but we think the pace of outflows should gradually slow and eventually shift. This process will likely take years, but positive flows would likely support equities in general and actively managed equities in particular.

Exhibit 4: A Possible Turn Toward Equities: Stock and Bond Mutual Fund Flows



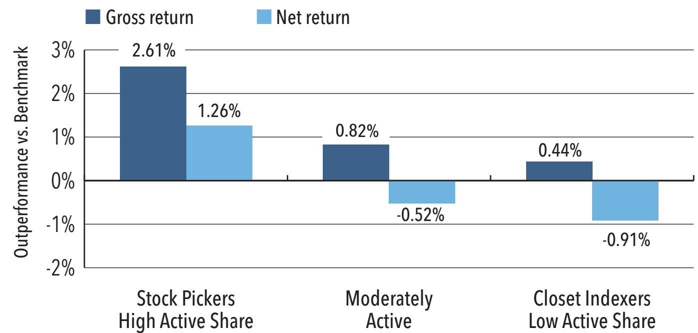
Data source: Strategas Research Partners, 1/01/08 – 10/31/16.

Picking the Right Active Manager

We believe the environment for active managers is set to improve. Given that, how should investors position their portfolios?

Investors should consider several factors. Most importantly, investors should take care to select a true active manager. Many managers claiming to be active actually only modestly deviate from their benchmarks. This disparity can be quantified using active share, a statistic that measures how widely a fund's holdings differ from the benchmark. Historically, there has been a strong correlation between high active share and outperformance, as shown in Exhibit 5.

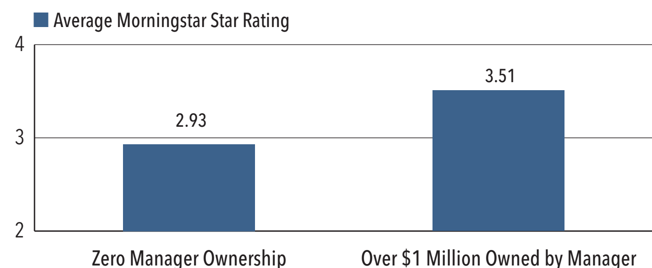
Exhibit 5: High Active Share Has Been Associated with Outperformance



Source: "Active Share and Mutual Fund Performance," Antti Petajisto, January 15, 2013. Period studies covers 1990 through 2009. Stock Pickers = Top Quintile Active Share; Moderately Active = 2nd, 3rd and 4th Quintile Active Share; Closet Indexers = Bottom Quintile Active Share. **These results do not depict the performance of any Nuveen products. Past performance is no guarantee of future results.** There is no assurance that any asset class or index will provide positive performance over time. Different benchmarks, economic periods, methodologies and market conditions will produce different results. Current maximum sales charges, expenses and fees will lower the return of the funds. It is not possible to invest directly in an index.

It is also important to ensure that an active manager's interests are well aligned with those of their clients. Consider the degree to which an active manager invests their own assets in their funds. Morningstar has periodically conducted studies to determine the correlation between manager ownership and the number of stars the funds receive. Not surprisingly, funds with high degrees of manager ownership have tended to perform better. One study is illustrated in Exhibit 6.

Exhibit 6: Manager Ownership Makes a Difference



Source: Morningstar. *More Evidence Supports Manager Ownership,* 2011. Based on average stars in the Morningstar Core Stock Fund Categories based on reported manager ownership. For funds with at least a three-year history, a Morningstar Rating™ is based on a risk-adjusted return measure (including the effects of sales charges, loads, and redemption fees) with emphasis on downward variations and consistent performance. The top 10% of funds in each category receive 5 stars, the next 22.5% 4 stars, the next 35% 3 stars, the next 22.5% 2 stars, and the bottom 10% 1 star. **Data is not intended to represent the performance of any product managed by Nuveen.**

Exhibit 7 summarizes the most important factors for investors to consider when selecting an actively managed fund.

Exhibit 7: Identifying the "Right" Active Manager

Factor	Rationale
Consistent Approach and Style	Managers should stay true to their stated approach, making it easier to know what you own.
Transparent and Proven Investment Process	The stock selection process should be clear, consistent, repeatable and proven successful in different market environments.
Scale and Nimbleness	Many of the largest equity mutual funds hold excess cash and may have long-term embedded capital gains. Relatively smaller funds may provide more flexibility.
High Degree of Manager Ownership	Managers who invest in their own strategies are better aligned with the interests of their clients.
True Active Management	Factors such as high active share can help identify managers seeking more ways to generate outperformance.

Source: Nuveen Asset Management

Looking Ahead

The last few years have been difficult for most active managers. But we do believe that the environment is changing and the tide may be turning toward an environment in which active management is set to experience better performance. These trends will take time to develop, and will likely happen unevenly. Nevertheless, we believe that if investors can find the right active equity managers as partners, they may be well positioned for the years ahead.

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Bob Doll is a senior portfolio manager and chief equity strategist at Nuveen Asset Management. Bob manages the Large Cap Equity Series, which includes traditional large cap equities, specialty categories and alternative strategies. He is a highly-respected authority on the equities markets among investors, advisors and the media. As the author of widely-followed weekly commentaries and annual market predictions, Bob provides ongoing, timely market perspectives.

Prior to joining Nuveen Asset Management, Bob held similar roles at other large asset management firms, including serving as chief equity strategist at Blackrock, president and chief investment officer of Merrill Lynch Investment Managers and chief investment officer of Oppenheimer Funds, Inc. He has 36 years of portfolio management experience, received a B.S. in accounting and a B.A. in economics from Lehigh University and an M.B.A. from the Wharton School of the University of Pennsylvania. He is a Certified Public Accountant and holds the Chartered Financial Analyst designation from the CFA Institute.

Bob appears regularly on CNBC, Bloomberg TV and Fox Business News discussing the economy and markets. He has also been quoted in major business publications such as The Wall Street Journal, Barron's and Financial Times.

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Scott is a portfolio manager for the Nuveen Asset Management Large Cap Equity Series, which includes traditional large cap equities, specialty categories and alternative strategies.

Scott began working in the financial services industry in 1994 and joined the firm in 2007. Prior to his current role, Scott served as the lead fundamental research analyst for the Large Cap Equity Series and was a senior quantitative research analyst responsible for building models to deliver relevant quantitative data to the equity portfolio teams. Previously, he worked at Ameriprise Financial as a quantitative equity analyst, business analyst, and account analyst.

Scott received a B.A. in accounting from the University of St. Thomas and an M.B.A. from the University of Minnesota's Carlson School of Management. He also holds the Chartered Financial Analyst designation and is a member of the CFA Institute and the Chicago Quantitative Alliance.

For more information, please consult with your financial advisor and visit nuveen.com.

RISKS AND OTHER IMPORTANT CONSIDERATIONS

1 Source: JP Morgan: "2016 A Challenging Year for Active Management in Terms of Performance and Flows." **2** Source: Bloomberg

The **S&P 500® Index** is a capitalization-weighted index of 500 stocks designed to measure the performance of the broad domestic economy. The **Russell 1000® Index** measures the performance of the large-cap segment of the U.S. equity universe. It is a subset of the Russell 3000® Index and includes approximately 1000 of the largest securities based on a combination of their market cap and current index membership. The Russell 1000 represents approximately 92% of the U.S. market.

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