Active management bears watching

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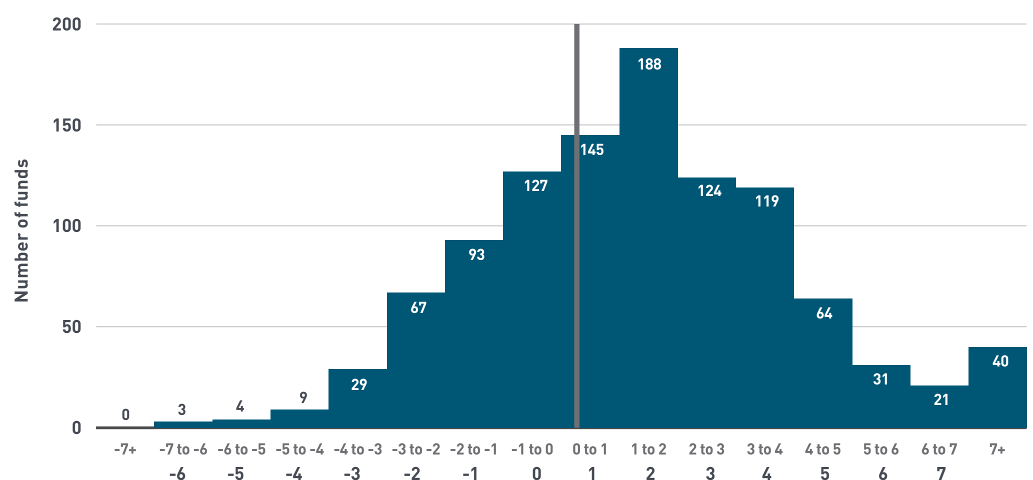
This summer, the US equity market accomplished what few investors would have imagined possible 10 years ago – the honor of being named the longest-running bull market in US history. Because active managers have struggled during this period, some market participants have expressed doubt about the ability of those managers to outperform the broad equity market. At MFS, we believe that investors should consider the merits of investing across market cycles, not just during a discrete phase of one of them.

This bull market has been the proverbial rising tide that lifts all boats, including passive managers whose sole purpose is to mimic the markets. But full market cycles include both bull and bear phases, and investors need to be prepared for both.

We took a look at the two most recent market cycles and segmented them into the bull and bear phases. We found that manager returns appear to follow different return distributions whereby the group exhibits a bell-shaped pattern during bull markets but a positively skewed pattern during bear markets.

During the bull market period from September 2002 to September 2007, the distribution of annualized excess returns appears somewhat normal, distributed with returns clustered around the market rate of return (see Exhibit 1).

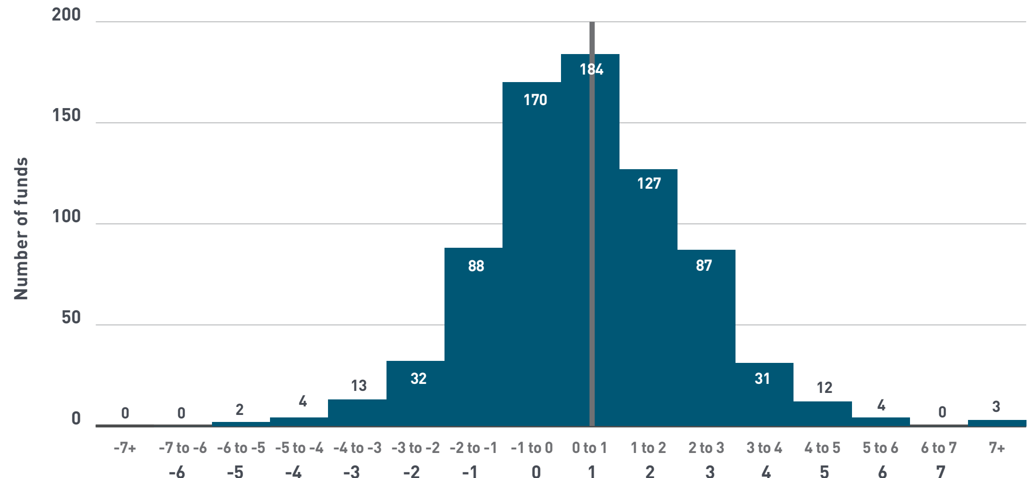
Exhibit 1: US Large Cap Strategy Annualized Excess Returns Bull Market 9/02 to 9/07



Source: eVestment, US large cap equity universe, as of 6/30/18.

Exhibit 2 shows that during the current bull market, which began in March 2009 (data as of March 31, 2018), the performance of active managers in the large-cap space was worse, with most showing negative excess returns.

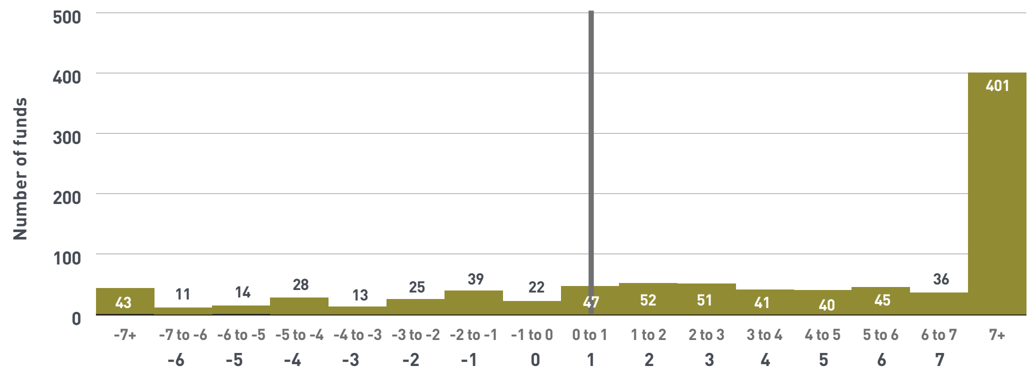
Exhibit 2: US Large Cap Strategy Annualized Excess Returns Bull Market 3/09 to 6/18



Source: eVestment, US large cap equity universe, as of 6/30/18.

However, the performance of active managers in the two most recent bear market periods paints an entirely different picture. As a group, more active managers delivered significant excess returns. Indeed, during the bear market that followed the bursting of the dot-com bubble (from December 1999 to September 2002), the vast majority of active managers in the large-cap universe outperformed the S&P 500 Index by in excess of 7% on an annualized basis, as illustrated in Exhibit 3.

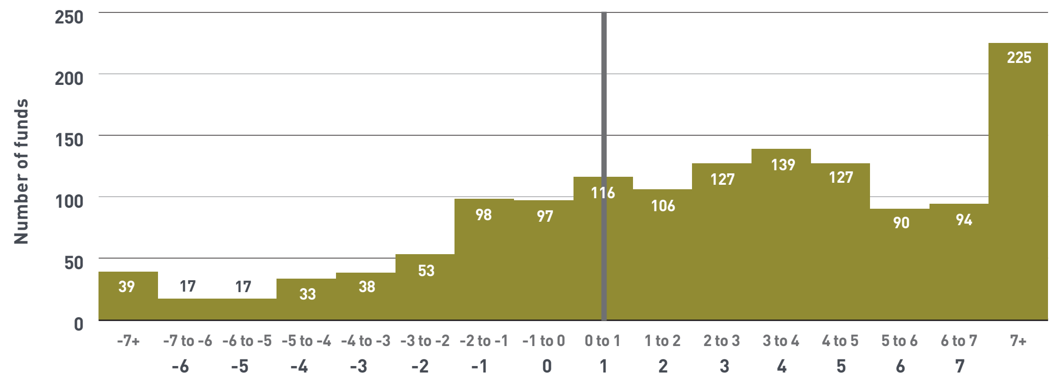
Exhibit 3: US Large Cap Strategy Annualized Excess Returns Bear Market 12/99 to 9/02



Source: eVestment, US large cap equity universe, as of 6/30/18.

During the bear market that ushered in the global financial crisis (September 2007 to March 2009), active managers again added significant alpha, as illustrated in Exhibit 4.

Exhibit 4: US Large Cap Strategy Annualized Excess Returns Bear Market 9/07 to 3/09



Source: eVestment, US large cap equity universe, as of 6/30/18.

These data suggest that alpha opportunities appear cyclical in nature, with active managers able to thrive during periods of high volatility and dispersion in equity prices, conditions that often accompany market downturns, but struggle during periods of low volatility and little dispersion. History shows that outperformance in tumultuous markets can set investors up for solid returns over the long term and can prevent a whole host of well know behavioral mistakes brought on by volatility.

In our view, active managers who are likely to have success over full market cycles share similar attributes. These include robust risk management frameworks, durable and repeatable investment processes and the patience to wait out long bull markets.

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