The Cycles of Performance: Active Managers and Index Funds

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Cycles persist and repeat over the long run, however, the length of each cycle changes. The current bull market has been one of the longest we have ever experienced, and it has been fueled by an unprecedented federal stimulus of $4 trillion. This fuel for the equity market's engine has favored a very speculative sub-set of the stock market since 2008.

Current Example: For the first 7 months of 2015, the largest contributor that led the Russell 1000 Growth Index was Amazon. It has an estimated P/E ratio of 156 while the overall average P/E of the index is only 23. The stock price has increased 92% while its earnings/share estimates have decreased by 74%.[1]

We have observed that any time market fundamentals are pushed to the side as they have been over the past 7 years, index funds have outperformed. Today, the Russell 1000 Growth index has outperformed 58% of managers over the PAST 5 years. The last time the index ranked this high among the Large Cap Growth universe was 1999.[2] It is very important to note that following that period of outperformance, the index's rolling 5 year return was then ranked among the bottom 25% of active managers for the next 8 years (see chart). That was a complete relative performance cycle from peak to trough. It is very important to keep in mind that we are currently observing only the out-performance period of this newest cycle of index performance; there is more than likely an under-performing period that we have not seen yet.

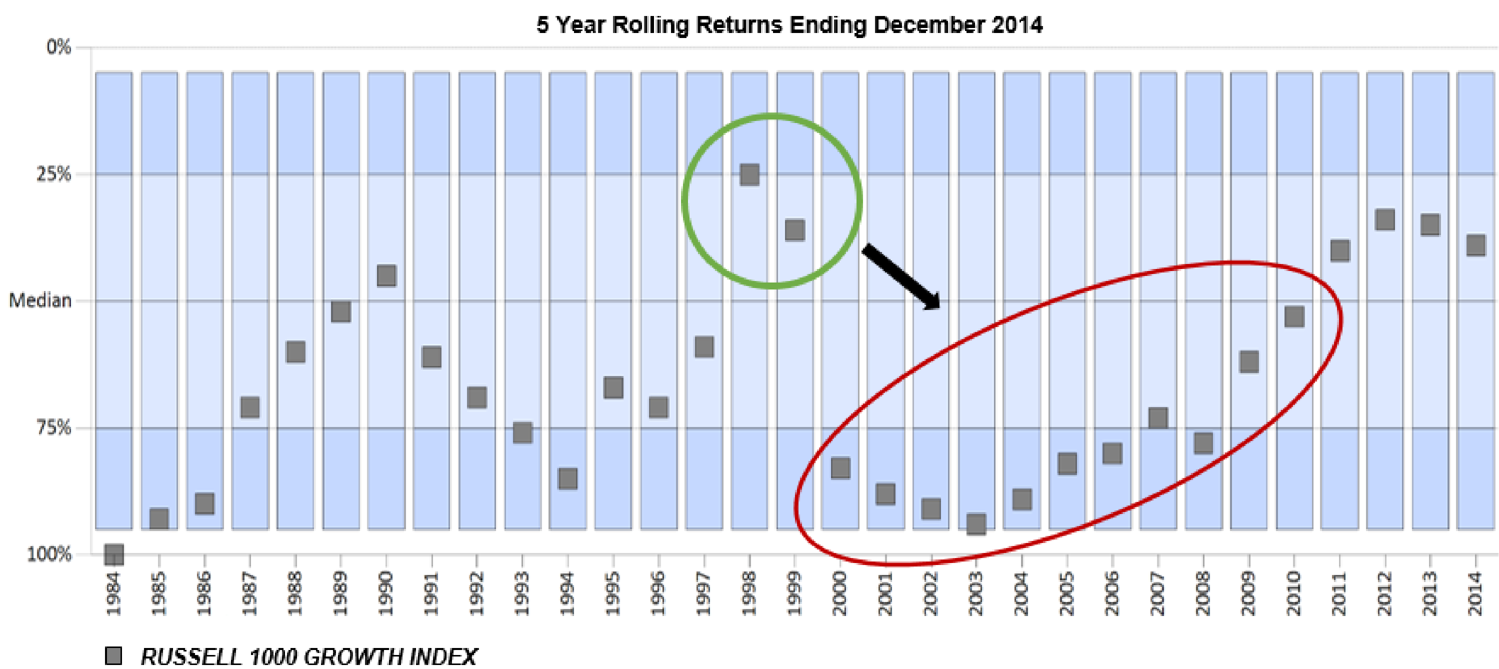
While the investment industry continues to advise against relying upon short-term past performance with regard to market timing, the recent asset flows into index funds demonstrates that this basic rule of investing has been cast aside. The human nature of chasing returns has taken over. The very same chasing of index returns occurred in 1999, and those investors were caught in the all too familiar and dreaded cycle of buying high and selling low. Index funds were discussed in every investment media outlet, and assets flowed toward these products. It seemed that active investors were doomed and that the cycle would continue. After a run of strong performance and outperformance of most active managers, the index became a below median or bottom quartile performer for the following decade. This is the type of performance that most institutional investment funds can't afford at this time.

"Those who do not remember the past are condemned to repeat it."
-George Santayana

Investors have the luxury of endless amounts of historical data to examine. We need only look to the last speculative market rally of the late 1990's where fundamentals were ignored and speculative stocks led the Russell 1000 Growth index. The important lesson to learn, and avoid repeating, is that the relative performance of index funds is cyclical. Therefore, we must try to understand where we are within each cycle. We believe that we are currently closer to the peak than the trough of the index's out-performance versus active managers. This should favor active managers going forward. An important investment decision must be made regarding how investors react to the recent past performance of index funds. This decision, utilizing active managers or passive management, will determine the investment success for the next phase of this investment cycle.

Large Cap Growth Index Performance Ranking Over Time –

Below Median Returns 80% of the Time!



The last time the index ranked this strongly, it was followed by 11 consecutive years of below median 5 year returns.

Footnotes: [1] FactSet 7/31/13 to 7/31/15; [2] Source: eVestment Alliance, Large Cap Growth Universe as of 12/31/14.