Update: Why are Active Managers Underperforming?

In 2016 we wrote a white paper discussing why active managers were underperforming that year. We started by creating a quantitative model to describe a simplified view of factor performance, and applied it to the previous five years. The analysis demonstrated the primacy of valuation as a predictor of performance (less expensive stocks tend to outperform more expensive stocks), as well as a strong record for an approach that incorporated both valuation and business momentum (earnings growth, earnings estimate revisions and price momentum). This simple model is described in more detail at the bottom of this page.

The key – and surprising – finding was the outperformance generated by expensive stocks with low business momentum throughout most of 2016. These stocks were outperforming at the expense of those with typically attractive fundamentals (low valuation and high business momentum), producing an unusually difficult period for active managers that focused on “good” companies that display strong characteristics of growth, value or a combination thereof. This pointed to a simple yet often overlooked truth – no investment approach outperforms all the time. Shifts in investor preferences can produce atypical leadership over shorter time periods (where “shorter” can be measured in years), with notable impacts on active managers’ relative performance.

Active management has continued to struggle over the ensuing three years, prompting us to update our research (the chart below illustrates our findings). The punch line remains the same – the characteristics that traditionally drive outperformance have remained out of favor.

The Model

Boston Advisors’ quantitative research department created a model of this behavior with a statistical analysis of factor performance. The team began by building a generic model of the U.S. stock market plotted along two axes, as shown in graphic below. On the horizontal axis, we plot the valuation spectrum of the market, which is an average of earnings yield, book value yield and return on equity. On the vertical axis we plot the market’s business momentum spectrum, which incorporates earnings growth, stock price momentum and earnings estimate revisions. When defined in this manner, the equity universe falls into four quadrants. Conceptually, these four quadrants incorporate the entire U.S. market in a rather simple but useful matrix.

Business Momentum

The top left quadrant is comprised of companies that score well on the “business momentum” model. These would normally be companies that make up the portfolios of a typical growth manager. When investors demand growth, this quadrant should outperform the broader market averages and other management styles.

Expensive & Low Momentum

The bottom left quadrant includes the antithesis of the top right quadrant – those companies that are the most expensive but growing the least (or contracting).

Value & Business Momentum

The top right quadrant uses a combination of 50% of the value model and 50% of the business momentum model. Consider this area inhabited by companies that exhibit both growth and value characteristics, but the extremes of neither. The stock selection models used at Boston Advisors fall in this area.

Value

The bottom right quadrant is comprised of companies that rank well on the “value” model. Typically, these would be the companies that make up the portfolios of both deep and relative value managers. When value performs well, this quadrant would/should outperform the broader market averages.

*All factors include: Earnings Yield, Book Value Yield, Return on Equity, Stock Price Momentum, Earnings Growth and Earnings Estimate Revision
As we discussed in the prior paper, one of the conditions driving the expensive, low momentum bucket to outperformance in 2016 was global central banks’ Zero Interest Rate Policy. This led investors to favor high dividend yields and stability over other factors, including valuation. Since 2017, against a backdrop of positive but generally low global economic growth, high business momentum has assumed the mantle of market leadership while the other three models have offered little differentiation (see adjacent chart) as investors have valued growth and profitability above all else. This is best exemplified in the performance – and subsequent historically expensive valuation – of software and technology-driven firms compounding high (double digit) revenue growth with high margins. Of particular note has been the inverse performance of valuation (less expensive companies have underperformed more expensive companies), with negative implications for investors who believe that the price paid to acquire an asset matters.

The hopeful news is that the dynamics appear to be balancing out. While too early to call a definitive turn, companies with lower valuation and attractive business momentum outperformed over the final four months of 2019. The macroeconomic backdrop - hopes for détente in the US-China trade war, accommodative global central banks, expectations for stable interest rates in the US, moderate global growth, the possible end of the Brexit saga – all provide opportunity for active managers to refocus on traditional company fundamentals as drivers of returns. Many key risks remain (uncertainty regarding the US presidential cycle, questions surrounding stability in the middle east, the ongoing impeachment drama, US-China relations, and the generally low levels of economic growth) that may cause investors to prefer the allure of “growth at any price” or the perceived safety of expensive, slow-growing but stable companies. For now, we remain hopeful.

About Boston Advisors

Established in 1982, Boston Advisors offers a range of investment capabilities, including equity, fixed-income, asset allocation, and socially responsible/fair-based asset management. Boston Advisors is known for its hybrid investment approach, combining sophisticated, proprietary quantitative modeling with a fundamental overlay to create custom portfolios with an emphasis on active risk management. On October 1, 2019, Boston Advisors became the equity division of Knights of Columbus Asset Advisors (KoCAA).

Source: Compustat & Boston Advisors. Chart is meant for illustrative purposes only. Past performance is not indicative of future results.

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