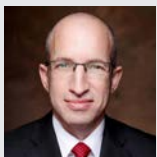




T. Rowe Price Insights

The active/passive debate in the shadow of coronavirus: Cheap might be costly



Yoram Lustig, CFA
Head of Multi-Asset
Solutions
EMEA

“A prerequisite for active management’s success is diversity.”

The corona crisis has taken the world by storm, shaking financial markets. Lockdown and social distancing measures to contain the outbreak, shutting down parts of the economy, have led to an economic cardiac arrest and turbulence. The ensuing recession may be deep yet short, but the ramifications of the crisis might last, changing behaviours and market dynamics.

While the selloff across risk assets, jump in volatility and elevated uncertainty brought misery and stress, the crisis has altered the fortunes of active management. Investors should rethink whether by opting for cheap passive they might pay dearly, not only because of the inherent risks of passive investing but also because of missing the unique opportunities for a skilled active approach.

Five areas bring special advantages for active management: diverging performance; crisis management; helpful volatility; constructive destruction; and deflected future.

Diverging performance

A prerequisite for active management's success is diversity. At the extreme, if all returns are the same, no outperformers are available to select and no underperformers are available to avoid. The crisis has unsettled markets, sending investments on varied trajectories, bringing welcomed dispersion from which skilled managers can select investments with tailwind stories and deselect those facing headwinds.

For example, in a world overtaken by health crisis and self-isolation, healthcare, connectivity-enabling technology and online commerce could be long-term winners. On the other hand, an economic standstill inflicts waning demand for commodities and transportation, while challenging banks and physical retailers. The first quarter of 2020 confirmed these trends. Some stocks of bellwether corporations fell by about 40% or more – such as Chevron, Exxon Mobil and Boeing – while others lost less than 10% – including Microsoft and Intel. Returns of sectors in the S&P 500 dispersed between falling more than 30% for Financials and 50% for Energy and less than 15% for Healthcare and Information Technology. It is not surprising that tech-heavy US large-cap growth stocks fell by “only” 14%, while financials-heavy large cap-value stocks by 27%, nearly double the fall of growth¹.

Talented active managers can flourish with such scattered returns. Portfolios could deliver not only different returns from those of the index, but also potentially outperform it because of the wide margin separating winners and losers.

Helpful volatility

While one characteristic of the last decade was low volatility, it abruptly rose in 2020. Implied equity volatility – as measured by the CBO Volatility Index (VIX) – broke its all-time

high². Realised volatility across stocks, bonds and currencies reached to the sky. The age of minuscule volatility may have come to an end and this is good.

A crisis is a whirlpool of sentiments as investors constantly calibrate expectations to an evolving reality. Like aiming at moving targets, prices constantly change based on developments, trying to price in the most probable scenarios. During such volatile periods of adjustments, emotional irrationality leads to deviations of market prices from fundamentals. This is the time when prices mostly diverge from intrinsic values so acute investors with a keen eye, clear head and patience can identify openings, waiting for prices to eventually converge with valuations over time. Volatility is helpful because it creates abundant investment opportunities.

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Crisis management

Beyond reflecting high-conviction views to add alpha, portfolios can also to integrate environmental, social and corporate governance (ESG) factors, helping to manage the crises our world is facing, especially during difficult times.

In the first quarter of 2020 oil prices crashed by over 50%³, boosting portfolios emphasising low carbon footprint. ESG was not only awarded by superior returns but perhaps also seeded green shoots of

impetus behind tackling the other global crisis – overshadowed by the corona crisis: climate change.

Active management can better fit ESG than passive not only by excluding some corporations – passive can systematically exclude oil producers – but also by rewarding corporations that could help us manage crises by developing green energy, promoting social fairness and adhering to good governance practices. Crises tend to bring people together, making them appreciate more those who do good for society, rather than those who focus solely on short-term profits.

Constructive destruction

Constructive destruction is the natural cleaning process that crises and recessions bring. Corporations with weak businesses do not survive, while those with viable businesses, strong balance sheets and sustainable cash flows do. In this process of survival of the fittest, fit active managers can select the survivors. Through diligent research focused on fundamentals, managers can identify the likely winners that would come out on the other side and avoid or short the likely losers.

In an environment as that of the last decade, where zombie corporations could survive by borrowing cheap to keep going and even inflate share prices through buybacks, it is more difficult for active managers to add value. When those who should fail do so, active managers can more easily differentiate between winners and losers.

Deflected future

Deflected future is the new course the future has taken, deviating from its prior one. The pace of change is rising in our ever-changing world. Active managers can be versatile and adapt to the future, relying less on the past.

¹ Source: S&P. Total returns, 31 December 2019 through 31 March 2020, measured in US dollars. Chevron Corporation -39.9%, Exxon Mobil Corporation -45.6%, Dow Inc. -46.6%, the Boeing Company -54.2%, Microsoft Corporation 0.0%, Walmart Inc. -4.4%, Intel Corporation -9.6%. S&P 500 Energy Index -50.5%, S&P 500 Financials Index -31.9%, S&P 500 Healthcare Index -12.7%, S&P 500 Information Technology Index -11.9%. Russell 1000 Growth Index -13.9%, Russell 1000 Value Index -26.5%.

² The CBOE Volatility Index (VIX) reached its all-time high of 82.7 on 16 March 2020.

The specific securities identified and described are for informational purposes only and do not represent recommendations.

³ The price of a barrel of Brent fell from 66.0 US dollars on 31 December 2020 to 22.7 on 31 March 2020.

One example of how the new future impacts investing is value and growth investment styles. Value and growth have been going through cycles, until the onset of the current longest-ever growth cycle in 2007. Considered one of the traditional risk premiums, value is often favoured by rule-based strategies. However, value overweights financials, where banks face headwinds because of low interest rates and bad loans. Growth, on the other hand, overweights technology⁴, so it may continue to outperform because of its positioning towards creativity and change. While passive investments rely on old paradigms, active can adapt to emerging ones.

Another example is reliance on policymakers. The last decade was challenging for active asset allocation because markets were trading less on fundamentals and more on liquidity injected by central banks. While

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policymakers are still likely to be a prominent driver of markets – in particular with the unprecedented monetary and fiscal stimulus following the corona crisis – some assets are likely to fair better than others during the recovery, opening the door for active asset allocation decisions.

Active managers can take advantage of the likely outcomes of policymakers' actions. In fixed income, for example, passive index trackers would automatically tilt portfolios to countries that must issue more debt to

fund their recovery, such as Italy, France and Spain. Active managers can avoid such issuers – they are unlikely to default, but the yields of their sovereign debt might rise. Yields of investment grade and high yield corporate bonds might exaggerate default rates based on historical statistics, without considering likely bail outs from central banks and governments in the new future. Active managers can use this divergence between the past and future to add value.

Investors need to recalculate their route. When the future takes a different turn, it is more difficult to extrapolate past trends and relationships. The rules are changing. Only investors who can acclimatise are likely to succeed. Passive investments, by definition, are based on the past, not the future. Only active management can imagine and adapt to the new future.

⁴Source: FTSE/Russel. Financials is over 20% of Russell 1000 Value Index. Information Technology is about 40% of Russell 1000 Growth Index.

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