Do Active Managers Outperform in Inefficient Markets?

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One of the most anticipated reports in the asset management industry is S&P Dow Jones' SPIVA® U.S. Scorecard, a semiannual report that provides a glimpse at the performance of active managers in each asset class. The report acts as a regular checkup on fund managers and has added fuel to the active versus passive debate.

While recent years' reports have generally acted as an indictment of active management, 2017 was more forgiving. Nearly 37% of actively managed U.S. large-cap funds outperformed the S&P 500 last year—the best showing since 2013—spurring conversation about a potential revival of active management. With the start of the financial crisis nearly a full decade ago, we thought it would make sense to dig into the report's 10-year numbers to get a comprehensive picture of the state of the active universe.

Beta in Efficient Markets, Active Elsewhere

A common portfolio construction approach we hear from investors is that they will build portfolios using low-cost index-tracking strategies in perceived efficient markets while allocating to active managers in less-efficient markets. The rationale is that while it is tough to beat the market where information is well-known, active management should do well where alpha is seemingly more readily available.

Looking at U.S. large caps over the last decade, this thesis had merit: It was very difficult for active managers to beat the market, with only 10.49% of large-cap funds outperforming the S&P 500 over the last 10 years. However, contrary to what investors might expect, active funds in mid- and small caps fared even worse than their large-cap counterparts.

	Percentage of U.S. Equity Funds Outperforming Their Benchmarks			
	Value	Core	Growth	ALL FUNDS
Large Cap	29.56	5.05	6.35	10.49
Mid Cap	11.96	3.85	2.31	3.52
Small Cap	7.22	3.77	4.44	4.29

Source: S&P Dow Jones Indices LLC Year-End 2017 SPIVA® U.S. Scorecard. Data showing the latest 10 years ending 12/31/17. Past performance is not indicative of future results. Green represents best relative performance, red represents worst relative performance, gradual colors represent values in between.

Inefficiency Does Not Imply Outperformance

Perhaps the most surprising finding in the latest SPIVA report is that a greater proportion of U.S. large-cap funds outperformed their benchmarks over the last 10 years than those in the mid- and small-cap spaces.

Both broadly speaking and across all U.S. equity investment styles, large-cap funds fared the best compared to their benchmarks, with higher hit rates in value, core and growth than mid- and small-cap funds. Further, this lack of mid- and small-cap fund outperformance was not limited to the latest decade—large-cap funds also had the best relative performance over the latest 3-, 5- and 15-year time frames as well.

Contrary to common perception, the ability to outperform in the supposedly less efficient mid- and small-cap spaces was achieved by fewer than one out of every 20 managers over the last decade. If alpha was available to active managers in these asset classes, it was apparently very difficult to find.

Active Fared Slightly Better Internationally

In addition to U.S. mid- and small caps, we often hear investors leaning toward active in other specialized asset classes such as international small caps, emerging markets (EM), and high yield. While that belief is perhaps misguided in high yield—with a shocking less than 2% *of high-yield funds outperforming their benchmarks*—funds in international small caps and EM fared slightly better than those in U.S. equities. But not by much.

Of all equity asset classes tracked in the report, international small-cap funds had the highest hit rate, with just over a quarter (27.45%) of managers beating the benchmark over the last decade. It should be noted that the report used the S&P Developed Ex-U.S. SmallCap Index as a benchmark for international small caps instead of the more commonly followed MSCI EAFE Small Cap Index, which was a more difficult bogey to beat than the S&P Index. A similar but less flattering story existed in EM, with 14.86% of funds beating the Index (using the S&P/IFCI Composite Index, which outperformed the MSCI EM Index).

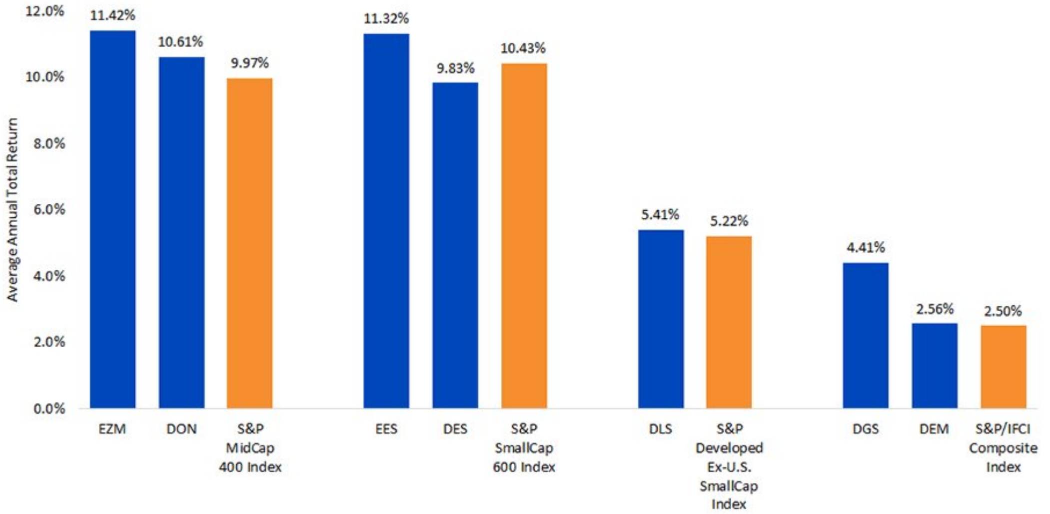
These numbers lend credence to the idea that, while it is more likely that an active manager can outperform in international markets, only a select handful actually have done so. Fees undoubtedly play a role in the results, as on an asset-weighted basis, actively managed equity mutual funds on average charge 0.78%1—and typically much more than that in the more esoteric, inefficient markets.

Active Approach at a Lower Cost

Similar to many active managers, we believe at WisdomTree that our fundamental approach of weighting by dividends or earnings typically can have greater excess return potential in the perceived inefficient markets. The key differences are that we implement our research passively, in a rules-based process, and through the beneficial ETF vehicle - all of which help drive down costs for investors.

True to form, many of our long-term flagship products outperformed their benchmarks and peers in a decade that saw significant struggles for non-index funds. Of every WisdomTree ETF with a 10-year track record in the inefficient equity asset classes covered above, all but one beat the comparable index used in the SPIVA report (the WisdomTree U.S. SmallCap Dividend Fund (DES) was the only one unable to overcome the headwind of value underperformance).

While we don't know what the next decade will bring, we think that the concept of active management combined with the structure of an ETF can continue to lead to better outcomes for investors.



Source: Bloomberg, for period 12/31/07 to 12/31/17 to align with end date of SPIVA® U.S. Scorecard.

Performance is historical and does not guarantee future results. Current performance may be lower or higher than quoted. Investment returns and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Performance data for the most recent month-end is available at wisdomtree.com.

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For standardized performance of the Funds in the chart, please click below.

EZM: WisdomTree U.S. MidCap Earnings Fund. DON: WisdomTree U.S. MidCap Dividend Fund. EES: WisdomTree U.S. SmallCap Earnings Fund. DES: WisdomTree U.S. SmallCap Dividend Fund. DLS: WisdomTree International SmallCap Dividend Fund. DGS: WisdomTree Emerging Markets SmallCap Dividend Fund. DEM: WisdomTree Emerging Markets High Dividend Fund.

1Source: ICI, 2018 Investment Company Fact Book.

Important Risks Related to this Article

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