



Why we believe NOW is
the time for active equities

As we all hunker down to our new normal with the hope that by doing so we can protect others from the invisible onslaught of the coronavirus (COVID-19), those of us in the investment industry are working hard to help ensure we keep client portfolios as healthy as possible against a backdrop of indiscriminate selling driven by sentiment rather than fundamentals. This quest has led us to revisit the aged old debate of active and passive management.

Over the past decade or so, roaring equity markets seem to have challenged active management to its very core. Contrastingly, the recent market downturn may offer skilled active managers an opportunity to outperform. At heart, most investors recognize that recent conditions (central bank quantitative easing and low interest rates), while having lasted longer than expected, were unlikely to persist indefinitely. But huge flows into passive management and ensuing fee pressure on active managers are all signs that investors have had enough. So why is this? And importantly, why have active managers been left behind?

This recent trend has caused some to wonder whether active managers still have a role to play in equity portfolios. We've taken a hard look at the space and believe they do, and we would argue that now is a good time to consider or even reconsider active equity. We've set out our case below and invite you to join our debate.

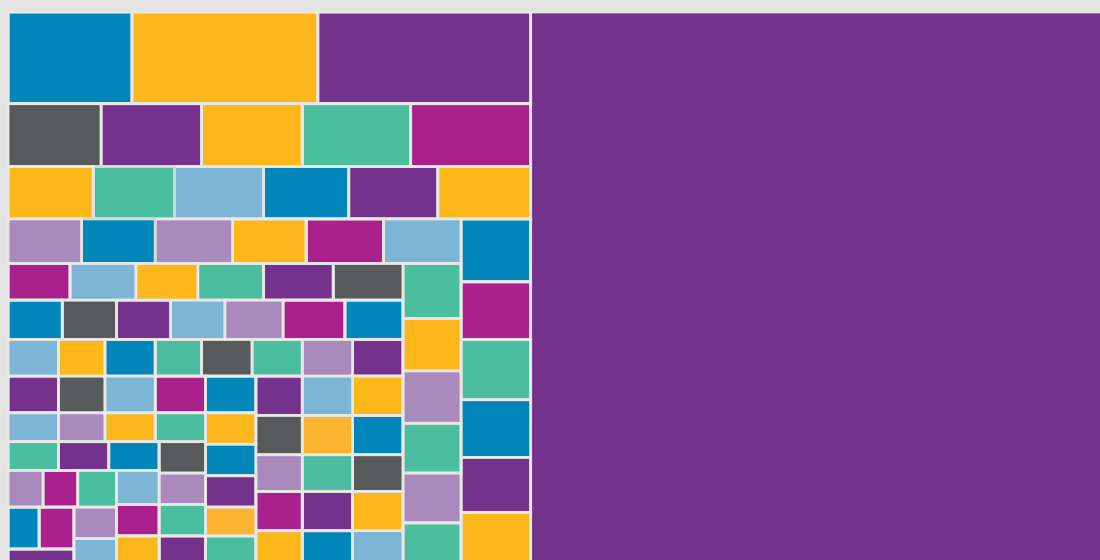
Beware of concentration risk

A first factor to consider is rising concentration risk associated with passive indices.

Many investors take refuge in the idea that they are making a "safe" choice when they choose to invest passively. The MSCI World Index is made up of around 1,600 stocks, so that means it's diversified, right? No, the reality is that the top 100 stocks now make up over 40% of the index and it's these 100 stocks that now dominate performance.

As shown in *Figure 1*, the multicolored cells to the left-hand side reflect the top 100 stocks and the purple shaded area to the right represents the remaining 1,500 or so stocks in the index. The bias toward the top 100 largest holdings has become more acute in recent years because many of these holdings constitute the U.S. mega cap technology companies that have been the largest driver of the index's return. In the U.S. specifically, the enormous growth of the FAANG stocks (Facebook, Apple, Amazon, Netflix, Google) over the past five years has heavily contributed to this. A recent report completed by MSCI shows that "the weight of FAANG stocks in the MSCI USA Index doubled during the last five years."¹

Figure 1. Relative weight of the largest 100 stocks in the MSCI World index as a proportion of the 1,646 stocks in the index



Source: Willis Towers Watson analysis of MSCI data at December 31, 2019

¹MSCI, Selected geographical issues in the global listed equity market, October 2019
www.regjeringen.no/globalassets/upload/fin/aff/2019-10-03-msci_report-for-the-norwegian-gpfg.pdf

The dominance of these very large companies has particularly exacerbated returns over the past couple of years. Indeed, equally weighting the MSCI World holdings (with quarterly rebalancing) would have yielded 3.8% and 3.5% lower returns in 2018 and 2019, respectively, than that of the traditional MSCI World market cap weighted index (Figure 2). As a result, many active managers have underperformed by not owning these U.S. mega cap, tech/high-growth stocks to the same level (weight) as the index.

Figure 2. **Return comparison**

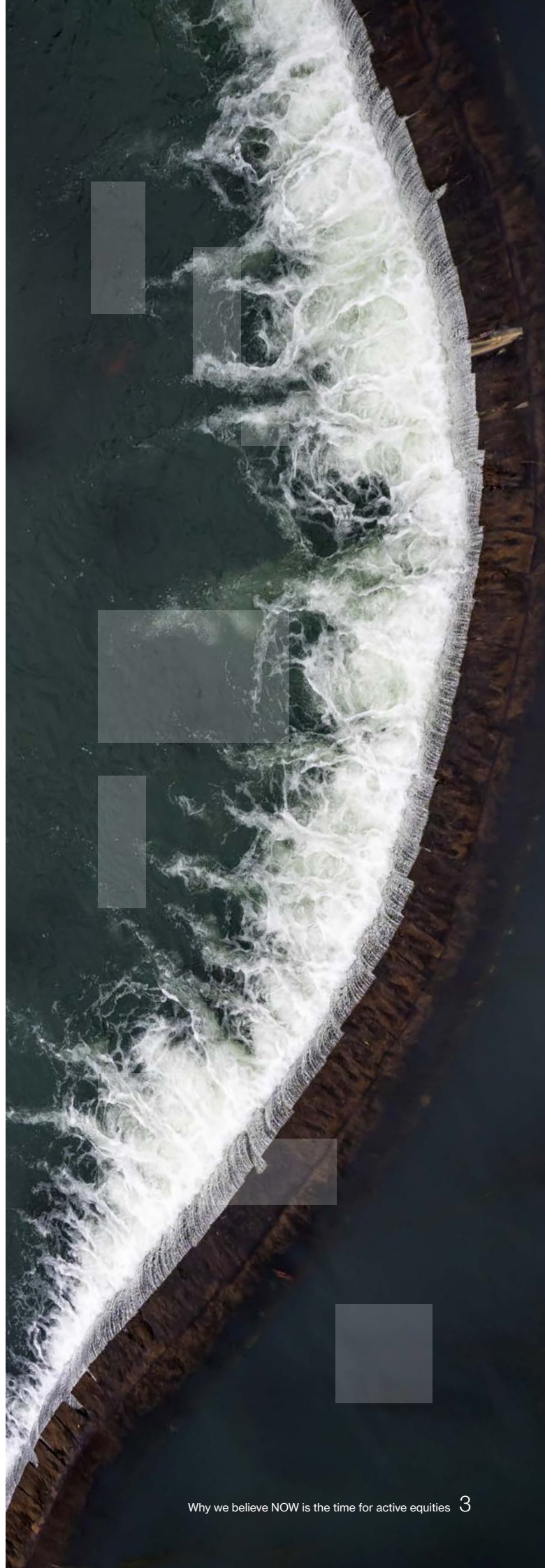
Year	MSCI World Equal Weighted Index	MSCI World Index
2019	23.9%	27.7%
2018	-12.2%	-8.7%
2017	23.3%	22.4%

Source: MSCI, December 31, 2019

Past performance is not a reliable indicator of future returns.

The problem with this increasing asset concentration, of course, is that should any of these stocks perform poorly, the impact would be significant. Simply owning the index exposes investors to a concentrated position in U.S. mega cap, tech/high-growth stocks, leaving investors with an unintended bias in their portfolio that they might not fully appreciate. And let's not forget that this concentration risk may also be exacerbated where investors' portfolios are structured with a bias to regional and domestic assets.

It's not that concentration risk hasn't caught out the market in the past, either. We need only to look back to the so-called "Nifty 50" valuations of the 1960s to 1970s for an example. Those of us old enough to remember will recall how investors became enamored with growth stocks and pushed the prices of their favorite companies to unjustified heights before they came back down to earth from 1973 onward.

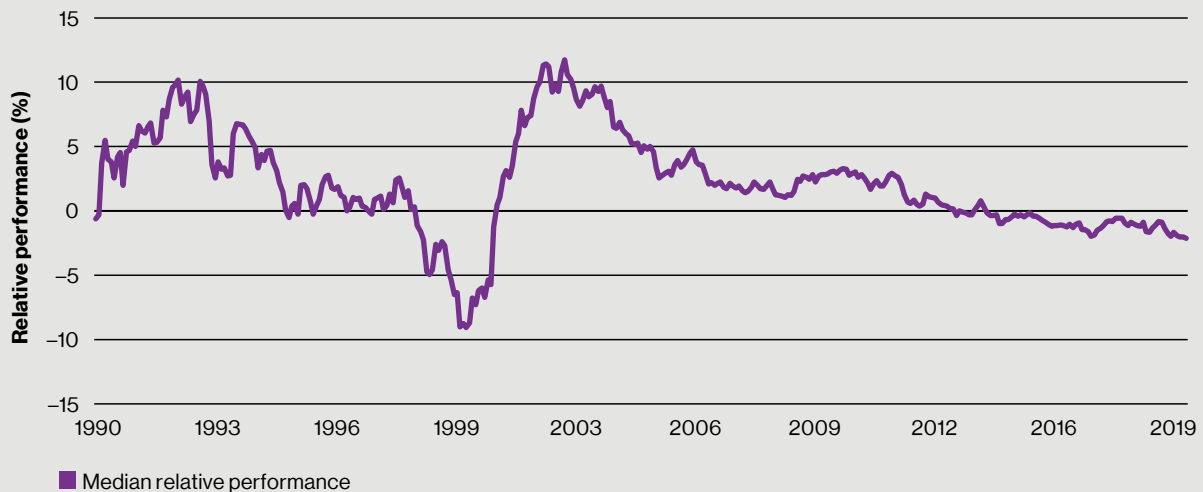


The natural cyclicality of active and passive management

Of course, market cycles, and therefore corrections, are unavoidable and expected when investing. Even when they are triggered by black swan events like COVID-19. But investors need to be astute enough to resist the urge to heavily focus on recent performance and instead recognize that the tables may turn, even if no one can predict exactly when – and, just as importantly, be in a position to be able to do something about it.

The most recent 10 years' performance has clearly seen passive strategies dominate over active, as reflected in the decline of the median relative performance of active global equity managers versus the MSCI World Index as shown in *Figure 3*. But could this cycle shift? And if so, what would the potential implications be?

Figure 3. Rolling three-year annualized median relative performance (vs. MSCI World Index), net of fees, of active global equity managers



Source: Willis Towers Watson, eVestment and MSCI, as at September 30, 2019

Median manager of the eVestment universe of global equity managers comprised of long-only all-cap active global equity strategies.

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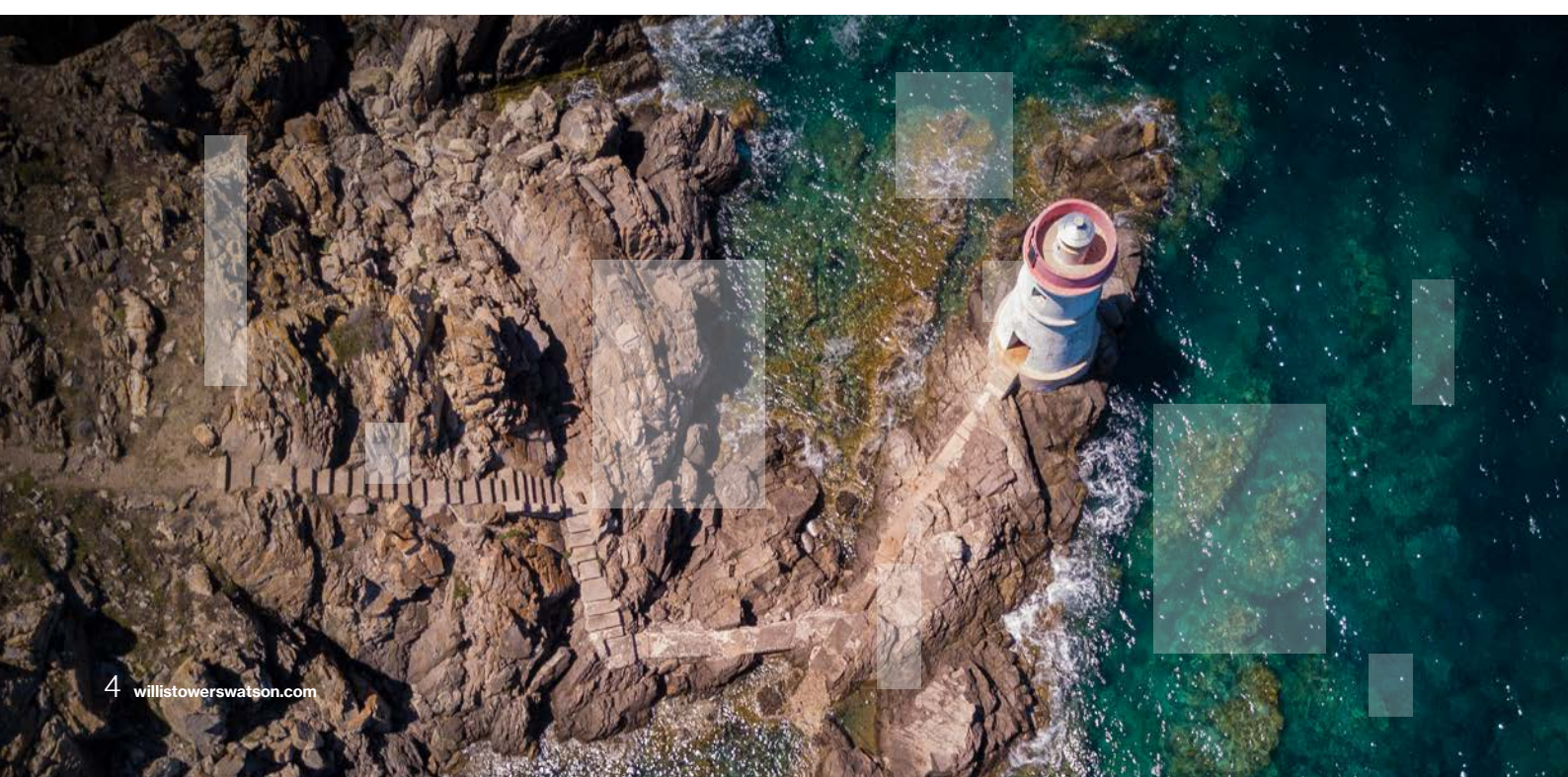
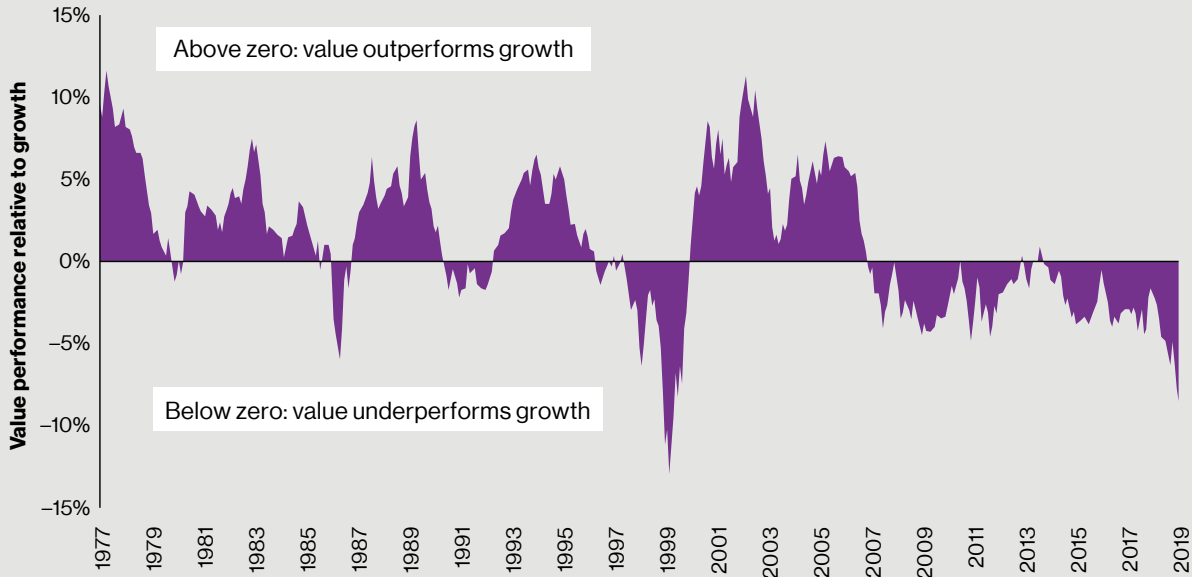


Figure 4. Rolling three-year annualized returns in USD of the MSCI World Value Index relative to the MSCI World Growth Index



Source: MSCI, as at December 31, 2019

Each data point is calculated by subtracting the three-year annualized performance of the MSCI World Growth Index from the three-year annualized performance of the MSCI World Value Index, at monthly intervals. Area above zero indicates periods where value outperformed growth. Area below zero indicate periods where value underperformed growth.

Past performance is not a reliable indicator of future returns.

We know the gap between growth and value stocks in the MSCI World Index has been prolonged for well over a decade now and has recently become historically wide. Looking at longer data (Figure 4), value stocks have also seen a fair amount of success, notably in the 2000s, before the global financial crisis. This shows that styles go in and out of favor over time and the number of days under the sun (or in the shadows) varies.

Factors such as geopolitical uncertainty have led to fluctuating market volatility and dispersion over recent months, creating more opportunities for active value creation. Going forward, we expect a better environment for skilled stock pickers to generate alpha. Meanwhile, passive strategies will be more tightly locked into their holdings and subsequent exposures that may be less than optimal from a valuation, fundamental or risk perspective.

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We believe skilled active managers can outperform. What drove the market up may well drive it down when the tide turns. The advantage for skilled active managers is that they can be more versatile and respond to changing market conditions more quickly, dodging bumps in the road and working to select the winners (versus the losers) over time. This toolkit will be critical in a sell-off environment.





“Institutional investors, especially in Europe, will shift away from passive investing because of their sustainable investment goals. These goals can only be achieved through more focused, long-term portfolios. Additionally, the stronger engagement with companies this may require cannot be done effectively through passive management.”

Ric van Weelden, Senior Partner at INDEFI

The growing importance of sustainable strategies

Thirdly, sustainable investment is a critical factor for long-term success, and this topic has gained significant momentum in the active versus passive equity debate.

Investors of all shapes and sizes are under increasing pressure to demonstrate their environmental, social and governance (ESG) credentials. This potentially impacts not only the stocks they hold but also the need to exercise their shareholder voting rights and engage with companies to bring about positive and progressive change in the wider business community. Arguably, investing passively creates headwinds for these positive changes as it is difficult to meaningfully engage with the over 1,600 companies in the MSCI World Index.

While exclusions in investment mandates may serve those purposes for some, it is harder to pursue an integrated ESG strategy passively compared with the opportunity to allocate capital more dynamically or opportunistically with an active approach. In some markets, such as the Netherlands, we are already seeing examples of pension funds working to restructure their portfolios to a more active strategy so that they can meet their ambitious sustainable investment goals. This is a trend we expect to see proliferate.

Turn strategy into action

We don't claim to be able to time bull or bear markets, or time shifts from growth to value, large to small caps, or between regions or sectors; we believe anyone who does is likely going to get caught out. However, we do firmly believe in the benefit of active equity management, when you have found truly talented stock pickers and crucially when you own a more balanced and well-constructed portfolio.

More specifically, we are strong believers in high-conviction active management, as opposed to quasi-active benchmark hugging. We prefer talented stock pickers to be concentrated and focused on identifying the best businesses in the world so that you own a manager's best ideas, without the need for “filler” stocks in order to further diversify the portfolio for risk management. However, we believe it's also important to understand what you own in aggregate, to withstand short-term underperformance or avoid those unintended biases like we see in the index today. By tapping into the top 10 to 20 stocks of multiple managers (say eight to 12 managers in total) we believe you can blend a portfolio together to ensure what you own in aggregate is well diversified and suitably risk controlled across style, country, sector and market cap.

Based on an approach like this, we believe the arguments in favor of increasing active equity investment allocation are now more compelling.



How Willis Towers Watson can help

We have tapped into our skill in high-conviction manager selection developed over many years and leveraged our global research team to find very talented concentrated stock pickers around the world. We then take their highest conviction idea portfolios (typically 10 to 20 stocks) and blend them such that the overall strategy does not take significant bets on either country, sector or style exposures. This approach focuses on maximizing returns from managers' stock selection skill with a prudent risk oversight. We have launched a fund to house this investment approach, aiming to ensure we can bring further cost savings to our clients by pooling assets and using our buying power to negotiate hard on fees.

We believe this approach can generate long-term improved performance for asset owners. Crucially, it also means that if equity markets do overheat, we are confident that we own some of the best companies in the world that have potential to outperform over the long term.

Lastly, recognizing the importance of sustainable investing, we integrate ESG principles into the entire investment process from setting mission and objectives through asset allocation, portfolio construction and manager selection, to monitoring and reporting. We not only take a long-term investment horizon but have partnered with EOS at Federated Hermes to drive more effective action and stewardship and reflect our commitment to being a responsible asset owner that is investing for a sustainable future.

Further information

For more information on our active equity investment approach, please contact your Willis Towers Watson consultant or:

Ben Leach

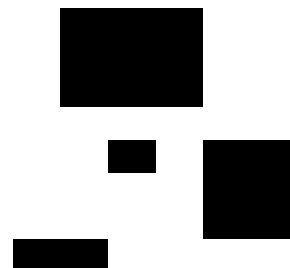
+1 312 288 7241

ben.leach@willistowerswatson.com

Christopher McGoldrick

+1 215 246 7492

christopher.mcgoldrick@willistowerswatson.com





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