Active vs Passive – The Age Old Debate

Cornerstone Invesment Partners

The debate between active versus passive investing has been going on for decades, likely beginning with the introduction of passive investing in the 1970s. Fast forward to today and passive assets have attained parity with their active brethren as both active and passive mutual funds total roughly $4.3 trillion in assets under management as of June 2019 (Morningstar). The merits of active and passive investing have been well documented. Passive investing offers diversification, low fees and a simple way to gain market exposure to an asset class. Passive funds track an index, thereby delivering returns in line with a chosen benchmark. Active investing attempts to outperform the benchmark over time by focusing capital on companies with more attractive characteristics, while avoiding unattractive areas of the market. The most common of these benchmarks followed by passive indexes is the S&P 500, and investors have poured money in, as the index has seen a positive flow of assets every year for the last ten. Why? Because the S&P 500 has delivered returns over 300% since the market bottomed in 2008, and has been nearly unbeatable by active managers over that time, finishing in the top half of large cap returns in 7 of the last 9 years, and in the top third of managers for the past decade.

But the question investors should be asking after a decade of nearly unparalleled outperformance and a flood of assets pouring into unmanaged equity products is what am I buying today with an index fund? Is the S&P 500 as cheap as it was during the late 2000s when this run began? Are there more attractive areas that I should focus on? Are there areas that investors should avoid going forward? What do I do if there is ever a down market again? And finally, is there a place for active management in portfolios going forward?

A Little Perspective

Ten years ago, the stock market looked incredibly cheap using almost any measure of value. Investors were coming to terms with the Great Recession while the Federal Reserve was pumping in an unprecedented amount of liquidity to "sure up" the system. Investors were rewarded for simply being willing to accept exposure to the markets, as investor confidence was significantly reduced after the market fell roughly 50% during 2008-2009. Today, after the longest recovery/expansion in US history, the market overall looks more expensive, and looking at the characteristics and constituents today offers a much more sobering prospect for investors.

Yet money continues to flow into passive index funds, with inflows of $1 trillion over the last 5 years alone according to Morningstar. These inflows continue to support the rise of the index, as capitalization-weighted passive investing is the biggest momentum trade there is. Passive funds are required to buy all companies, regardless of whether they may be underpriced or overpriced. Given the high levels of inflows, this means that the fund needs to continue buying more of those stocks that have returned the most along with those with the highest market capitalizations.

Year	*S&P 500 - Median Mgr*	*S&P 500 Rank*
2000	*-8.01*	*87*
2001	*-2.79*	*67*
2002	*-1.65*	*67*
2004	*-1.03*	*61*
2005	*-2.41*	*75*
2007	*-2.10*	*70*
2008	*-1.49*	*62*
2009	*-0.32*	*52*

Source: Evestment
Universe: Large Cap Core Equity

It seems like forever ago, but at the beginning of 2009, passive investing had been a losing strategy to active management over the previous decade, having only performed better than the average manager in the large cap core space 2 out of 10 times (according to Evestment). However, the index had an attractive level of valuation on its side, as the S&P 500 traded at a P/E ratio of 10x, a significant discount to its historical average of 16x. Using the Cornerstone Fair Value Model, we see that the S&P 500 benchmark was trading at 60% of its fair value, with nearly 66% upside, and nearly 95% of the constituents were trading at some level of discount to their fair value in our work. This was unlike any period we have seen in over 30 years of history within the Fair Value Model. If we looked at the total universe of 800 large cap stocks that Cornerstone follows, roughly 750 of these stocks were trading at some level of discount, a percentage of cheapness not seen before or since.

What if the S&P 500 was a single security

Compared to 2009, today's S&P 500 looks more expensive, trading at a premium to its historical P/E of 16x and trading close to its fair value. The S&P 500 now ranks in the bottom half of our 800 stock universe, and while positive results have been achieved historically from that position, it is not the optimal part of our universe from which to own. Based on over thirty years of hisory in the Fair Value Model stocks in the bottom three quintiles of our investable univserse have lagged the top two quintiles by 300 basis points on average.

What a difference a decade makes

Given the tremendous run the S&P 500 has experienced, and the less flattering valuation picture and return expectations that are present today, we wanted to highlight a few areas that may give further pause to investors as they think about index investing alone, and offer some reasons for reducing blind exposure to passive equities: The Top 10, Low Volatility, Down Markets and Expensive Outliers.

The Top Ten

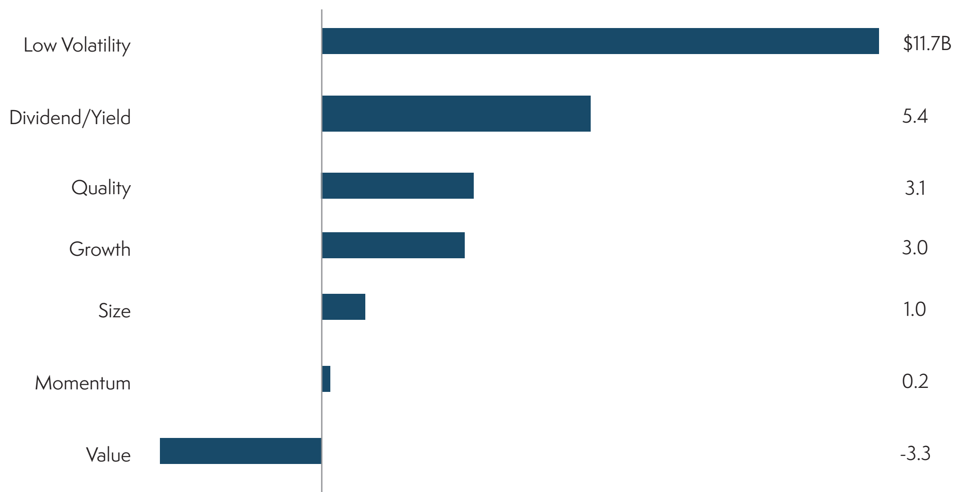
When investors purchase index investments, they often purchase a capitalization weighted index, warts and all. They do not get to pick and choose which names they hold, or at what weighting. They are also not nearly as diversified as they may think. For example despite the S&P 500 having exposure to 500 companies, the top 10 names in the index make up a surprisingly large weighting that has been persistent over time. In fact, the Top 10 names represent roughly 22% of the index, roughly the equivalent of the bottom 336 components of the S&P 500. To elaborate further, Microsoft's weighting alone is equal to the bottom 124 names in the benchmark.

Then v Now

Ten years ago, the top ten names in the S&P 500 also made up roughly 22% of the benchmark, but that is where the similarities seem to end. Unlike in 2009 when the ten largest constituents traded at a slight discount to the market's P/E multiple (11.5x v 11.6x), today the top 10 names are trading at a 56% premium to the market (26.3x v 16.8x). The 2009 version of the benchmark was headlined by three sectors, Energy, Consumer Staples and Health Care, making up 66% of the top 10 names. Today the Technology, Consumer Discretionary and Financial sectors make up 76% of the top 10. Only four names remain from the top 10 from a decade ago, with Walmart, Microsoft, Johnson & Johnson and JP Morgan the only holdovers. This is consistent with historical turnover in the top 10, as six members have turned over every decade since 1980, calling into question whether investing in those top 10 remains a relevant strategy once they have become so large. It also introduces the law of large numbers, illustrating how difficult it can be for the largest companies to continue to grow faster than their peers. It's also worth noting that as the S&P 500 was returning roughly 250% since the beginning of 2009, the top 10 names returned over 100% less over that time, again in line with historical underperformance. According to Ned Davis Research, for the period from 1972 to 2013, the S&P 500 returned nearly 5,000%, but if you simply owned the single biggest stock in the index every year as your only investment you would have gained closer to 400%. The top names certainly feel bulletproof at this point in time (and they almost always do), but history dictates that they will experience issues going forward. We can only guess what those issues may be, but looking at the current makeup within the top 10 there will likely be headwinds to outperformance including the aforementioned premium valuations, optimistic growth assumptions that will need to be met/exceeded, and continued regulatory pressures as governments globally look to address antitrust concerns.

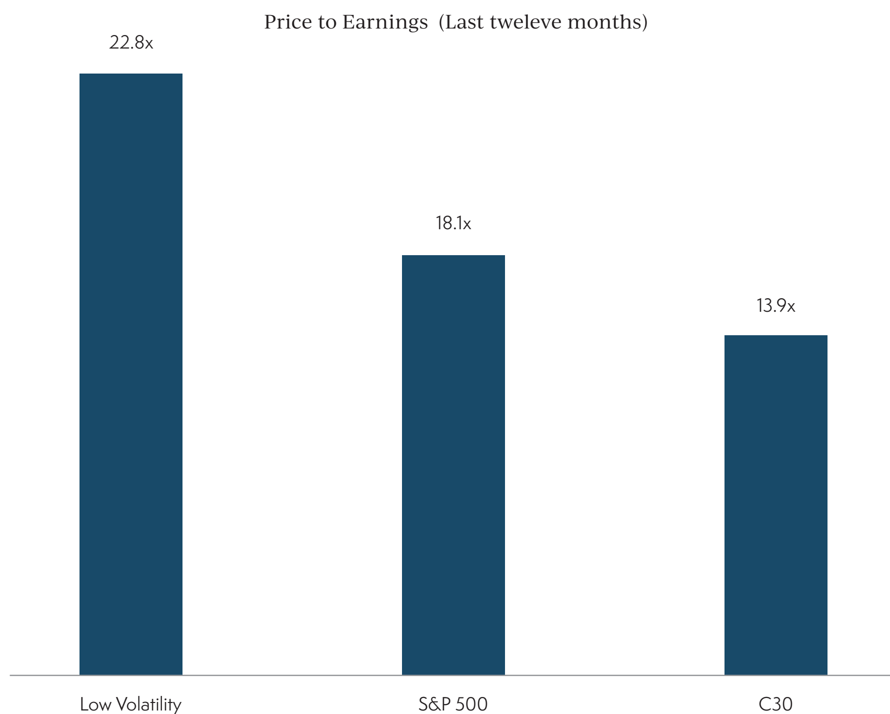
Low Volatility

The second area of concern is low volatility. At first this was an ideal solution to help a small sub segment of investors protect against wild fluctuations within the markets by focusing on stocks that have historically been the lowest in volatility. Today, the low volatility trade has become very crowded and a highly sought after investment.



Source: Bloomberg year to date as of 6/30/19

The unfortunate consequence of this sudden flood of inflows is that stocks that were likely cheap due to slow, consistent growth and lower volatility are now trading at multiples 43% north of the broader market despite growth expectations being below the index for 2 of the next 3 years.

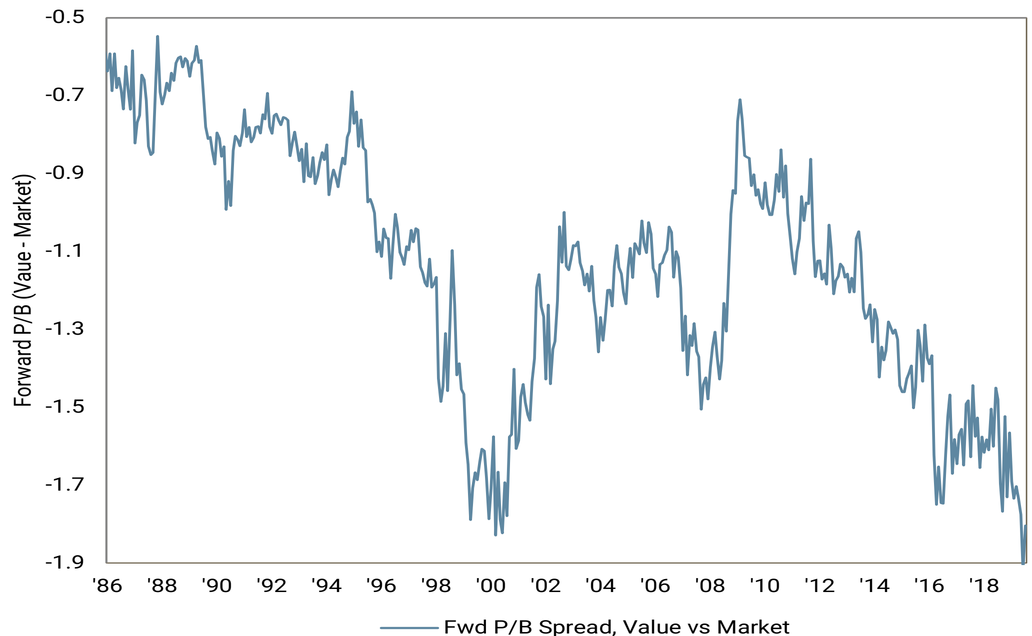


Source: FactSet as of 6/30/19

Down Markets (and When Value Beats Growth)

Yes, Virginia, there really are down markets, and value will someday beat growth again. The broad market had managed to avoid negative returns over a calendar year for nearly a decade. Despite relative weakness in the 4th quarter of 2018 causing negative performance for calendar 2018, the markets rallied back with a vengeance and remained near new highs. The S&P 500 witnessed a period of 9 straight years where performance was positive from 2009-2017, tying a run of positive performance only seen in the go-go 1990s (1991-1999). Now, as it was then, this performance was largely on the back of a heavy growth market, with the growth index outperforming its value peer by nearly 200% over that time. The divergence between value and growth P/Es and P/Bs are now at levels not seen since the end of that run in 1999-2000.

Source: JP Morgan US Equity Strategy and Quantitative Research as of 7/31/19



Source: JP Morgan US Equity Strategy and Quantitative Research as of 7/31/19

Another unicorn unseen and forgotten about for some time are negative markets. When negative markets appear, passive management has historically performed worse than the average manager. In the five negative markets since 1990, the S&P 500 has underperformed the average manager in four of them, ranking on average in the bottom 40% of market participants and underperforming by nearly 400 basis points annually.

Year	S&P 500	Median Active Mgr	S&P - Median Active Mgr
2000	(9.1)%	(1.1)%	(8.0)%
2001	(11.9)%	(9.10)%	(2.8)%
2002	(22.1)%	(20.5)%	(1.7)%
2008	(37.0)%	(35.5)%	(1.5)%
2018	(4.4)%	(5.3)%	0.9%

Source: Evestment

This combination of heavy growth outperformance and potential for negative markets are certainly items to monitor, as it does not usually perform well for investors in passive vehicles.

Expensive Outliers

The final area of concern to give investors in passive vehicles pause is the expensive outliers. At the start of 2009 there were only a handful of companies within the S&P 500 trading at a significant premium to their fair value in our valuation methodology, as roughly 2% of the index traded at twice their fair value. Today that number is nearly 11%, with 3.7% trading over 3x their fair value. Said another way, 53 companies in the benchmark are trading for 2x what they should be based on our valutaion work.

S&P 500	Over 2x Fair Value	Over 3x Fair Value
Number of Securities as of 06/30/19	53	18
Number of Securities as of 12/31/08	10	4

Source: Cornerstone Investment Partners, FactSet

That's not to say these companies won't continue to grow into these valuations, but the margin for error continues to get smaller. Financial stocks appear compelling, as they are trading at a significant discount to fair value, and are expected to grow earnings faster than the overall market. Large cap financial companies are also as well capitalized as they have been in decades, with many expected to return double digits in the form of dividends and share repurchases following strong CCAR showings. Investors have instead chosen to focus on concerns around lower interest rates, net interest margin compression and economic malaise, which appear more than priced into the current shares. Discerning investors can also find other sectors that look appealing, given below market valuations and higher expected growth. Cautious investors will likely avoid sectors that appear expensive with little growth expectations.

Forward Growth		Valuation		Earnings	
Sector	**EPS (%)**	**Sector**	**Forward P/E (x)**	**Sector**	**PEG Ratio (x)**
Industrials	9.7	Financials	11.6	Financials	1.3
Discretionary	9.4	Energy	14.8	Industrials	1.6
Financials	8.9	Health Care	15.1	Energy	1.7
Energy	8.8	Industrials	15.4	Health Care	1.9
Health Care	7.8	**S&P 500**	**16.4**	**S&P 500**	**2.1**
S&P 500	**7.7**	Materials	16.8	Discretionary	2.2
Communication	7.4	Communication	17.3	Communication	2.3
Technology	7.0	Technology	18.7	Technology	2.7
Materials	5.8	Utilities	18.8	Materials	2.9
Utilities	5.2	Staples	19.4	Utilities	3.6
REITs (Real Estate)	3.9	REITs (Real Estate)	19.5	Staples	5.0
Staples	3.9	Discretionary	20.9	REITs (Real Estate)	5.0

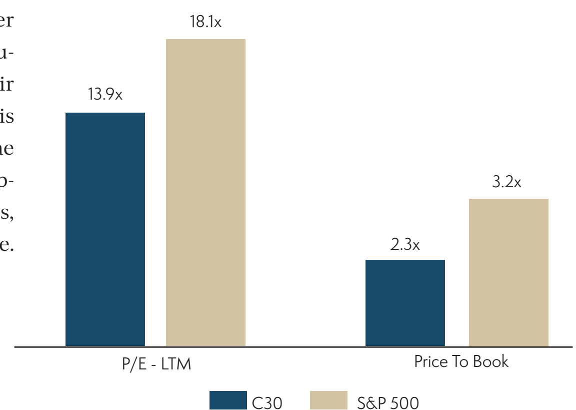
Source: Standard & Poor's, Thomson Financial, FactSet, Credit Suisse as of 6/17/19

So What Is An Investor To Do?

So what is an investor to do? Market timing is a difficult if not an impossible exercise, and while we wouldn't recommend attempting to time the market, or pull fully away from passive investing, we do believe there are portfolios available that are complementary to the S&P 500 while offering more upside and considerably less risk. Complementing passive portfolios with managers that will cover the benchmark's weaknesses could be helpful moving forward. This would include managers that have a long term record of success, a value orientation, high active share, high conviction in what they own, and have historically protected assets in a downturn.

Cornerstone's answer is...Cornerstone!

The Cornerstone Concentrated 30 portfolio is designed to select the 30 most compelling names in our US, large cap, 800 stock universe. These names offer considerable upside, are industry leaders, have strong balance sheets, generate strong cash flows, and are led by compelling management teams. As Cornerstone vets the investable universe, we utilize our Fair Value Model that assigns a value to all of the companies, highlighting those companies with the best potential for outperformance given their attractive valuation and long term record of success. The Fair Value Model also helps identify those names that do not offer a compelling value proposition and those where there is the potential for value destruction. Once those names with attractive valuations have been identified, the Cornerstone investment team performs a deep fundamental dive on each name under consideration. It is only after each team member has performed their own due diligence on a security that the team will assemble to carry out their daily investment meetings, ensuring everyone is fully versed and prepared for the discussion. The result is a portfolio that is considerably cheaper than the market on all traditional measures, while also trading at a discount to its fair value.



In fact, if the Concentrated 30 portfolio were a stock, it would rank approximately 250 out of 800, suggesting a discount to fair value of 15% using highly conservative assumptions. In the thirty plus years of history in the Fair Value Model, stocks with a ranking near this level have produced the highest risk adjsuted returns. More importantly, the portfolio has removed exposure to the riskiest, most expensive names, while focusing on attractively priced industry leaders.

Thinking Outside the Box

While you may also find the thought of being out of equities worrisome, may we offer another suggestion: the Cornerstone Compass strategy. Cornerstone's Compass portfolio is a new twist on the old notion of a traditional balanced account that simply weights stocks at 60% and bonds at 40%. Cornerstone realizes that stocks do not always assume the same level of risk: there are in fact times when the broad market is not fairly valued relative to the underlying fundamentals. Cornerstone also understands that stocks perform better when they are undervalued. Given those facts, we believe we can add excess return and reduce risk by adjusting the allocation between stocks and bonds to be more reflective of where the more attractive opportunities lie. This weighting adjusts regularly to ensure appropriate exposure to the more attractive asset class between stocks and bonds so that you are not taking unnecessary risks with your capital.

The Big Finish

Active and passive investing were never intended to be adversaries, but rather complementary pieces of an investment portfolio. However, given the efficiencies within the past decade, too many investors are simply closing their eyes, holding their nose and buying the index. At some point, what you buy matters, and the price matters more. While riding the wave of passive investing blindly has become more common, it does not make it a more reasonable investment. In fact, given the current valuation, concentration of the index in the largest names and lower expected returns presently in the benchmark, we believe it is time for investors to diversify away in some manner to active managers with a long term track record of success, high active share, low turnover and a history of downside protection. This can be the Cornerstone of your investment success going forward. You can thank us later.

Source: Cornerstone Investment Partners Fair Value Model universe of 800 stocks. Past performance does not indicate future results. As with all investments, the possibility for profit is accompanied by the risk of loss. Fair Value is a term relating to the Cornerstone Investment Partners' Fair Value Methodology. There is no guarantee these values will be achieved.