August 2022

From this weekend's WSJ:

U.S. Stocks Give Up Gains on Fed Fears

BY CAITLIN OSTROFF AND GUNJAN BANERJI

A late-summer selloff in the stock market accelerated in a volatile session Friday, with investors betting an encouraging monthly jobs report wouldn't ultimately alter the Federal Reserve's course on interest rates. Major indexes initially surged after the release of the jobs report but turned lower midday, capping a third consecutive week of losses. The end-of-week moves continued a stretch of turbulence that dragged the S& P 500 down 3.3% for the week and 8.3% over the past three weeks. ...

The tech-focused Nasdaq lost ... for a sixth consecutive session in its longest losing streak since August 2019. ... The Nasdaq tumbled 4.2% for the week, while the Dow shed 3%.

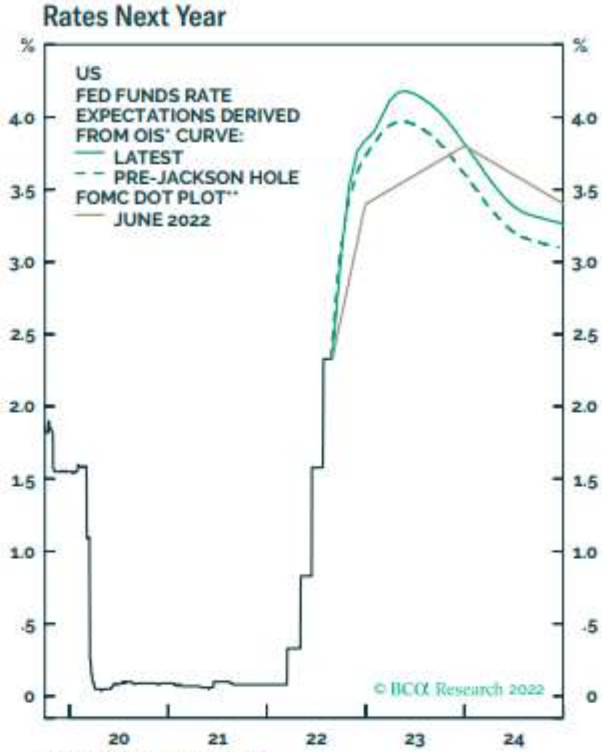
At first, the monthly jobs report appeared to hit a sweet spot for investors. The Labor Department said the U.S. economy added 315,000 jobs in August— roughly in line with what economists surveyed by The Wall Street Journal expected.

Meanwhile, wage growth came in below what investors and analysts forecast, an encouraging sign for the path of inflation. Some analysts referred to it as a "Goldilocks" report—strong enough to soothe fears about a slowing economy, but not so strong as to stir concerns about an even more aggressive path of interest rate increases ahead. ...

The optimism proved to be short-lived. By the afternoon, major indexes had given up those gains and traded lower. ... The path of rate increases remains the paramount concern of investors, and many are worried the central bank's aggressive tightening may tip the economy into a recession.

Since Fed Chairman Jerome Powell's speech in Jackson Hole on Aug. 26 when he reaffirmed the central bank's commitment to curbing inflation, traders have ramped up wagers on a faster pace of interest rate increases and ditched their stock bets. ...

CHART 1
Markets Still Think The Fed Will Start Cutting Rates Next Year



* OVERNIGHT INDEX SWAPS.
** SOURCE: FEDERAL RESERVE, SUMMARY OF ECONOMIC PROJECTIONS.

From Friday's Global Investment Strategy Report:

The Hawks Descend On Jackson Hole

Jay Powell's Jackson Hole address jolted the stock market last week. Citing the historical danger of allowing inflation to remain above target for too long, the Fed chair stressed the need for “maintaining a restrictive policy stance for some time.”

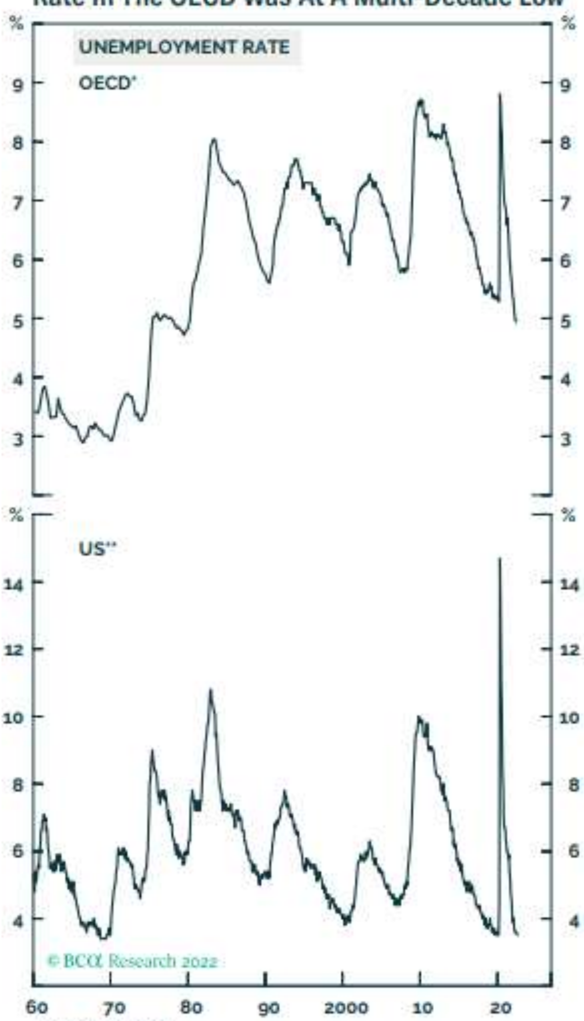
Powell’s comments were consistent with the Fed’s dot plot, which expects rates to remain above 3% right through to the end of 2024. However, with the markets pricing in rate cuts starting in mid 2023, his remarks came across as decidedly hawkish (**Chart 1**).

While Fedspeak can clearly influence markets in the near term, our view is that the economy calls the shots over the medium-to-long term. The Fed sees the same data as everyone else. If inflation comes down rapidly over the coming months, the FOMC will ratchet down its hawkish rhetoric, opting instead for a wait-and-see approach...

In early 2020 ... The unemployment rate in the OECD stood at 5.3%, the lowest in 40 years (**Chart 3**). In the US, the unemployment rate had reached a 50-year low of 3.5%. Thus, not surprisingly, as fiscal and monetary policy turned simulative, inflation moved materially higher.

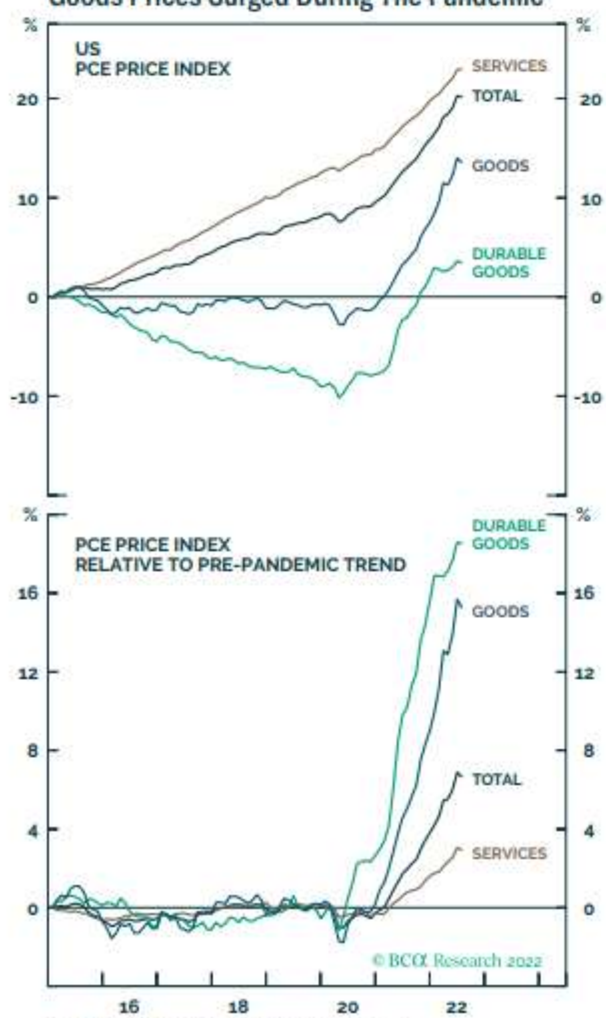
Goods inflation, in particular, accelerated during the pandemic (**Chart 4**). Perhaps most notably, the exodus of people to the suburbs, combined with the reluctance to use mass transit, led to a surge in both new and used car prices (**Chart 5**). The upward pressure on auto prices was exacerbated by a shortage of semiconductors, itself a consequence of the spike in the demand for electronic goods.

CHART 3
The Pandemic Began When The Unemployment Rate In The OECD Was At A Multi-Decade Low



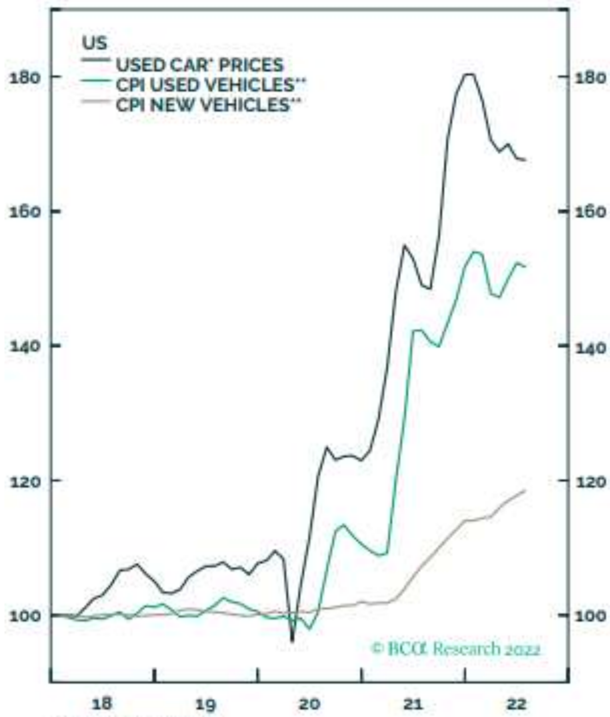
* SOURCE: OECD.
** SOURCE: BUREAU OF LABOR STATISTICS (BLS).

CHART 4
With Supply Unable To Meet Demand, Goods Prices Surged During The Pandemic



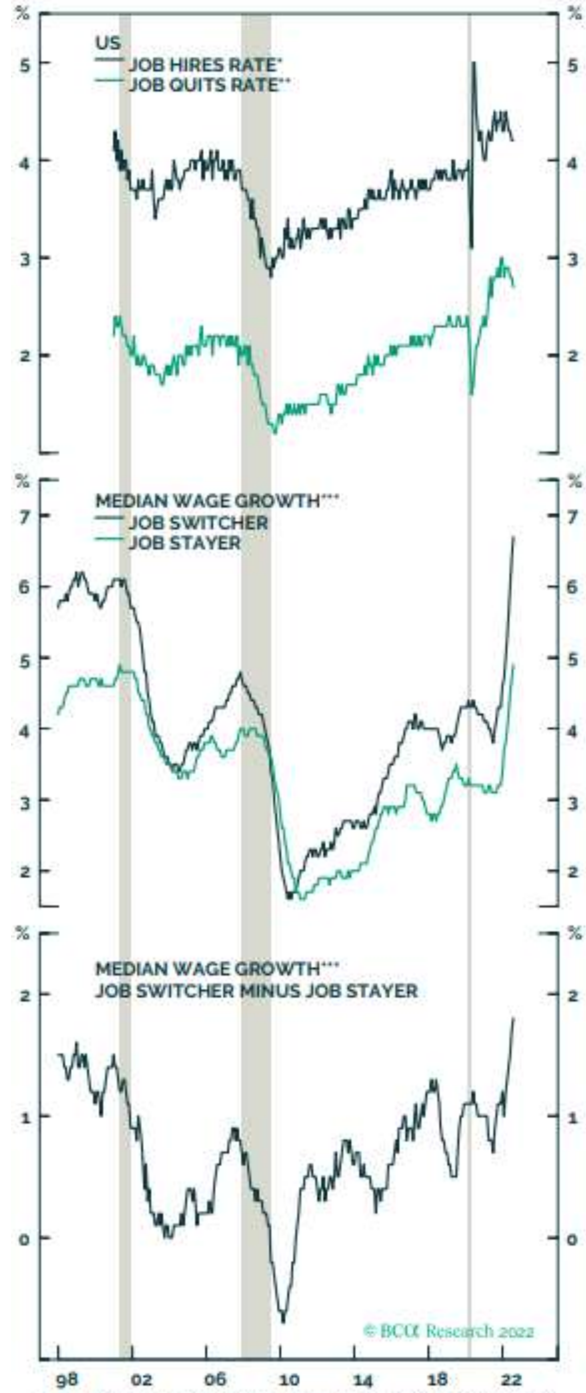
NOTE: ALL SERIES REBASED TO JAN. 2015 = 0%.

CHART 5
Car Prices Went On Quite A Ride During The Pandemic



* SOURCE: MANHEIM.
** SOURCE: BUREAU OF LABOR STATISTICS (BLS).
NOTE: SERIES SHOWN REBASED TO JAN. 2018 = 100.

CHART 7
Job Switchers Usually See Faster Wage Growth



* TRUCATED AT 5. SOURCE: BUREAU OF LABOR STATISTICS (BLS).
** SOURCE: BUREAU OF LABOR STATISTICS (BLS).
*** 12-MONTH MOVING AVERAGE OF MEDIAN WAGE GROWTH (HOURLY DATA). SOURCE: FEDERAL RESERVE BANK OF ATLANTA.

... Once the US unemployment rate fell back below 4%, wages began to accelerate sharply. ...

Faster labor market churn further turbocharged wage growth. Both the quits rate and the hiring rate rose during the pandemic. Typically, workers who switch jobs experience faster wage growth than those who do not (**Chart 7**). This wage premium for job switching increased during the pandemic, helping to lift overall wage growth.

A Symmetric Relationship?

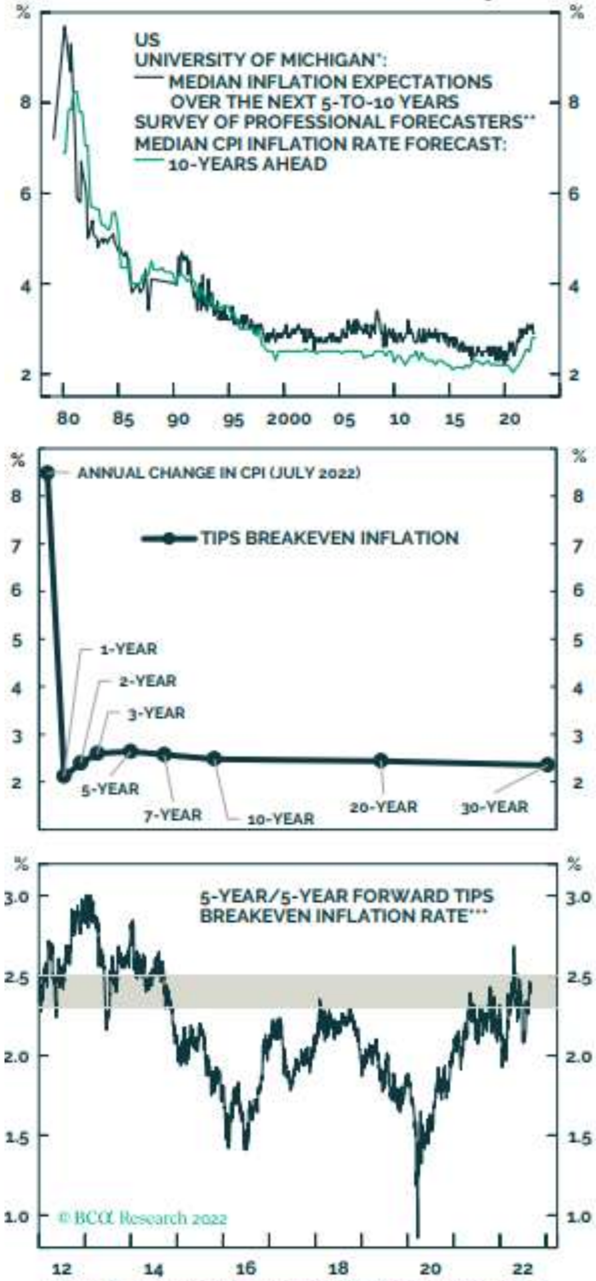
All this raises a critical question: If an increase in aggregate demand ... mainly leads to higher prices rather than increased output and employment, is the inverse also true – that is, would a comparable decrease in aggregate demand simply lead to much lower inflation without much of a loss in output or employment? If so, this would greatly increase the odds of a soft landing.

Skeptics would argue that disinflations are rarely painless. They would point to the 1982 recession which, until the housing bubble burst, was the deepest recession in the post-war era.

The problem with that comparison is that long-term inflation expectations were extremely high in the early 1980s. Both consumers and professional forecasters expected inflation to average nearly 10% over the

CHART 8

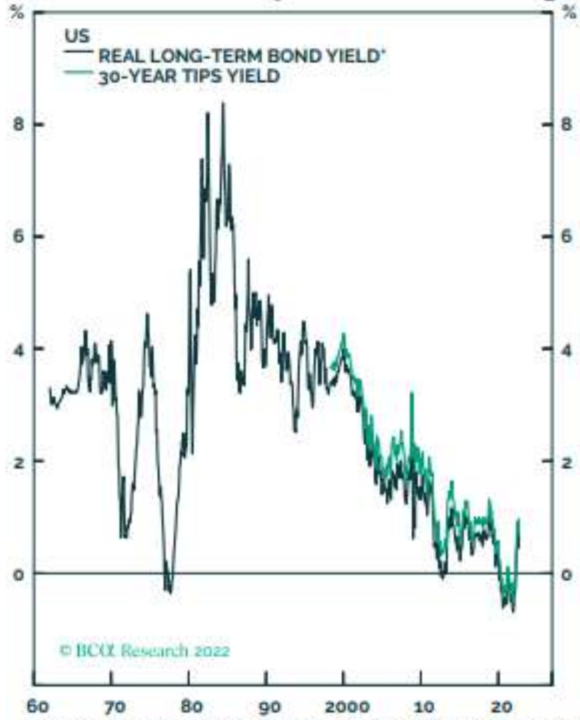
Long-Term Inflation Expectations Are Much Better Anchored Now Than In The Early 1980s



* SOURCE: UNIVERSITY OF MICHIGAN, SURVEY OF CONSUMERS.
** SOURCE: FEDERAL RESERVE BANK OF PHILADELPHIA.
*** THE FEDERAL RESERVE TARGETS AN AVERAGE INFLATION RATE OF 2% FOR THE PERSONAL CONSUMPTION EXPENDITURES (PCE) INDEX. THE TIPS BREAKEVEN IS BASED ON THE CPI INDEX. DUE TO COMPOSITIONAL DIFFERENCES BETWEEN THE TWO INDICES, CPI INFLATION HAS HISTORICALLY AVERAGED 30-TO-50 BASIS POINTS HIGHER THAN PCE INFLATION. THIS IS WHY THE FED EFFECTIVELY TARGETS A CPI INFLATION RATE OF 2.3%-TO-2.5%.

CHART 9

Real Long Terms Bond Yields Are Currently A Fraction Of What They Were Four Decades Ago



* CALCULATED AS 30-YEAR GOVERNMENT BOND YIELD MINUS LONG-TERM INFLATION EXPECTATIONS, WHERE LONG-TERM INFLATION EXPECTATIONS ARE DEFINED AS 30-YEAR CPI SWAP RATES FROM JULY 2004.

remainder of the decade (**Chart 8**). To bring down long-term inflation expectations, Paul Volcker had to engineer a deep recession.

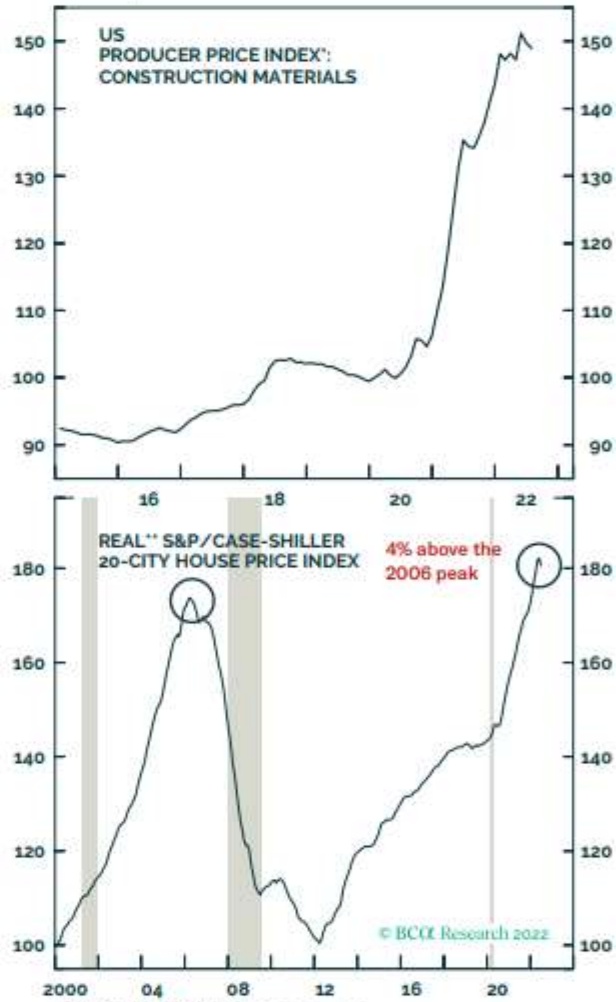
Jay Powell does not face such a problem (but is determined not to allow inflation expectations to rise significantly). Both survey-based and market-based long-term inflation expectations are well anchored. Whereas real long-term bond yields reached 8% in 1982, the 30-year TIPS yield today is still less than 1% (**Chart 9**).

The Impact of Lower Home Prices

While falling consumer prices would boost real incomes, helping to keep the economy out of recession, a drop in home prices would have the opposite effect on consumer spending.

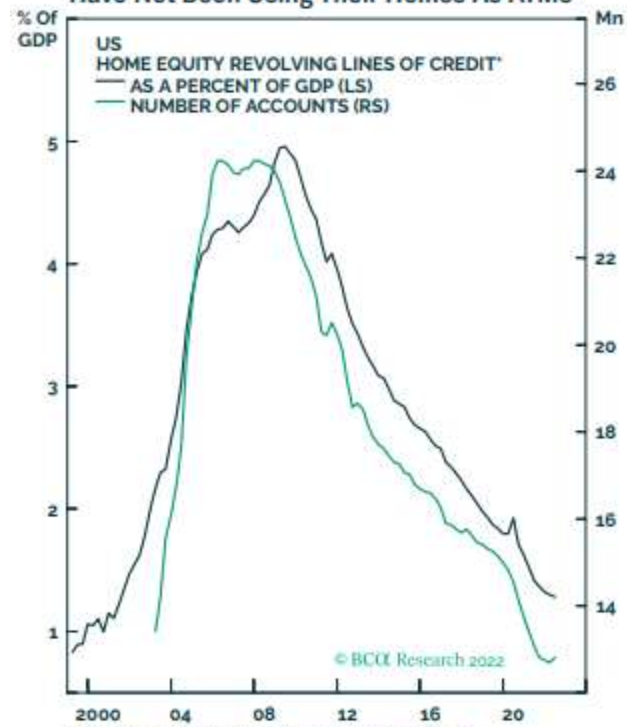
As occurred with other durable goods, a shortage of building materials and qualified workers prevented US homebuilders from constructing as many new homes as they would have liked during the pandemic. The producer price index for construction materials soared by over 50% between May 2020 and May 2022 (**Chart 10**). As a result, rising demand for homes largely translated into higher home prices rather than increased homebuilding.

CHART 10
Supply-Side Constraints Limited Home Building During The Pandemic, Helping To Push Up Home Prices



* SHOWN REBASED TO JAN. 2020 = 100.
SOURCE: BUREAU OF LABOR STATISTICS (BLS).
** DEFLATED BY HEADLINE CPI; SHOWN REBASED TO JAN. 2000 = 100.

CHART 11
Despite Higher Home Prices, Households Have Not Been Using Their Homes As ATMs



* SOURCE: FEDERAL RESERVE BANK OF NEW YORK.

Real home prices, as measured by the CaseShiller index, have increased by 25% since February 2020, rising above their housing bubble peak. ... US home prices will almost certainly fall in real terms and probably in nominal terms as well over the coming years.

How much of a toll will falling home prices have on the economy? It took six years for home prices to bottom following the bursting of the housing bubble. It will probably take even longer this time around, given that the homeowner vacancy rate is at a record low and reasonably prudent mortgage lending standards will limit foreclosure sales. Thus, while there will be a negative wealth effect from falling home prices, it probably will not become pronounced until 2024 or so.

Moreover, unlike during the housing boom, US households have not been tapping the equity in their homes to finance consumption (**Chart 11**). This also suggests that the impact of falling home prices on consumption will be far smaller than during the Great Recession. ...

Europe's Energy Squeeze

At this point, it looks like both the UK and the euro area will enter a recession. In continental Europe, the near-term outlook is grimmer in Germany and Italy than it is in France or Spain. The latter two countries are less vulnerable to an energy crunch (Spain imports a lot of LNG while France has access to nuclear energy). Both countries also have fairly resilient service sectors (Spain, in particular, is benefiting from a boom in tourism).

CHART 12

Europe: Squirrelling Away Gas For The Winter

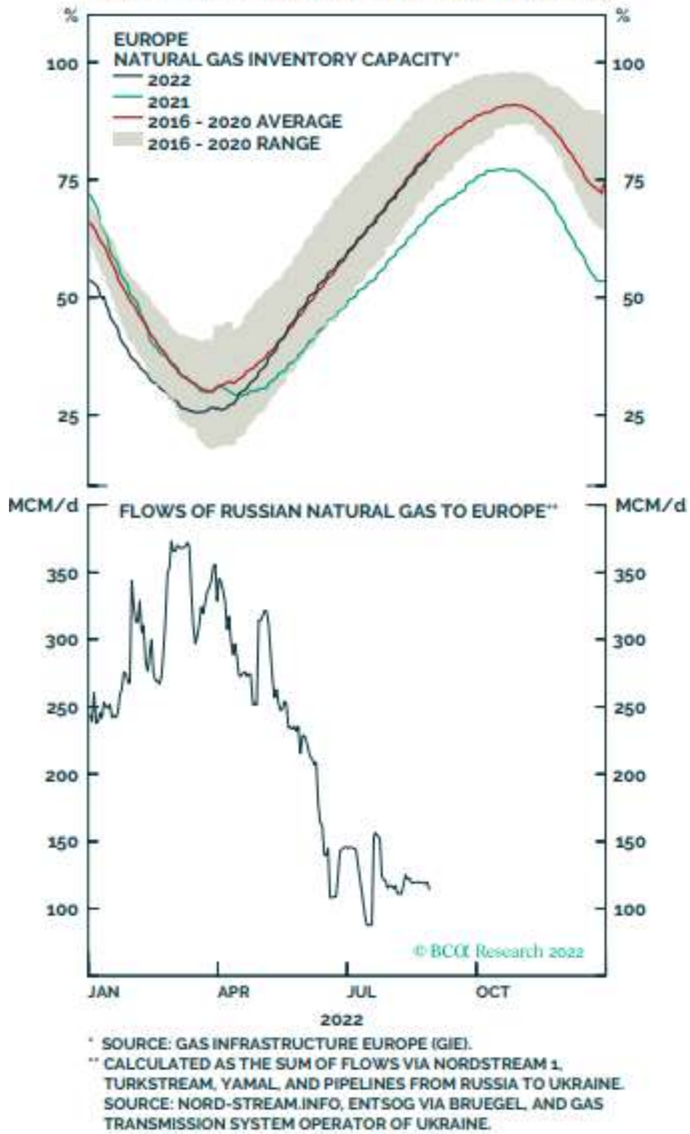
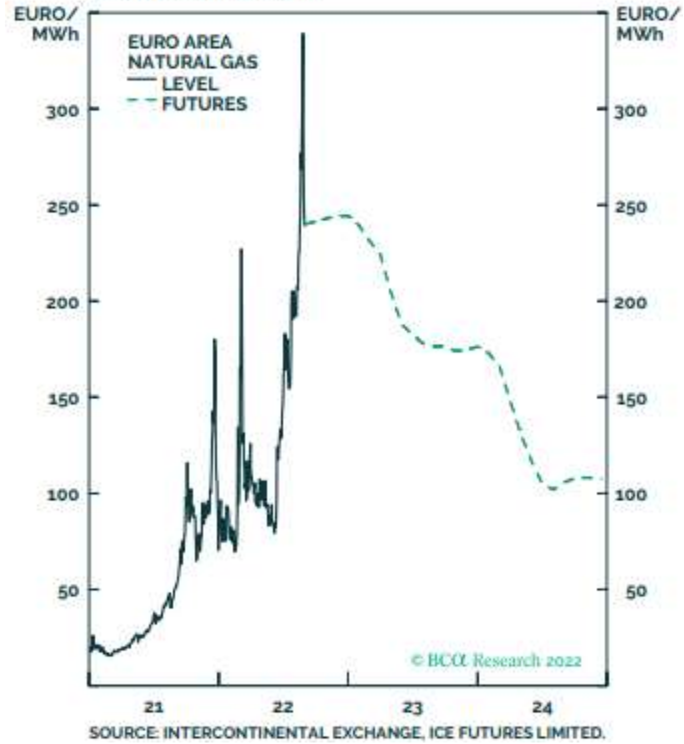


CHART 13

Natural Gas Prices In Europe Will Come Back Down To Earth



The good news is that even in the most troubled European economies, the bottom for growth is probably closer at hand than widely feared. Despite the fact that imports of Russian gas have fallen by more than 60%, Europe has been able to rebuild gas inventories to about 80% of capacity, roughly in line with prior years (**Chart 12**). It has been able to achieve this feat by aggressively buying gas on the open market, no matter the price. While this has caused gas prices to soar, it sets the stage for a possible retreat in prices in 2023, something that the futures market is already discounting (**Chart 13**).

Europe is also moving with uncharacteristic haste to secure new sources of energy supply. In less than one year, Europe has become America's biggest overseas market for LNG. A new gas pipeline linking Spain with the rest of Europe should be operational by next spring.

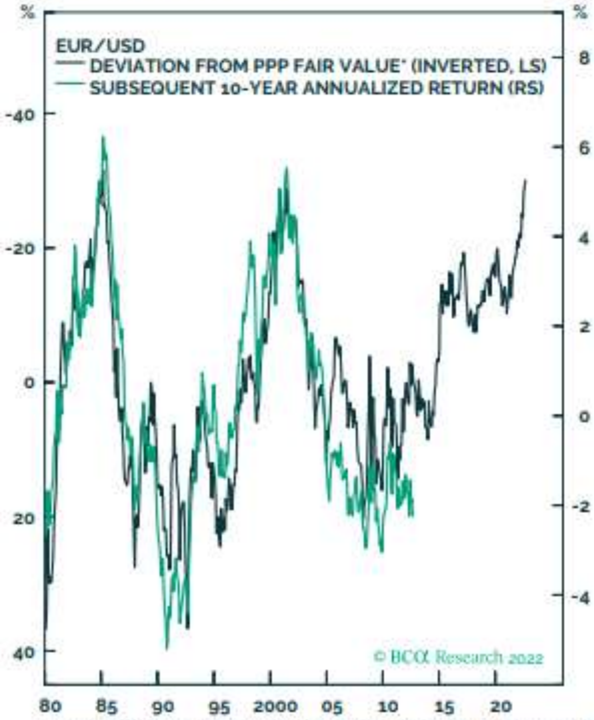
In the meantime, Germany is building two "floating" LNG terminals. Germany has also postponed plans to mothball its nuclear power plants and has approved increased use of coal-fired electricity generators.

France is seeking to boost nuclear capacity. As of August 29, 57% of nuclear generation capacity was offline. Electricité de France expects daily production to rise to around 50 gigawatts (GW) by December from around 27 GW at present.

For its part, the Dutch government is likely to raise output from the massive Groningen natural gas field.

CHART 14

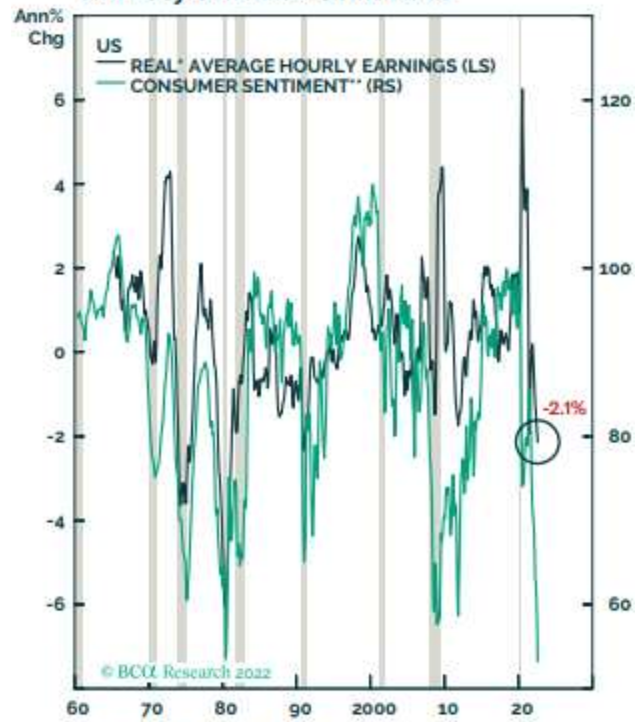
The Euro Is Undervalued



* BCA PURCHASING POWER PARITY MODEL BASED ON ADJUSTED CPI.

CHART 15

Falling Inflation Should Boost Real Wages And Buoy Consumer Confidence



* DEFLATED BY HEADLINE CPI.
** SOURCE: UNIVERSITY OF MICHIGAN, SURVEY OF CONSUMERS.
NOTE: BOTH SERIES SHOWN AS 3-MONTH MOVING AVERAGES; SHADED AREAS DENOTE NBER-DESIGNATED RECESSIONS.

All this suggests that contrary to the prevailing pessimistic view, Europe is heading for a V-shaped recovery. The euro, which is 30% undervalued against the US dollar on a purchasing power parity basis, will rally (**Chart 14**).

Investment Conclusions

On the eve of the pandemic, most developed economies were operating at close to full capacity.... Not surprisingly, in such an environment, pandemic-related stimulus, rather than boosting output, simply stoked inflation.

Looking out, the inverse may turn out to be true: Just as an increase in aggregate demand did more to lift prices than output during the pandemic, a decrease in aggregate demand may allow inflation to fall with little loss in production or employment.

Will this be the end of the story? Probably not. As inflation falls, US real wage growth, which is currently negative, will turn positive. Consumer confidence will improve, boosting consumer spending in the process (**Chart 15**). ... triggering a “second wave” of inflation in the back half of 2023.

Rather than cutting rates next year, as the market still expects, the Fed will raise rates to 5%. This will set the stage for a recession in 2024.

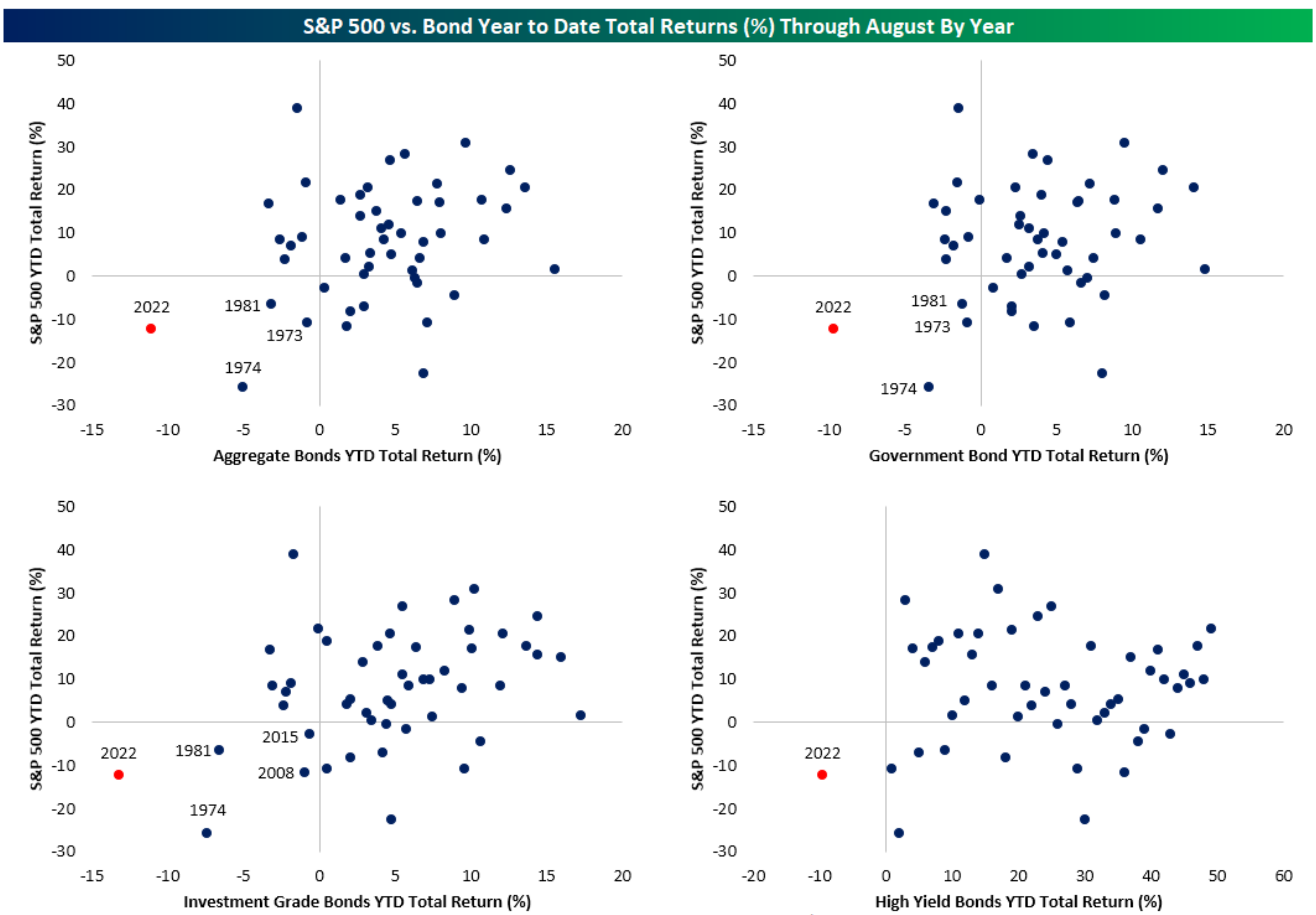
Investors should overweight global equities over the next six months but look to turn more defensive thereafter.

From Bespoke on Aug. 25:

2022 Slams Both Stocks and Bonds

It is no secret that 2022 has not exactly been the year of the 60/40 portfolio. This year has left nothing safe with both stocks and bonds hit hard. Both are in the red by 10%+ on a year to date basis headed into the final week of August. In the charts below, we show the year to date total returns of the S&P 500 (y-axis) and the year to date total returns of various ICE Bank of America bond indices (x-axis) through August for each year going back to their respective inceptions (each index began in 1973 except for high yield which began in 1987). No matter which way you cut it, 2022 has been the worst year of the past half century for stocks and bonds combined.

With the S&P 500 down a little over 12% YTD, aggregate bonds (government and corporate bonds combined) are only around one percentage point better. For the comparable time of the year, the only years that also have seen both bonds and stocks sitting on a loss through August were 1973, 1974, and 1981. The same applies for government bonds. The corporate investment grade bond index has a bit more variety of years with stocks and bonds falling in 1974, 1981, 2008, and 2015. Again though, none of those other years have seen as sharp of a decline as 2022, and the S&P 500's drop in the same time also ranks as one of the worst. 2022 is the only year that the high yield bond index has fallen simultaneously with stocks, however as we noted earlier, it does not have as long of a history as those other categories.



** ICE BofA Bond Indices since inception. Year to date total return through the end of August and through 8/24 for 2022.*

From Verdad on Aug. 29::

Abandoning Diversification

Does the S&P 500 deserve its premium valuation over small, international, and value stocks?

By: Daniel Rasmussen

We are believers in the benefits of international diversification. We are convinced by the long-term evidence that value stocks should earn a premium over time. And we think there's a greater opportunity for alpha generation in small and micro caps compared to mid and large caps.

But those beliefs about how to invest over the long term have not been short-term winners. On the contrary, the winning trade over the last decade has been to go long US technology stocks or to put the bulk of your money in the passive indices they dominate (the S&P 500 and the Nasdaq).

There are two ways to interpret the clash between long-term evidence and short-term results.

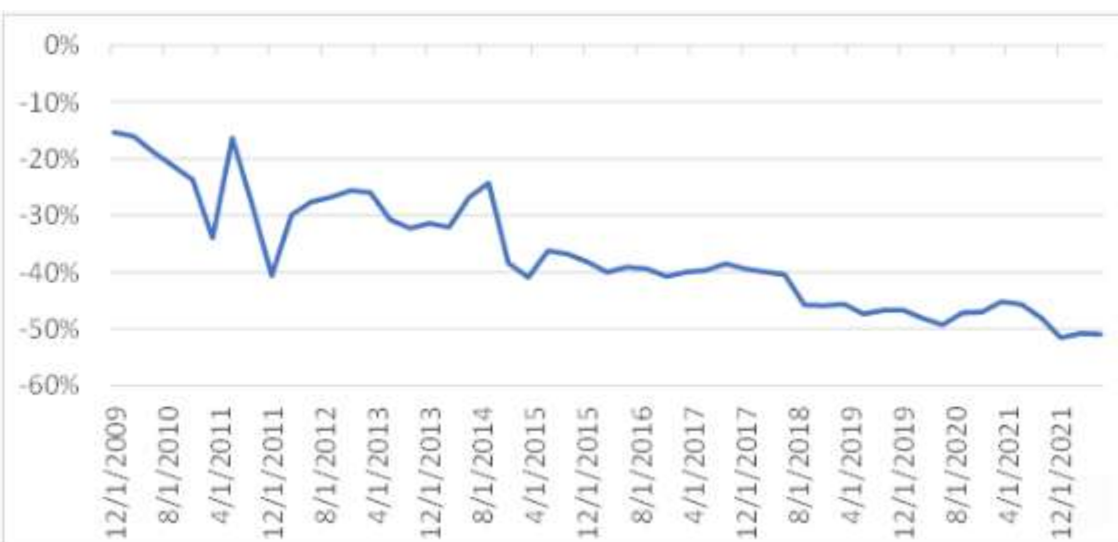
The first is the idea that there's been a paradigm shift: that the US economy is simply a far better engine than Europe or Asia, that software is eating the world, that traditional industries are in decline, and that we've entered a winner-takes-all world where large caps should dominate small caps.

The second is the idea that markets are cyclical, that what works one decade rarely works the next decade, and that the recent results were largely attributable to changes in valuations and investor preferences that have little predictive power for the next decades' fundamentals.

It's hard to prove the first interpretation, though there's certainly a plethora of anecdotal evidence. But the way to evaluate the second interpretation would be to look first at the extent to which changes in valuation multiples have explained stock returns rather than changes in fundamentals.

Let's start with international stocks versus US stocks. The below chart shows the discount on enterprise value-to-sales ratio of international stocks (as measured by the S&P International 700 index) versus US stocks (as measured by the S&P 500 index).

Figure 1: International Discounts on EV/Sales vs US Stocks

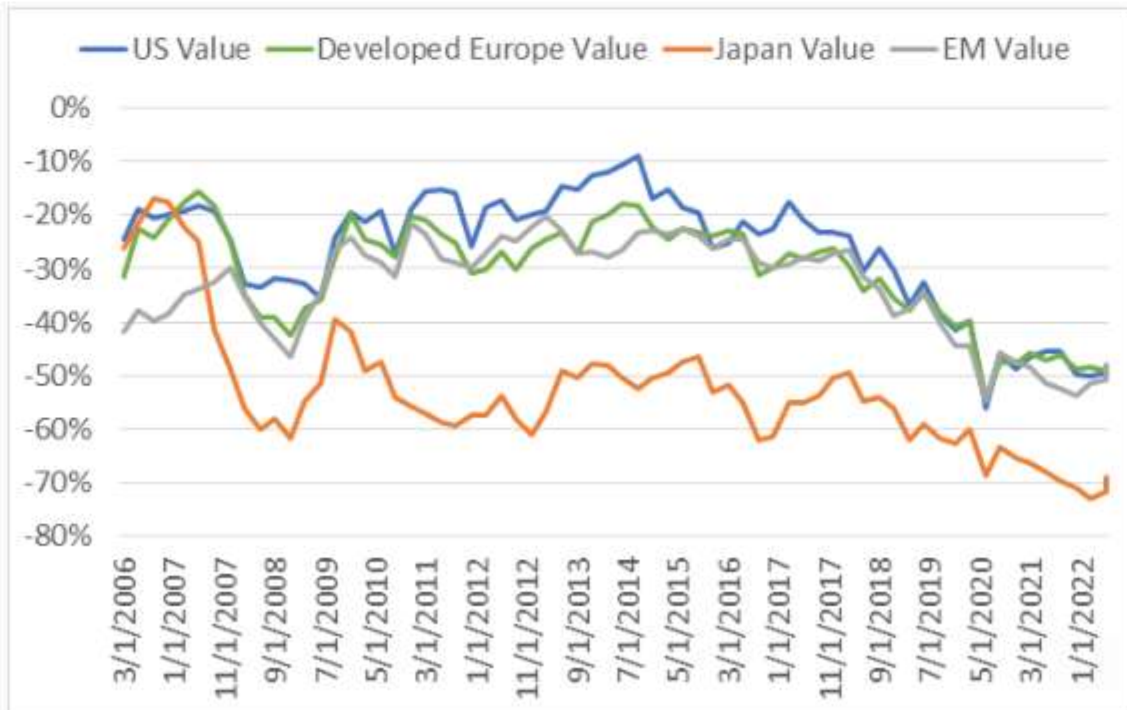


Source: Capital IQ

Over the past decade, international stocks went from trading at about a 15% discount to US stocks on EV/sales to a 50% discount, making quite a dramatic case for the cyclical theory.

... The below chart compares the EV/EBITDA ratio for the cheapest 30% of stocks in each market to that of the S&P 500 index.

Figure 2: International Value Discount Relative to the S&P 500



Source: Capital IQ. NOTE: Value stocks defined as the cheapest 30% of all stocks with a minimum market capitalization of $25M.

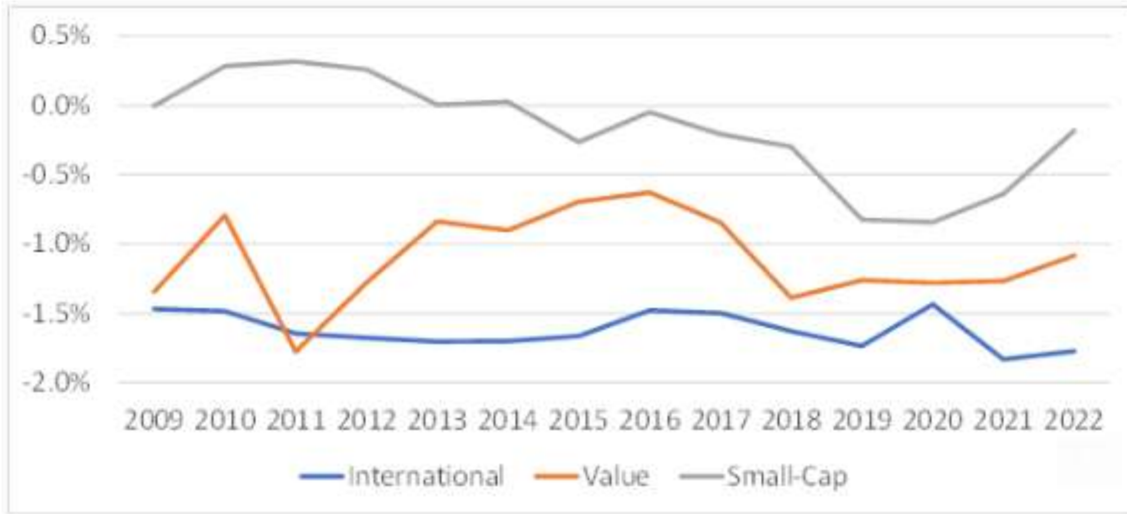
Value stocks globally "cheapened" by 20 percentage points or more over the past decade relative to the S&P 500. US, developed Europe, and EM value stocks are now trading at a 50% discount to the S&P 500, while Japan is trading at a staggering 70% discount. This is ignoring the size effect, which should further widen the discount.

The valuation multiples of international stocks, small-cap stocks, and value stocks have become significantly cheaper relative to US stocks over the past decade, with discounts in some cases widening more than 35 percentage points.

The natural next question, though, is to what extent this steep discount is justified by fundamentals. Three of the most common rationalizations are differences in return on assets, margins, and growth rates.

Let's start with return on assets. The below chart shows the difference between the return on assets of the S&P 500 and international stocks (as measured by the S&P International 700), small-cap stocks (as measured by the S&P 600), and value stocks (as measured by the S&P 500 Pure Value) over the past 13 years.

Figure 3: ROA of International, Value, & Small-Cap Stocks Minus the S&P 500



Source: Capital IQ

The chart shows that, while international stocks, value stocks, and small-cap stocks have lower ROAs on average than US stocks, the differences are small and there's been relatively little change over time.

We next look at margins. The below chart shows the difference between the EBITDA margins of the S&P 500 and international, small-cap stocks, and value stocks (as measured by the same indices as in Figure 3 above).

Figure 4: EBITDA Margins of International, Value, & Small-Cap Stocks Minus the S&P 500

Source: Capital IQ

International stocks, value stocks, and small-cap stocks have lower margins than S&P 500 stocks but are relatively unchanged from a decade ago, albeit with high volatility for value stocks.

When looking at return on assets or margins, we don't see the type of sharp drop that we see in the valuation multiples. Nothing about ROA or margins explains the sharp drop in valuations for international, value, and small-cap stocks relative to the S&P 500.

But what about growth? The below chart compares the trailing three-year revenue CAGR of international stocks, small-cap stocks, and value stocks relative to the S&P 500 over the past decade.

Figure 5: Growth Rates of International, Value, & Small-Cap Stocks Minus the S&P 500

Source: Capital IQ

Small caps have consistently grown revenues faster than large caps, which makes their discount puzzling on this metric. Value stocks have swung from growing faster to growing slower to growing faster to growing slower, and we suspect this volatility will continue, making the current valuation gap for value stocks seem difficult to justify.

The case for a fundamental gap is best for international stocks. International stocks have consistently grown slower than US stocks by about 5% per year over the past decade. This seems perhaps the closest to a fundamental explanation for the lagging relative returns of value and international stocks, if we believe that growth is predictable and persistent and that US companies will continue to have a significantly higher growth rate than international stocks.

The question of whether US or international stocks will have faster revenue growth over the next decade is insoluble. But we can ask a more basic question: are growth rates persistent and predictable? We will be publishing a major study on that topic this fall, one that we hope will help contextualize this question. And if, as we plan to argue, growth rates are neither persistent nor predictable, then extrapolation of the international growth lag into the future might be creating a big and exploitable expectation error for investors.

Perhaps at the time when many investors are abandoning diversification in favor of putting all their money in the S&P 500, it’s time to reconsider—and make the bet—that valuation gaps that have driven wide relative return differences might be strongly mean reverting.

From Morningstar:

Where Do Active Fund Managers Hold the Upper Hand?

These are the markets where active managers reign supreme.

Bryan Armour
Aug 16, 2022

Diversified, low-cost index funds are tough to beat. They are a living account of the market, perpetually changing with every trade. By owning the market, these funds collect all the bets made by active managers, then turn around and sell that portfolio back to investors at a low price.

On average, passive funds outperform active funds using this framework. But it doesn't work in every corner of the market. Passive funds intentionally avoid discretion. As Jack Bogle put it, "the two greatest enemies of the equity fund investor are expenses and emotions." But certain markets benefit from a dose of discretion and aren't suitable for systematically buying and selling securities. Here, I'll highlight active fund success rates and compare returns in several Morningstar Categories, then discuss the circumstances under which active managers hold the upper hand.

Success Rates of Active Funds

Morningstar's Active/Passive Barometer tracks success rates for active managers in several categories and over different time horizons. Successful active funds must survive and beat the average of their passive peers over a given period. Exhibit 1 shows active funds' success rates over the trailing 10 years through the end of 2021. Passive funds tend to do particularly well in the United States, especially in large-cap stocks. Foreign developed-markets stock funds are relatively steady across the Morningstar Style Box, with active funds winning nearly one third of the time over the past 10 years. ... The categories where active funds had roughly a 50% success rate over the past 10 years are emerging markets (which we avoid), real estate, and high-yield bonds (also avoid). Even in those circumstances, success rates grow significantly across most categories when targeting the cheapest active funds (which we target, along with Process).

Categories Where Active Funds Skewered Passive Funds

Success rates illustrate how often active funds beat their average passive peer, but funds that succeed may not outperform by the same margin as those that underperform. The skew of the distribution of active funds' excess returns versus the average surviving passive fund adds more nuance. In some categories, active funds that successfully outperform their passive peers do so by a wide margin.

As a proxy for skew, I compared active and passive funds' average asset-weighted 10-year returns with the success rate of active funds by category. ... half of active funds beat their average passive peer in global real estate (SREZX, a 5* actively managed OEF, is our choice for Funds only clients in this category.), yet the 10-year equal-weighted return of active funds was 1.3 percentage points higher than passive funds. ...

Exhibit 1 Active Funds' Success Rate by Category (%)

Category	1-Year	3-Year	5-Year	10-Year	15-Year	20-Year	10-Year (Lowest Cost)*	10-Year (Highest Cost)
U.S. Large Blend	41.4	33.5	20.6	9.5	9.4	9.3	19.2	1.3
U.S. Large Value	34.1	37.0	21.9	14.8	12.8	13.4	27.1	9.8
U.S. Large Growth	31.9	31.5	31.8	8.2	6.2	5.5	18.0	3.4
U.S. Mid Blend	66.7	30.0	18.8	16.9	7.7	6.6	29.2	4.0
U.S. Mid Value	28.8	53.2	37.1	10.7	25.6	—	9.1	28.6
U.S. Mid Growth	46.0	52.2	56.1	37.9	22.3	—	41.5	32.6
U.S. Small Blend	58.6	39.1	23.2	17.2	12.3	19.8	31.4	13.9
U.S. Small Value	37.1	41.4	36.2	20.2	26.9	17.9	20.0	5.0
U.S. Small Growth	47.4	65.8	55.1	44.0	27.9	12.9	48.8	48.8
Foreign Large Blend	43.7	51.4	38.5	31.6	29.1	23.2	48.6	18.4
Foreign Large Value	33.7	54.7	35.6	29.8	11.4	—	28.6	14.3
Foreign Small-Mid Blend	48.1	48.5	31.3	31.8	—	—	75.0	40.0
World Large-Blend	38.9	26.5	18.9	16.7	—	—	22.2	10.0
Diversified Emerging Markets	30.1	61.3	47.4	54.4	40.7	—	69.0	53.3
Europe Stock	53.3	73.7	50.0	42.9	37.9	21.8	80.0	16.7
U.S. Real Estate	82.5	83.6	64.2	48.5	27.0	41.1	50.0	30.8
Global Real Estate	83.3	72.2	62.9	50.0	—	—	33.3	50.0
Intermediate Core Bond	69.2	47.0	43.2	37.8	17.0	8.8	54.8	20.6
Corporate Bond	64.2	47.5	26.0	28.9	—	—	33.3	25.0
High-Yield Bond	72.0	56.1	44.7	55.3	—	—	76.9	36.7

Source: Morningstar. Data and calculations as of Dec. 31, 2021. *Green/red shading indicates that active funds in this fee quintile had above/below-average success rates.

Global real estate funds share ... a niche, illiquid market. There are also major differences in the structure of real estate securities globally: The U.S., United Kingdom, and Australia favor REITs, while China and Hong Kong favor real estate development companies, for example.

Intercategory trends spotlight key considerations for whether to choose active or passive funds. For example, navigating illiquid foreign markets is a tough task for an inflexible index. The most critical market features to consider before deciding between a passive or active fund are liquidity, representativeness, efficient pricing, and cost.

Indexes Prefer Liquid Markets

Liquidity, or the ability to easily trade securities, is a defining feature of markets where passive investing rules the roost. The flip side is that passive funds' mechanical rules become cumbersome in illiquid markets, potentially leading to a breakdown in their process and high transaction costs. Active managers can benefit from discretion in illiquid markets by searching for good prices and walking away when the costs outweigh the benefits. Passive funds don't have that same flexibility.

Passive investors benefit from competitive, liquid markets with tight bid-ask spreads. This leads to efficient trading and low transaction costs. Portfolio rebalances can be swept in with the rest of the market activity, making it hard for other participants to anticipate and benefit off rebalancing trades. Likewise, the cost of mechanically buying and selling into wide spreads adds up quickly. The bigger the fund, the more magnified the market impact of its trades, especially in illiquid markets.

Indexes' Ability to Represent the Market

Index providers can avoid collecting high transaction costs by adding index rules to focus on more-liquid securities. When index funds employ restrictive liquidity screens ..., they lose their ability to fully represent the market where the fund is deployed. Excluding certain securities means the portfolio no longer owns the market, and the fund must balance costs and remaining representative of the underlying market.

The goal of an index fund to construct a low-cost portfolio of active bets breaks down when trades occur outside of the index fund's opportunity set with frequency. In these scenarios, active funds can take advantage of passive funds' more-narrow opportunity set by hunting for alpha in the slices of the market excluded by passive funds.

Accurate Pricing

The U.S. large-cap market is a prime example of efficient pricing, whereby information on companies is readily available and quickly embedded in their prices. This leaves little room for active managers to identify mispriced stocks, making it difficult to earn back their higher fee. Active managers are better suited in markets where information is less accessible and mispricing is abundant, like in small-cap stocks (which is where we also employ selective actively managed OEFs, particularly in the Foreign Small-Mid categories) .... However, it is difficult for active managers to consistently identify and take the right side of mispriced stocks, so manager selection is crucial.

Costs Are Critical

Comparing the costs of the average active fund against index funds charging next to nothing oversimplifies the math of active versus passive. Exhibit 1 takes a closer look at how fees affect success rates. Comparing the 10-year success rates of all active funds versus the cheapest quintile of active funds shows that choosing a low-cost active fund clearly boosts investors' success rates. Investors in active funds in the cheapest quintile of fund fees have a 10-percentage-point higher chance of beating passive peers, per the average success rate across each category equally. Cheap active funds were particularly effective in the foreign small-mid blend, Europe stock, and fixed-income categories.

Final Verdict

The Morningstar Active/Passive Barometer clearly flagged categories in which investors may want to consider using an active manager over passive funds. ...

Going back to Bogle's quote, emotion can sway investor success all by itself. After selecting an active manager in a particular category, that fund may go in and out of style. Investors have a knack for chasing returns and buying high when a manager gets hot, then selling low when the strategy sours. ...

Follow-ups

A figure from Verdad's Aug. 15th Weekly Research clearly illustrates why we repeatedly warn against investing in Emerging Markets (EM), showing compound annual growth rates (CAGR), and standard deviations (SD), a common risk metric:

EM equity market volatility is in line with arguably the most cyclical US equity class, small-cap value. However, EM returns are considerably worse.

Figure 3: Performance Indicators by Asset Class (USD Returns, 7/1989 – 6/2022)

Source: Capital IQ, MSCI, FRED.