The Surprising Results from S&P's Latest SPIVA Analysis

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S&P's SPIVA scorecard provides persuasive evidence of the futility of active management. But its most recent scorecard illustrates something else – why active managers underperform even in the best performing asset class.

Since 2002, S&P Dow Jones Indices has published its S&P Indices Versus Active (SPIVA) scorecard, which compares the performance of actively managed equity mutual funds to their appropriate index benchmarks. The 2019 Mid-Year Report includes 15 years of data. Following are some of its highlights:

- Over the 15-year period ending June 2019, 90% of large-cap, midcap and small-cap funds underperformed their benchmark S&P indices. In only one asset class, large value (80% underperformed), was the percentage of underperformers below 86%.
- Over the 15-year period, on an equal-weighted (asset-weighted) basis, the average actively managed U.S. equity fund underperformed by 1.4% (0.74%)per annum. The worst performances were small caps, with active small-cap growth managers underperforming on an equal-weighted (asset-weighted) basis by 1.99% (0.90%) per annum, active small-cap core managers underperforming by 2.43% (1.82%) per annum, and active small--value managers underperforming by 2.00% (1.71%) per annum. So much for the idea that the small-cap asset class is inefficient and active management is the winning strategy.
- Over the 15-year period, across all international equity categories, a large majority of active managers underperformed their respective benchmarks. For example, 82% of active global funds underperformed, 90% of international funds underperformed, 73% of international small-cap funds underperformed, and in the supposedly inefficient emerging markets, 94% of active funds underperformed.
- Over the 15-year period, on an equal-weighted (asset-weighted) basis, active global funds underperformed by 1.32% (0.36%) per annum, active international funds underperformed by 1.83% (0.68%) per annum, and active emerging market funds produced the worst performance, underperforming by 2.34% (1.09%) per annum. And while on an equal-weighted basis, international small-cap funds underperformed by 0.70%, on an asset-weighted basis, they managed to slightly outperform (+0.19%).
- The performance in fixed income funds was also poor. Over the 15-year period, in none of the 14

categories did the majority outperform. Fewer than 82% underperformed in only three cases, more than 90% underperformed in five cases, and 99% underperformed in high-yield funds, the worst-performing category. On an equal-weighted basis, the underperformance ranged from 0.1% (global fixed income funds) to as much as 3.46% (government long-term funds). The news was better on an asset-weighted basis, with active funds outperforming in three categories: investment-grade intermediate-term (0.37%), investment-grade short-term (0.37%) and global income (0.89%). In the other 11 categories, the worst performances were in long-term government (refuting the claim that active managers can time bond markets), underperforming by 2.89%; long-term investment grade, underperforming by 2.3%; and high yield, underperforming by 1.51%.

- Highlighting the importance of accounting for survivorship bias, over the 15-year period, 57% of domestic equity funds, 49% of international equity funds, and 52% of all fixed income funds were merged or liquidated.

Before concluding, there's one more finding regarding short-term performance that is important to discuss. For the one-year period ending June 2019, while 71% of domestic equity funds underperformed the S&P Composite 1500 – as did the majority of large caps (70%) and multicaps (72%) – midcap and small-cap active funds performed better, with approximately 64% of active managers in both categories beating their benchmarks for the one-year period. Before you jump to any conclusion, we need to discuss the law of style purity, otherwise known as "Dunn's law."

Dunn's law

Dunn's law states that when an asset class does well, index funds will outperform active managers in that asset class. However, when an asset class does poorly, active managers have a greater chance to outperform their benchmark index. The logic is simple. Index funds generally have the greatest exposure to the relevant risk factor responsible for the vast majority of the returns. In other words, when large-cap stocks are the leading asset class, index funds will dramatically outperform large-cap active managers. This has been the case in the recent past.

The reason is that active managers tend to style drift (i.e., large-cap funds often own mid- and small-cap stocks, and small-cap funds often own mid- and large-cap stocks). Thus, active managers lose some of their exposure to both the "winning" and "losing" asset classes. In other words, active managers of large-cap mutual funds tend to own smaller-cap stocks than those in the S&P 500 Index, and active small-cap managers tend to own larger-cap stocks than in the S&P 600 Index.

With this concept in mind, let's review the performance of large-, mid- and small-cap stocks over the period July 2018 through June 2019 – the most recent year for the SPIVA Mid-Year 2019 scorecard. The large stocks in the CRSP 1-2 Index (the two largest deciles) returned 10.6%, far outperforming the stocks in the midcap CRSP 3-5 Index (which returned just 4.6%) and the stocks in the small-cap CRSP 6-10 Index (which actually lost 4.7%). Dunn's law predicts that based on this relative performance, we would expect that active large-cap managers would perform the worst, and active managers in the mid- and small-cap categories might outperform – which is exactly what happened over the most recent one-year period.

The academic evidence, and the long-term SPIVA results, demonstrate that as a group, active managers fail miserably at intentionally style drifting to the asset class that will outperform. Thus, we can conclude that the recent outperformance in the mid- and small-cap categories has nothing to do with stock-picking skills and everything to do with style drift. Keep this in mind the next time you hear that “it’s a stock-picker’s market.” It never is.

While the preceding data is compelling evidence of the active management industry’s failure to generate alpha, the report’s figures are based on pretax returns. Given that actively managed funds’ high turnover generally makes them less tax efficient, on an after-tax basis the failure rates would be much higher (taxes are often the greatest expense for active funds).

Conclusion

The SPIVA scorecards continue to provide powerful evidence of the persistent failure of active management’s ability to generate alpha (risk-adjusted outperformance). In particular, they serve to highlight the canard that active management is successful in inefficient markets like small-cap stocks and emerging markets.

We continue to see a persistent flow of assets from actively to passively managed funds. As the scorecards and countless academic studies have documented, the odds of identifying an actively managed fund that will outperform an appropriate benchmark are exceedingly small.

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