Russell Investments

Russell Research

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The cycle of success: The cyclical nature of active growth investing

Investors are often reminded that past performance is not a good indicator of future results. This commonplace advice has proven to be true with respect to stocks, asset classes and, in our view, active management returns across capital markets cycles. We believe that chasing active management returns, or reflexively rotating from active to passive equities as a result of poor active returns, can be highly detrimental to investment returns in the long run. We also believe that despite a difficult environment for active U.S. large cap growth managers over the last several years, the future looks bright for skilled active managers in this space.

Introduction: a historically difficult time for active growth investing

Since the onset of the financial crisis in 2008, the U.S. equity market has been impacted meaningfully by macroeconomic and political events, both domestic and international. In retrospect, it seems that a cascade of events – the sub-prime lending crisis, the Arab Spring uprisings, the European sovereign debt crisis, and the fractious U.S. debt ceiling and budget deficit debates, to name just a few – induced significant equity market movements that were largely unrelated to stock-specific fundamentals. This has presented a very challenging environment for active managers across many equity investment styles.

To illustrate, Table 1 shows the recent experience of managers in Russell's three primary U.S. large cap style universes. Most managers in Russell's U.S. large cap market-oriented and growth universes have trailed their benchmarks over the past five years, and the median value manager was only slightly ahead of its benchmark.

Table 1: Russell universe median annualized excess returns, 2008–2012

	Value	Market-oriented	Growth
Russell Universe Median (%)	0.72	1.75	1.7
Primary Benchmark* (%)	0.59	1.92	3.12
Excess Return (%)	**0.13**	**-0.17**	**-1.42**

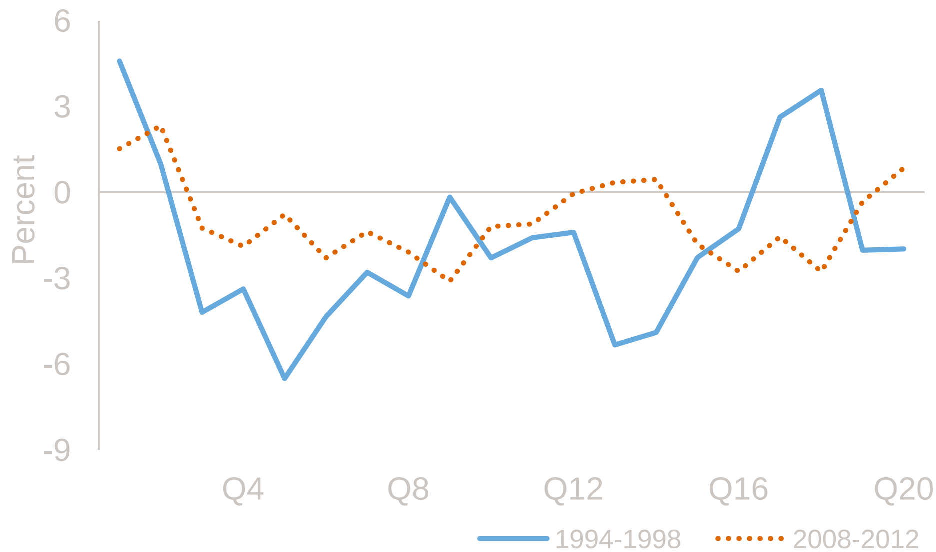
Primary benchmarks for Russell Value, Market-oriented, and Growth universes are the Russell 1000® Value Index, the Russell 1000® Index, and the Russell 1000® Growth Index, respectively.

Despite these challenges, generally speaking Russell remains a proponent of active investing in large cap U.S. equities. Given the poor excess return outcomes over the last five years, it would certainly be reasonable to question our position. However, we believe that excess returns from active investing are cyclical in nature. In our decades of equity manager research and multi-manager investing, Russell has witnessed extended weak periods for active equity investing. We have also seen substantial rebounds in excess returns when active management returned to favor. We continue to advocate for active equity investing because, over longer-term investment horizons that encompass both favorable and unfavorable environments for active management, as indicated in Table 3, we have seen the benefits to investor portfolios of an approach that combines active equity management and skilled manager selection.

The mid-1990s all over again?

To illustrate the cyclicality of active investing, this paper focuses on comparing the recent experience of active managers in Russell's U.S. large cap growth universe, hereinafter referred to as "growth managers," to that during a multi-year period in the mid-1990s. Figure 1 illustrates the similarity in one-year rolling excess returns for the Russell growth universe median manager in the 1994–1998 period and for the last five calendar years, 2008–2012.

Figure 1: One-year rolling excess returns – Russell growth universe median manager versus Russell 1000® Growth Index, 1994–1998 and 2008–2012



Indexes are unmanaged and cannot be invested in directly. Past performance is not indicative of future results.
Source: Russell

The return experiences were similarly poor in these periods because the market environments shared many common attributes that serve as headwinds to active management – e.g., the markets favored mega cap stocks; the Consumer Staples sector outperformed; and strategies that emphasized earnings and price momentum and earnings acceleration and surprises underperformed. (We address these similarities in more detail later in the paper.)

There were similarities in investor moods as well. In 1997, in a Russell research paper titled "Have Growth Managers Lost Their Touch?", Paul Greenwood acknowledged that "the unprecedented magnitude of [active management's] underperformance has left many institutional investors questioning the abilities of their growth managers and seriously considering passive alternatives." Yet Greenwood counseled clients to maintain their allocations to active large cap growth management, as Russell does now. And while benchmark-relative performance did not improve immediately, it improved significantly over time and rewarded investors who stayed the course with active investing.

Active growth investing thrived for a long period of time following the challenging period in the mid-1990s. While it is not possible to project when the market conditions will return to favor active management, we do expect an inflection point to occur in the near- to intermediate-term future, and thus we expect that investors in active growth equity products will be rewarded. Indeed, while it is a short time horizon, the second half of 2012 demonstrated that active growth strategies have been rewarded substantially when market conditions reverse. (In the second half of 2012, some market conditions that had been headwinds to active management reversed. Thus, several of the charts in the ensuing sections use data ending at June 30, 2012. Additional charts, under "Conclusion," show data for the second half of 2012.)

Capitalization tier impacts

As during the market experience of the 1994–1997 period, a small group of the largest capitalization stocks (specifically, the largest 50 stocks, by market cap, in the Russell 3000® Index, commonly referred to as the "mega cap" segment) has once again dominated U.S. equity market performance over the last five years. This serves as a headwind to active management for a number of reasons, the most obvious being that managers are systematically underweight the largest stocks in the index (see Figure 2). As in the 1990s time period, this trend was more pronounced in the U.S. growth manager universe relative to the U.S. value universe. Figure 3 illustrates the magnitude and the persistence of outperformance by the largest capitalization stocks relative to other stocks in the Russell 1000® Growth Index over the last five years.

Figure 2: Russell Growth manager universe active capitalization tier weight versus the Russell 1000® Growth Index (five years ending June 30, 2012)[1]

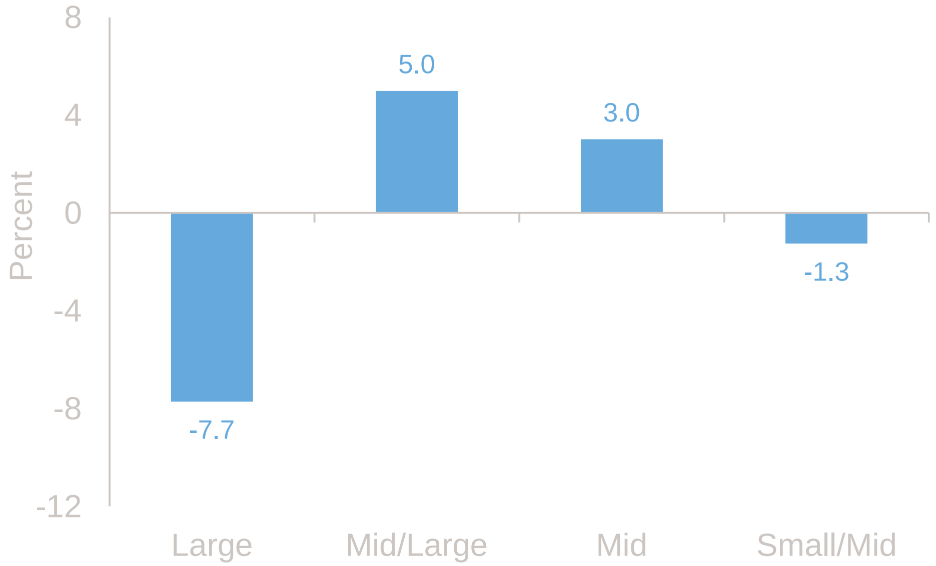


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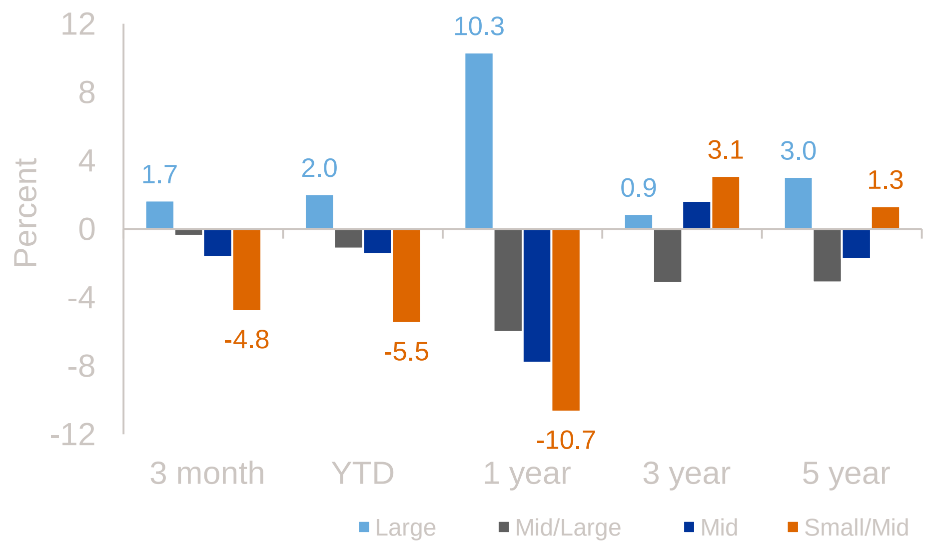
Figure 3: Russell 1000® Growth Index excess returns by market capitalization tier for periods ending June 30, 2012 (annualized for periods greater than one year)



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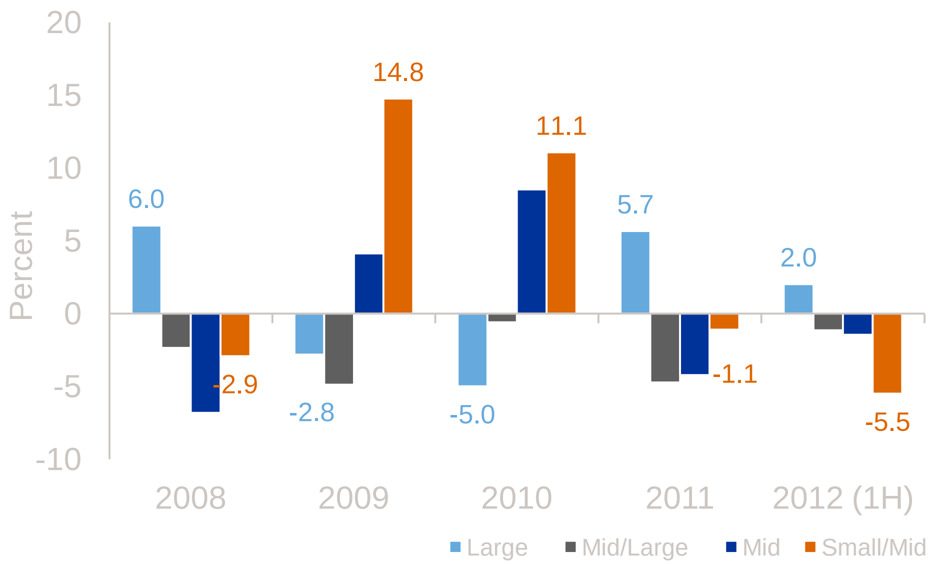
[1] Market capitalization tiers are delineated by having a fixed number of stocks fall into each tier using the Russell 3000 Index as the universe. The breakout is as follows: Large (top 50 stocks by market capitalization), Mid/Large (stocks 51-200), Mid (stocks 201-500), Small/Mid (stocks 501-1000) and Small (stocks 1001-3000). At each annual rebalancing of the Russell Indexes, the first four market capitalization tiers become the Russell 1000 Index, and Small market capitalization tier becomes the Russell 2000 Index.

Active growth managers in the universe persistently underweight mega cap stocks for several reasons, many of which were discussed in Greenwood's paper. One reason is that active managers generally believe that the largest stocks are more efficiently priced, and that they therefore offer less excess return potential. Also, active managers tend to have a preference for companies with more dynamic growth potential, which is generally found among smaller companies with less mature businesses and longer runways for growth.

Outperformance of mega cap stocks over the last several years was primarily driven by superior returns in 2008, 2011 and the first half of 2012 (see Figure 4). Mega cap constituents of the Russell 1000 Growth Index exceeded that benchmark by 6.0% in 2008, 5.7% in 2011 and 2.0% in the first half of 2012, while all of the other capitalization tiers significantly trailed the index. Not coincidentally, 2008 and 2011 were among the worst years for active growth managers in the last 15 years (based on the percentage of growth managers outperforming the Russell 1000 Growth Index and average manager excess return). 2009 was also among the worst years for active growth managers, but for different reasons, which we discuss in the "Earnings Momentum and Price Momentum Exposures" section of this paper.

Figure 4: Russell 1000® Growth Index excess returns by market capitalization tier (calendar year)



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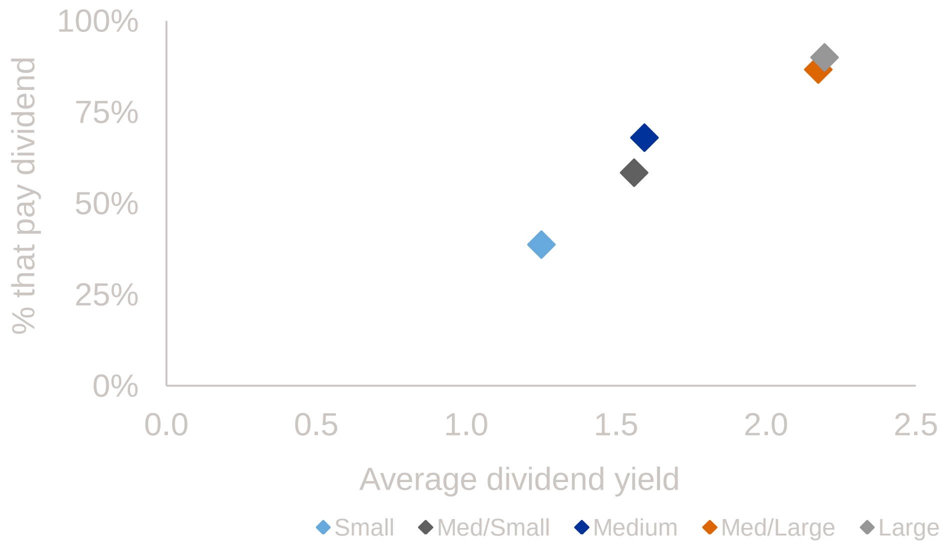
The second half of 2008 was characterized by a classic "flight to safety," when stock prices collapsed and investors sought shelter in blue chip companies with strong balance sheets and more stable earnings. It is not at all surprising that very large capitalization stocks of relatively more stable companies outperformed in this market environment. Strong outperformance of mega cap stocks in 2011 and in the first half of 2012 (1H'12) was a more unique outcome, as defensive equities were clearly in favor; yet the Russell 1000 Growth Index was up approximately 13% in that period. One contributing factor to mega cap outperformance from 2011 through 1H'12 was strong demand for "bond proxies," or very safe stocks that provide meaningful dividend income. Larger capitalization stocks tend to have sustainable dividends and are typically viewed as the safest companies, which makes them attractive to more conservative investors requiring income. In addition to having had their fears stoked by the European sovereign debt crisis and slowing global growth, investors have become more prone to consider "bond proxies" as a way to supplement income lost due to historically low bond yields. Figure 5 shows that, in 2012, a higher percentage of large capitalization stocks paid dividends, and that the average dividend yield was higher. The chart shows a single point in time, but the outcome has been persistent over time.

Figure 5: Percentage of companies that paid dividends, and average dividend yield by market capitalization tier, in the Russell 3000 Index (2012)



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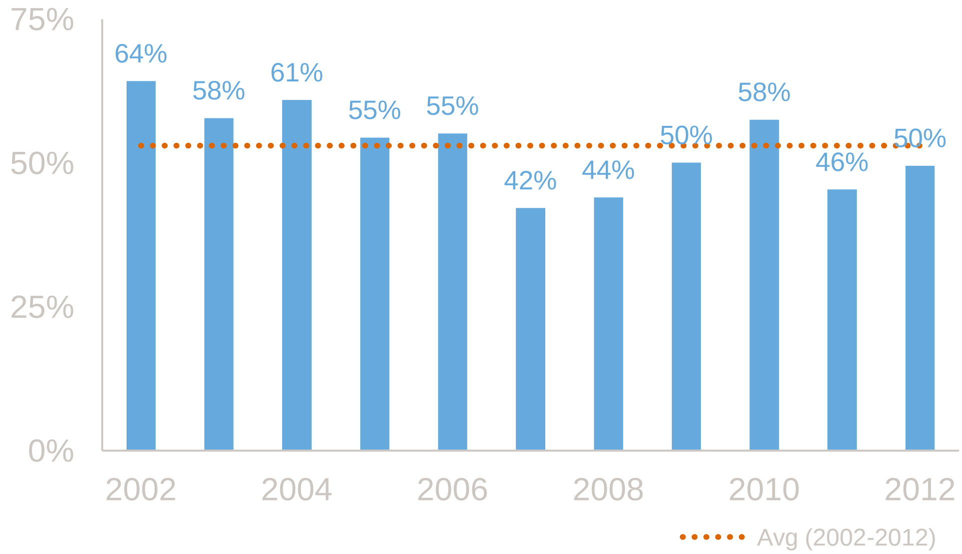
Another contributor to mega cap outperformance from 2011 through 1H'12 was Apple Inc.'s (Apple) multi-year run of strong performance, as its market capitalization increased at an incredibly rapid pace. Between December 2007 and June 2012, Apple appreciated approximately 27% per year, on average, while the Russell 1000 Growth Index returned just over 2% per year, and the stock swelled to become nearly 10% of the Index. Apple's continuing growth at such a rapid pace even as it moved into the mega cap tier of the market was uncommon, and it presented a bit of a conundrum for active managers. While many managers owned Apple, a majority of them were underweight the stock relative to the benchmark as Apple grew, partly because they were unwilling to allocate such large portions of their portfolios to one security (and also because some clients' guidelines for maximum position sizes prevented managers from overweighting the stock). Thus, Apple was a large negative contributor for many active managers, particularly from 2011 through the third quarter of 2012, when its market cap and weight in the Russell 1000 Growth Index peaked. Apple is one of the largest capitalization companies in the U.S., and its strong performance also helps to explain why mega cap stocks outperformed during the period of positive market performance from 2011 through the first three quarters of 2012.

Related to mega cap stocks' strong outperformance, the percentage of stocks within the Russell 1000 Growth Index that have outperformed the index in recent periods has been low relative to history. Some of this has been driven by the outperformance of larger cap stocks; mathematically, the strong performance of one mega cap stock can have a much greater impact on market cap–weighted index returns than the strong performance of several smaller cap stocks is likely to have. Therefore, in periods where mega cap stocks outperform, it is more likely that the number of stocks outperforming the benchmark is lower. This is clearly a headwind for active managers, as it means that their probability of choosing stocks that outperform the benchmark is lower.

Figure 6: Percentage of Russell 1000® Growth Index constituents that outperformed the index (calendar year)



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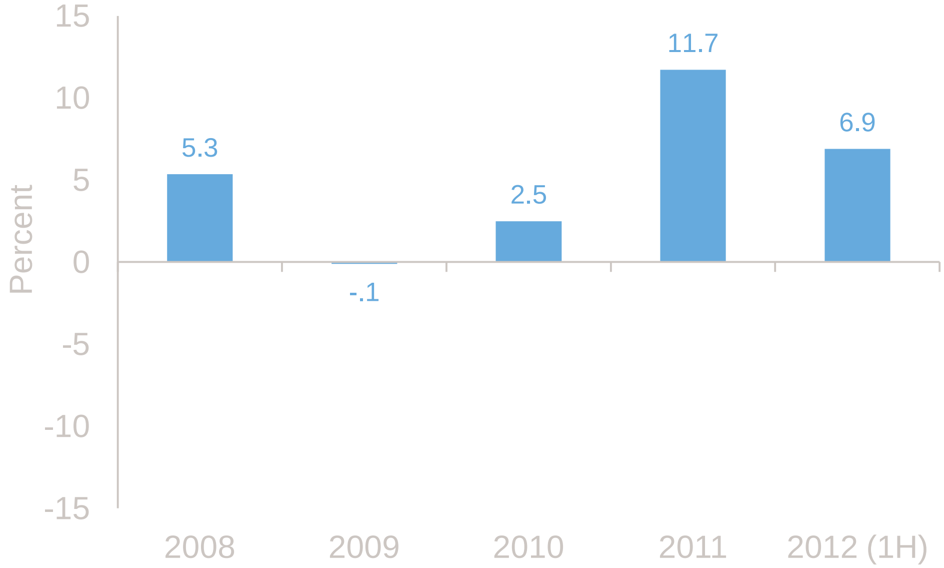
International exposure

Another way by which active managers attempt to add value is by opportunistically investing in companies outside the benchmark, including American Depository Receipts of stocks that are domiciled outside the United States. The average exposure of managers in Russell's growth universe to non-U.S. companies over the last five years was roughly 5%, compared to 0% for the Russell 1000 Growth Index. Managers typically pursue these stocks in order to broaden their opportunity sets, as they sometimes view securities domiciled in other countries as being more attractive than their U.S. counterparts. However, in recent years, fears of slowing growth in emerging markets and continuing concern about the European sovereign debt crisis drove international equities lower, while U.S. equities held up much better. In this environment, it seemed that the domicile of a company mattered more than the fundamentals of its business, and so active managers' exposure to non-U.S. companies was an obstacle to positive excess returns. The strong performance of U.S. equities relative to non-U.S. equities in recent years is illustrated in Figure 7.

Figure 7: Russell 1000® Growth Index returns less Russell Developed ex-U.S. Large Cap Growth Index returns (calendar year and the first two quarters of 2012)



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Economic sector impact

As illustrated in Table 2, the impact of growth managers' economic sector allocations on performance was mixed between positive and negative in the last five years.

Table 2: Five-year average economic sector weightings and returns

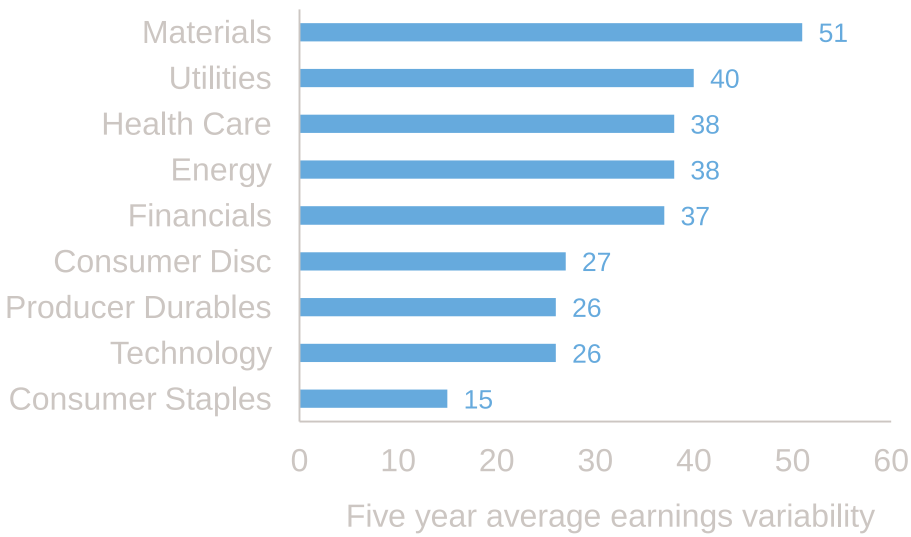
	Russell Large Cap Growth Universe Avg. Weight	Russell 1000® Growth Index Avg. Weight	Difference (Weight)	% Qtrs Overweight	Five Year Avg. Annual Return	Help/Hurt Returns?
Consumer Staples	6.3	10.0	-3.7	0%	10.7	-
Technology	27.4	26.5	0.9	70%	6.4	+
Consumer Discretionary	16.6	15.7	0.9	85%	4.1	+
Health Care	14.6	13.2	1.5	80%	3.9	+
Producer Durables	9.7	10.9	-1.2	5%	0.4	+
Financial Services	8.9	6.6	2.3	100%	-1.5	-
Materials & Processing	5.6	5.1	0.5	70%	-1.6	-
Energy	7.6	8.0	-0.3	35%	-3.6	+
Utilities	1.1	1.3	-0.2	25%	-9.2	+
Russell 1000® Growth					2.9	

Period ending June 2012

The sectors with the largest average difference in portfolio weight between the Russell growth universe average and the Russell 1000 Growth Index during the measurement period were Consumer Staples, Financial Services, Health Care and Producer Durables. Of these, the largest and most consistent bias was the underweight to Consumer Staples. Since the Consumer Staples sector was the strongest-performing sector by a wide margin, this was a key headwind for managers over the measurement period.

Growth managers' persistent underweights to the Consumer Staples sector and to stocks among the largest market capitalization tier are to some extent related. Over the five years ending June 2012, a larger percentage of Consumer Staples stocks fell into the top 50 market capitalization tier than did stocks in any other sector. This isn't surprising, as the Consumer Staples sector consists of many mega cap, mature, slow-growing companies, such as Coca-Cola, PepsiCo and Altria. The scarcity of unit sales growth and earnings acceleration potential among a large proportion of Consumer Staples companies generally makes the sector less attractive to active managers. Additionally, as Figure 8 illustrates, the variability of earnings among Consumer Staples companies is very low relative to all other sectors. This reduces active managers' ability to come up with differentiated earnings estimates and to benefit from earnings revisions and positive earnings surprises.

Figure 8: Five-year average of historical five-year earnings variability by sector for companies within the Russell 1000® Growth Index as of December 2012



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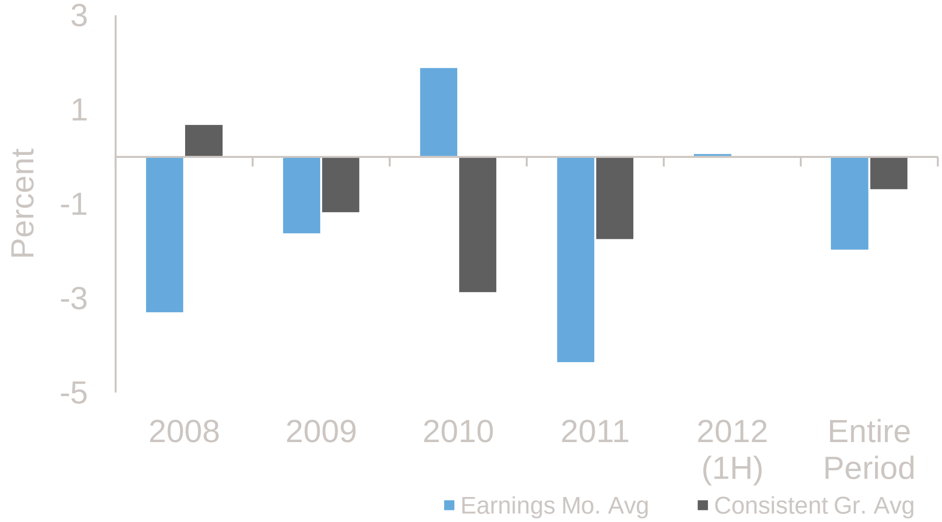
Earnings momentum and price momentum exposures

While the majority of active growth managers have had a difficult stretch of index-relative performance over the last several years, those seeking to exploit stocks with positive earnings momentum have tended to perform worse than others. A large percentage of active growth managers fall into this category. As Russell classifies active growth managers, more than 80% are in the "earnings momentum" substyle, which consists of managers who tend to exhibit some preference for stocks that have more cyclical earnings streams than the benchmark. Many of these managers seek to exploit near-term earnings acceleration and positive earnings surprise and revisions. The rest of the growth manager universe falls into the "consistent growth" substyle. These managers typically tend to be a bit more concerned with valuation and less concerned with earnings and price momentum. They also provide more defensive exposure, due to their greater emphasis on stocks of companies with high financial quality and lower earnings variability. As Figure 9 shows, 2010 was the only year of the last five wherein earnings momentum managers beat consistent growth managers (neither substyle meaningfully outperformed the other in the first half of 2012).

Figure 9: Consecutive excess returns versus the Russell 1000® Growth Index



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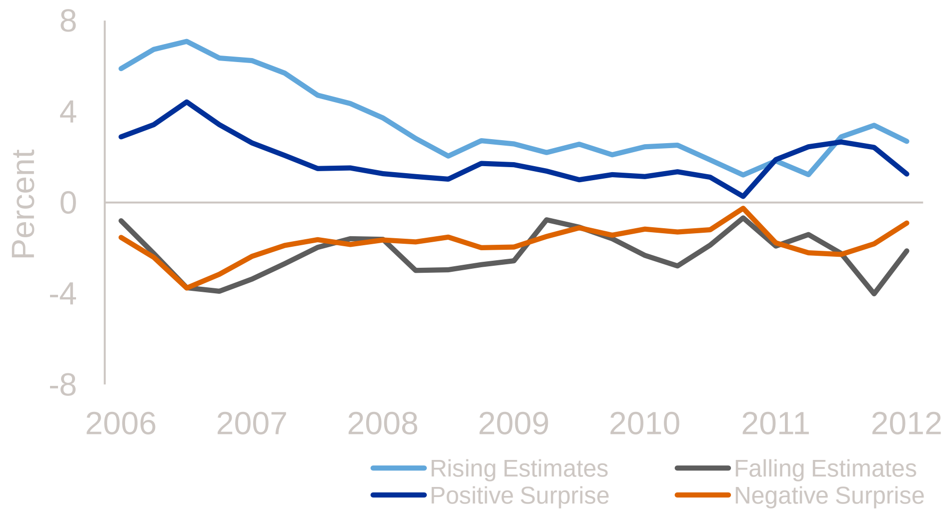
The problem isn't that managers have become worse at identifying stocks with rising earnings estimates and positive surprises (or at avoiding falling estimates and negative surprises). As illustrated in Figure 10, active growth managers have been consistently overweight (underweight) stocks with rising (falling) earnings estimates and positive (negative) surprises relative to the Russell 1000 Growth Index. Instead, managers simply haven't been rewarded for identifying these fundamentally attractive stocks. As we noted at the beginning of this paper, the cascade of major macroeconomic events over the last several years has caused the market to be less focused on stock specific fundamentals. As a result, the prices of stocks with favorable earnings results were often not positively differentiated from the broad market.

Figure 10: Average four-quarter large cap growth manager active exposure to stocks with rising/falling earnings estimates and positive/negative earnings surprises versus the Russell 1000® Growth Index



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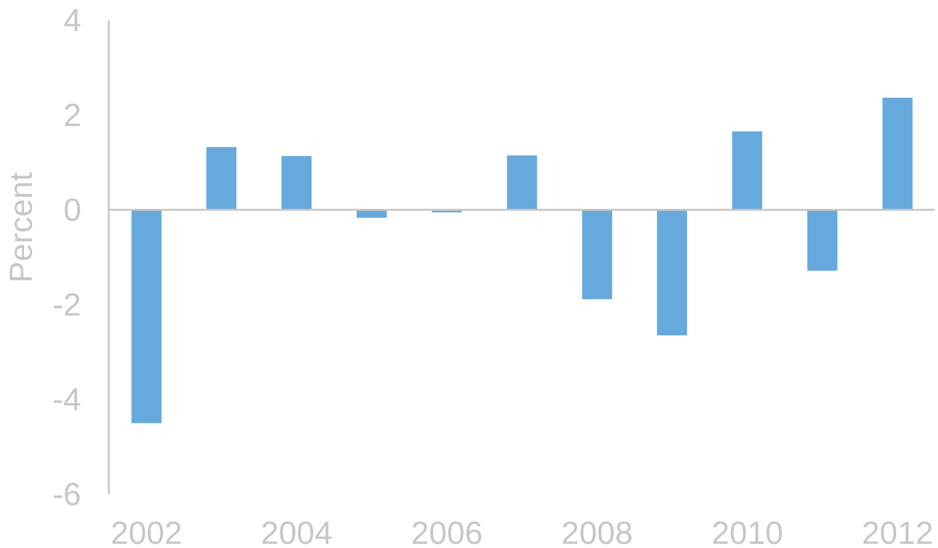
As illustrated in Figure 11, stocks with positive earnings surprises actually had a significant negative payoff in 2008, 2009 and 2011, which were also very poor years for managers in Russell's earnings momentum universe, compared to the consistent growth manager universe. Prior to 2008, the only other year with a meaningful negative payoff to earnings surprises in the last decade was 2002. Clearly, stocks that surprise positively on earnings are typically expected to outperform, on average, in environments where investors are focused on stock-specific fundamentals.

Figure 11: Trailing four-quarter average performance spread between top three and bottom three deciles of earnings surprise among stocks in the Russell 1000® Growth Index



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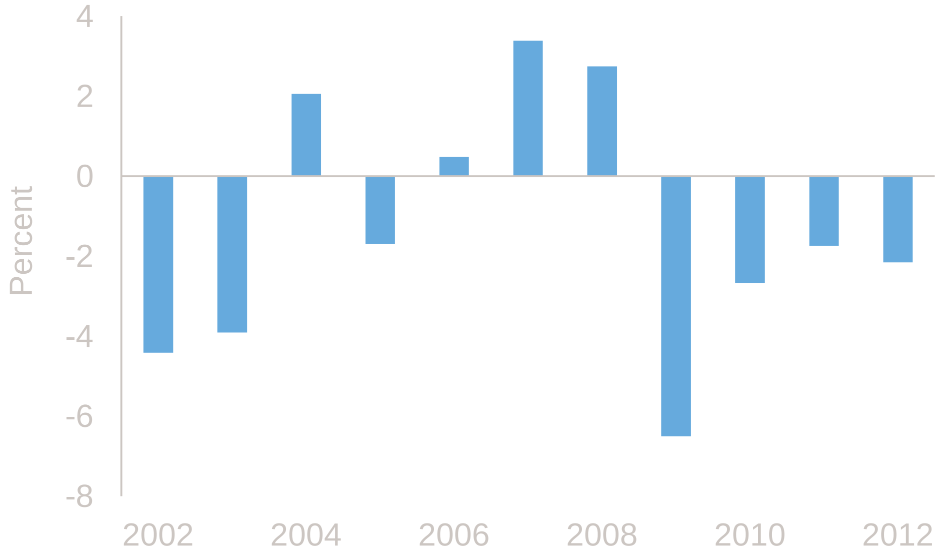
Another part of the problem for earnings momentum managers has been the dearth of sustained trends in the market. These managers often favor stocks with positive price momentum that have been "working." In a volatile market, managers more sensitive to valuation may be better equipped to outperform than many earnings momentum managers, who tend to let winners run. The market has experienced a great number of swings in the past several years, which is evidenced by the poor payoff of stocks with short-term price momentum from 2009 through 2012 (see Figure 12). The huge underperformance of stocks with positive short-term price momentum in 2009 contributed to the historically poor performance of active growth managers in that period, especially earnings momentum managers with a preference for strong price trends. Many managers were whipsawed between the first and second quarters of 2009, when the market bottomed and then quickly turned and accelerated upward when investor sentiment improved.

Figure 12: Trailing four-quarter average performance spread between top three and bottom three deciles of short-term price momentum among stocks in the Russell 1000® Growth Index



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The impact of skillful manager selection

Despite the difficult market conditions that have prevailed for active growth management since 2008, Russell's recommended managers have fared significantly better than others. Russell believes that strong manager research and skillful manager selection can dampen investors' negative excess-return experiences in adverse active management environments and provide meaningful upside potential in favorable active management environments. To illustrate, the following table shows 5-, 10- and 15-year annualized returns for Russell's growth manager "Hire list" versus the Russell 1000 Growth Index and the growth manager universe median.

Table 3: Annualized returns of Russell's growth manager Hire list, growth manager universe median and Russell 1000® Growth Index

	5-years	10-years	15-years
Russell Growth Hire ranks	2.20%	8.15%	4.98%
Russell Growth Universe Median	1.70%	7.35%	3.90%
Russell 1000® Growth Index	3.13%	7.47%	3.52%
Hire rank Excess Return vs. Median	0.50%	0.80%	1.08%
Hire rank Excess Return vs. Index	-0.93%	0.68%	1.46%

Period ending December 31, 2012
Manager Universes are unmanaged and cannot be invested in directly. Returns represent past performance, are not a guarantee of future performance, and are not indicative of any specific investment.

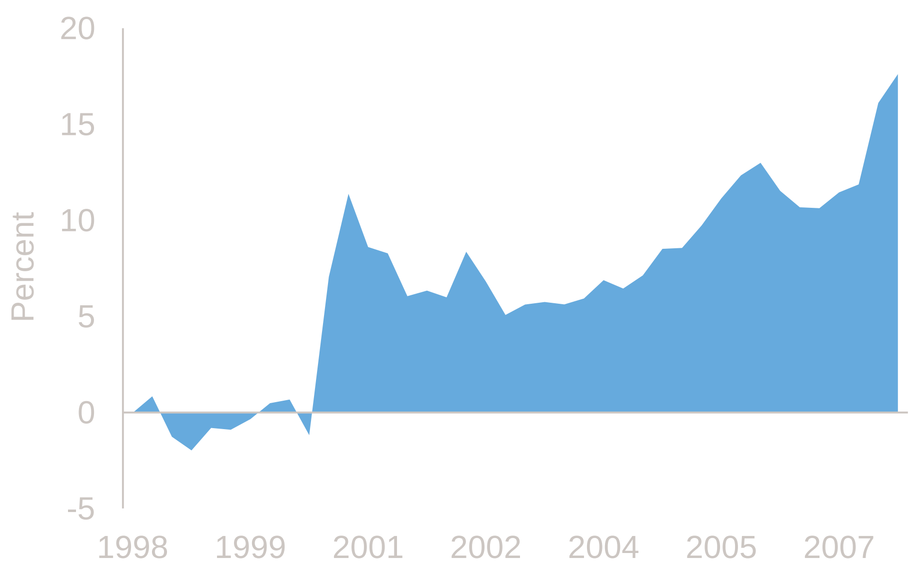
While the average Russell growth Hire rank trailed the index in the most recent five-year period, it still provided significantly better performance compared to the typical growth manager in the universe. Most importantly, over the 10- and 15-year periods, which include favorable and unfavorable active management environments, Russell's Hire list has added significant value versus both the median manager and the index.

Although it is uncommon for investors to have an investment horizon of 10 or 15 years to evaluate the efficacy of actively managed strategies, the above data emphasize the importance of adopting a long-term investment horizon for equities. Equities are a long-duration asset class, and the investment strategies employed by most active managers that seek attractive fundamental and valuation characteristics attempt to provide positive payoffs over most medium- to long-term time horizons. Given the role of equities as prominent drivers of excess long-term returns in multi-asset portfolios, it is Russell's strong belief that investors who adopt a long-term investment horizon should stand to gain significantly via the skillful selection of active management strategies versus relying on passive alternatives.

Conclusion

There is no question that recent market environments have been challenging for active management, and excess-return outcomes have been particularly poor among large cap growth managers, similar to the mid-1990s. However, Russell believes that returns to active management are cyclical, and that there is a significant opportunity for long-term investors to benefit from active growth equity management in the next several years. For historical context, those who had the patience to remain invested in active growth strategies subsequent to the period of very poor benchmark-relative performance between 1994 and 1997 were on average rewarded with good long-term excess returns. Investors who succumbed to the temptation to terminate their active growth equity assignments in 1997 missed out on the excellent active management environment over most of the next decade. Figure 13 shows that the median active growth manager provided nearly 18.0% cumulative excess returns versus the Russell 1000 Growth Index over the 10 years after 1997 (1.2% excess return per year).

Figure 13: Cumulative returns, Russell growth universe median excess returns versus Russell 1000® Growth Index, 1998–2007



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As discussed in this paper, the environment for active growth management became difficult again for the majority of the period subsequent to 2007. Despite these difficulties, the historical context gives us confidence that active management will be rewarded in the long run.

We would also expect several of the conditions that persisted throughout much of the 2008–2012 time period to reverse or moderate. In fact, many of these conditions reversed during the second half of 2012, and active growth managers' benchmark-relative returns improved meaningfully. During the third and fourth quarters of 2012, the median growth manager returned 5.4% and beat the Russell 1000 Growth Index by about 0.7% (more than 1.4% on an annualized basis). As shown in the following charts, a few of the headwinds to active growth managers that recently reversed were the relative returns of mega cap stocks and non-U.S. growth stocks.

Figure 14: Russell 1000® Growth Index excess returns by market capitalization tier (five years ending June 2012 [annualized], and June 2012–December 2012)

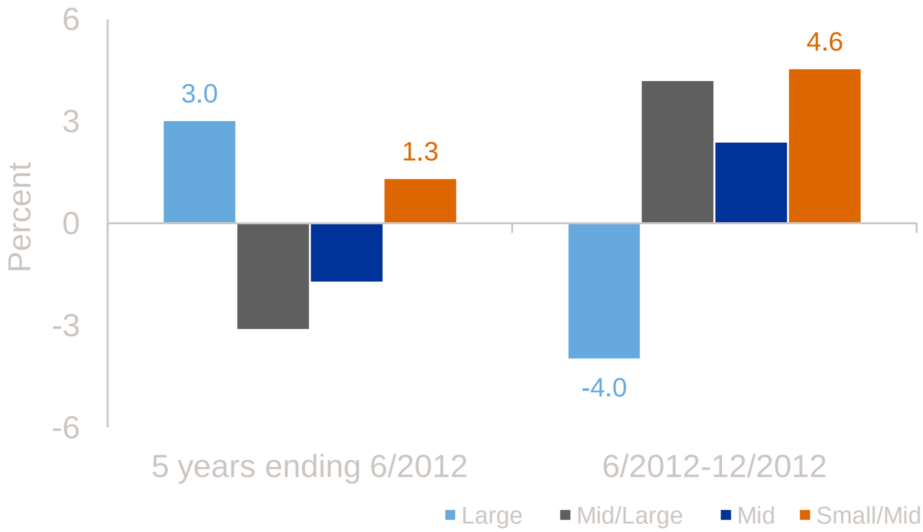

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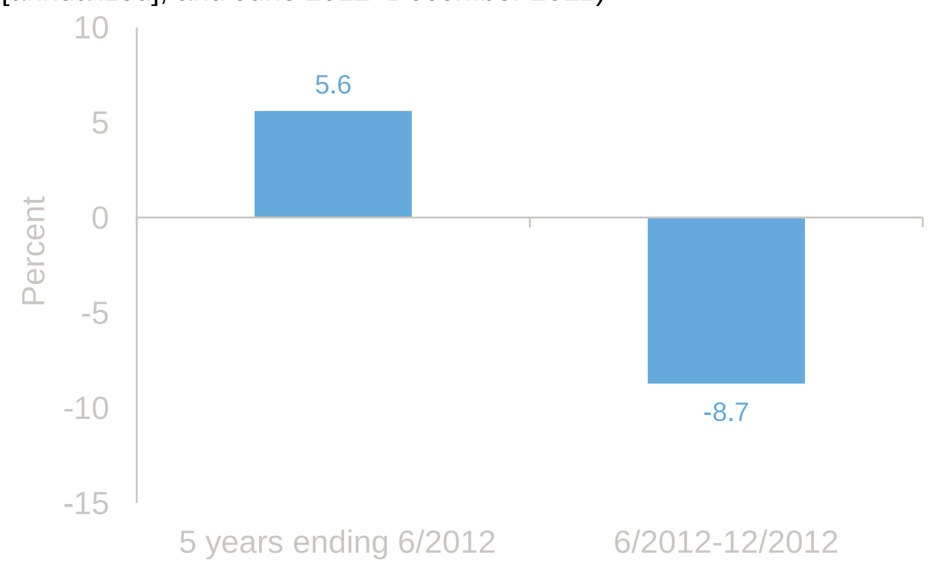
Figure 15: Russell 1000® Growth Index returns less Russell Developed ex-U.S. Large Cap Growth Index returns (five years ending June 2012 [annualized], and June 2012–December 2012)



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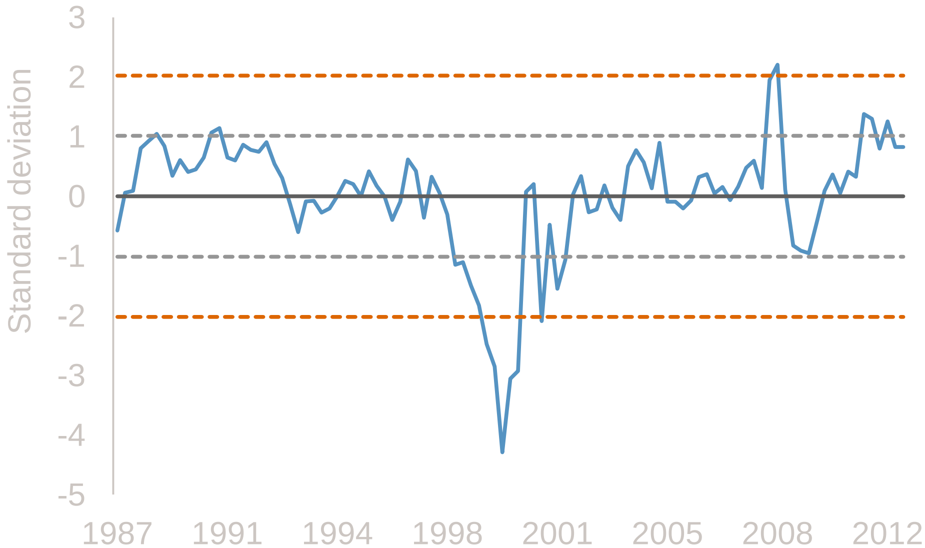
While this is much too short a period by which to determine that a longer-term sea change is under way for active management, it does indicate the value active growth managers can provide when headwinds subside.

Additionally, as different sectors in the market may generate strong earnings and cash flow results and attract investor interest going forward, we would expect investor sentiment to turn from the Consumer Staples sector to spur market leadership in other industries, a shift that would benefit the average active growth manager. Indeed, the one-year forward price/earnings ratio of the Consumer Staples sector of the Russell 1000 Growth Index relative to the Russell 1000 Growth Index suggests the sector is expensive compared to the past 25 years (one standard deviation above the 25-year average), and that it may be more likely to lag the broad market in the coming years.

Figure 16: Ratio of [P/E (FY1) of the Russell 1000® Growth Index Consumer Staples Sector] / [P/E (FY1) of the Russell 1000® Growth Index] over the 25 years ending December 2012



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Finally, a continuation of the expanding market breadth during the second half of 2012, as a progression from a very narrow market favoring mega cap stocks, would create a more favorable environment for active management. Such a progression would be consistent with the 2002–2006 period, shown earlier in Figure 6.

Given the historical context provided above, and in light of our expectation that factor headwinds to active growth managers over much of the past five-year period will eventually reverse, we caution investors who seek to replace active mandates with passively managed equity strategies at the current time. Investors who convert active management assignments to passive assignments at this point will be effectively locking in the negative excess returns of the past few years and forgoing opportunities to recoup losses as active management returns to favor. We also expect that a meaningful premium can be gained from Russell's skillful selection of active managers. We believe that investors, who on average have endured negative excess returns from active management over the last several years, will be rewarded for their patience as market conditions change going forward.

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"Have Growth Managers Lost Their Touch?" Paul R. Greenwood. Russell Research Commentary, September, 1997. Available on request

For more information:

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Important information

This paper contains data as provided by internal Russell applications. These applications are populated with data collected from individual managers by BNY Mellon and then provided to Russell's Research Database. The data is not thoroughly verified by Russell and although deemed reliable, its accuracy is not guaranteed by Russell Investments or its affiliates. Most data is gross of advisory fees, but net-of-fee data is utilized where gross-of-fee data is not available.

Note: In some cases, money managers do not provide data on their products; therefore, readers should be aware that the representations may be misleading; performance of Hire lists may be higher or lower than represented.

Hire ranked does not imply that such products have been placed in any of our funds or products.

Excess returns: Each product in our Hire lists is compared to the relevant Russell-assigned benchmark and universe median to determine product-level excess returns. Product-level excess returns are calculated using a geometric methodology. Excess returns for measurement periods greater than one year are annualized. Product-level excess returns are averaged across all products in the buy list to determine an average buy list excess return. The buy list average is compared against the benchmark Index return and the median manager return associated with each buy list to create summary statistics for all buy lists.

Note: Benchmarks are total return (they include the reinvestment of dividends) and cannot be invested in directly.

Representation: No client of Russell Investments has been able to achieve the represented performance, due to the fact that the buy lists and universes are comprehensive composites that cannot be invested in directly. The buy lists and universes in Russell's research database that are used in this material (presentation) cannot be purchased or held by any client. These manager products are available for our consulting clients and internal portfolio managers to use in the construction of portfolios for our fund and separate account clients.

Past performance is not indicative of future performance.

Timing: Data is based on performance ending December 31, 2012. Manager products are included and excluded as our product ranks change over time; not all products are continually Hire ranked over these indicated time periods.

The information presented is for illustrative purposes only.

Defensive style emphasizes investments in equity securities of companies that are believed to have lower than average stock price volatility, characteristics indicating high financial quality, (which may include lower financial leverage) and/or stable business fundamentals.

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