Thoughts from the CIO

# Active or Passive?

WESTFIELD
CAPITAL MANAGEMENT

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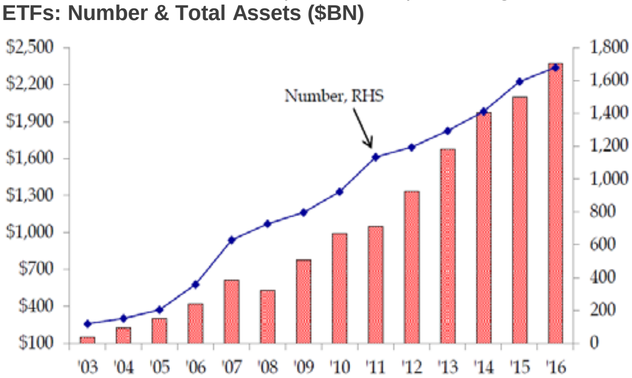
As an active manager of public equities who has faced some of the challenges of the recent market environment, our views of the Active vs. Passive debate may be seen as biased, however, we think it is important to put the current conditions in historical perspective.

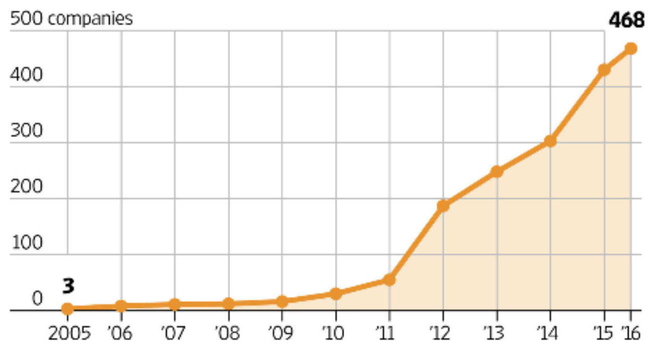
In the late 90's leading up to the dot com bubble of 1999, passive index funds greatly outperformed actively managed funds. At the time, there were several articles on the death of active investing stating that valuation no longer mattered. A few months later, active started to outperform passive, a trend that lasted for the next 7 years. Markets move in cycles. Recently, passive investing has become all the rage again; the three year period ended August 2016 saw $1.3 trillion move into passive funds while active funds have seen record redemptions. ETF assets have grown from $100 billion in the 1990's to almost $2.5 trillion today. These funds are so large that according to the WSJ, at the end of June, exchange traded funds that track the S&P 500 owned 11.6% of the S&P 500, up from 4.6% a decade ago. In addition, Vanguard's U.S. passive funds owned 5% or more of 468 of the 500 S&P companies, up from just 3 companies at the end of 2005. The issue here is that investors in passive funds are not always aware that due to index construction, they often own a larger percentage of the most expensive stocks, which in many cases are not growing earnings. Low volatility stocks that look and act like bonds have been the momentum stocks and outperformed over the last several years.

Exhibit 1: ETF assets have experienced exponential growth
**ETFs: Number & Total Assets ($BN)**

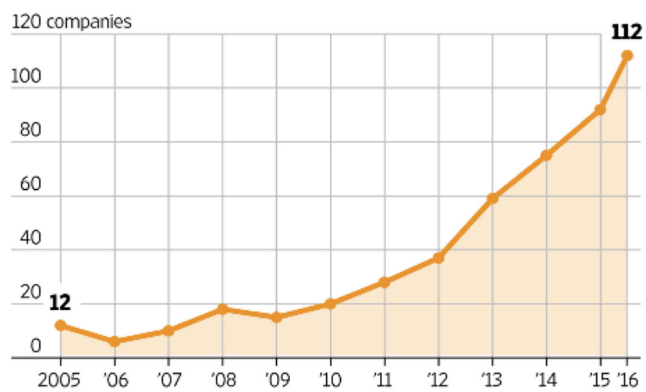



Source: Strategas Research Partners, ICI, as of October 24, 2016

Exhibit 2: Passive mutual funds are accumulating larger stakes in more big companies, often collectively exceeding the holdings of actively managed funds.
**Number of S&P 500 companies in which Vanguard Group's U.S.-based passive mutual funds and exchange-traded funds owned 5% or more**




**Number of S&P 500 companies in which U.S.-based passive mutual funds and ETFs collectively own more stock than active ones do**

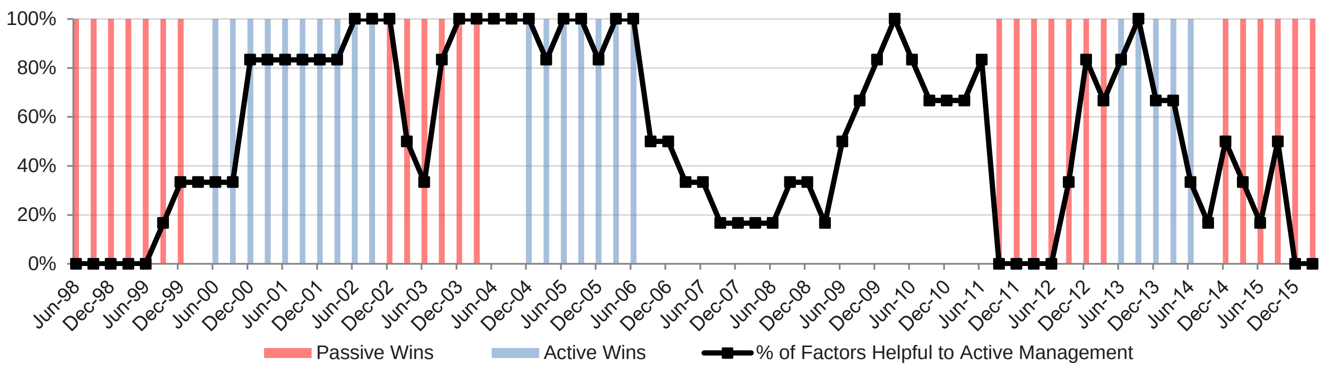



Note: Applies to total market value of share classes included in the S&P 500. All figures as of year-end except for 2016, which is as of June 30.
Sources: Wall Street Journal analysis of data from Morningstar (funds and stock ownership); S&P Global Market Intelligence (S&P constituents, share classes, share counts, and market values)

According to a study by Leuthold Research, analyzing the last 25 years of market data, during periods of time when passive funds outperformed active, the average annual rate of return for the S&P 500 was 18% per annum. We saw this type of market strength in the late 90's and we have seen a similar market for the last 7 years. In contrast, during periods of time when active outperformed passive, the average annual rate of return for the S&P 500 was +6% per annum. We are not calling for a bear market, but we do expect modest returns going forward because the stock market has more than doubled off of its 2009 lows, central banks around the world have eased, and there is limited growth across much of the world. Historically, active has outperformed passive in modest return and negative return environments. The largest and most expensive stocks drive index returns. If and when we get away from Fed-induced zero interest rates, we feel strongly that valuation will matter again. We have already started to see this over the last several weeks, as expensive, high dividend yield, no growth stocks characterized by Staples, Utilities, tobacco and REIT's have notably underperformed the broader market. Defensive stocks are not acting defensively at all. The Leuthold study mentioned above identified six market conditions or "factors" corresponding most strongly to the cyclicality of active manager performance relative to passive. As shown graphically below, the number of factors favoring active management is again at zero, the same level experienced in 1998 and 1999.

great companies and effectively ignore the rest of the benchmark. Lastly, sentiment is very important to recognize, as expectations are incredibly important both to individual stocks and to broader market performance. Whenever an investment decision becomes obvious and people feel like they have a "no lose" situation, it is usually the sign of an imminent top. This has happened throughout history with recent examples being retail investors ahead of the dot com bust in 1999, and people flipping pre-construction homes in 2006 and 2007. In both of these manias, unsophisticated market participants entered late with a "free money" mentality, only to find their investments worth much less or wiped out in a short period of time. In my opinion, whenever there is a broad powerful momentum theme, when an investing style becomes "easy", it does not last. Over the last several years, it paid to ignore valuation and buy low volatility, high dividend yield stocks. Since the financial crisis and throughout the zero interest rate

Exhibit 3:
**Factors Benefitting Active for the Six Strongest Signals**




Source: Leuthold Research
The six factors identified by Leuthold Research benefitting active management: Small caps beat Large caps (Russell 2000 minus S&P 500); International beats U.S. (EAFE minus S&P 500); Value beats Growth (Russell 1000 Value minus Russell 1000 Growth); Equal-Weighted S&P 500 beats the traditional cap-weighted S&P 500; Other 475 S&P 500 companies beat the largest 25; High percentage of S&P 1500 companies beating the S&P 500 return.

It is logical that passive investing looks attractive in an era when zero interest rates lessen volatility and increase stock correlations. As Fed Chair Yellen has signaled for a rate hike in December, the expectation that quantitative easing will somehow last forever is diminishing.

The incredible size of passive and indexed assets may potentially sow the seeds of its own underperformance. In choppy and down markets, the talented active manager can add significant alpha through fundamental research. In bullish market environments as witnessed over the last seven years, that feat becomes harder to accomplish. In a slow growth environment, there are relatively few companies that can grow organically at double digit rates. A scarcity of growth provides the talented active manager the opportunity to own 20 to 30

environment, investors have all been on one side of the boat, increasing duration and pouring money into bond funds. Both individual investors and institutions could take serious capital losses on this money which they perceive as safe. The Fed is likely to raise interest rates by 25 bps in December. Oil has rallied to $50 a barrel, +80% year over year. The job picture in the U.S. remains steady and wages are slowly rising. The yield on the 10 year Treasury has risen from 1.2% to 1.8%. Emerging markets have healed and have outperformed developed markets handily this year. Some inflation is creeping back into the system. Zero and negative interest rates could finally be a thing of the past. We feel strongly that passive investing is in the 9th inning and that active management will have a tailwind and outperform in the years ahead.