Three factors could position active U.S. large-cap equity strategies for significant alpha generation in 2015 and beyond:

- The end of quantitative easing in the U.S.
- Lower stock correlations
- Wider performance dispersion
**Introduction**

In recent years, investors have continued to pour assets into passively managed U.S. large-cap equity funds in lieu of actively managed strategies in the space. Over the past five years, passive U.S. large-cap equity funds have experienced cumulative net inflows of $397 billion, while their actively managed counterparts have suffered $346 billion of cumulative net outflows. (See Exhibit 1.)

Spurring this shift are the lower fee structures of index funds and exchange-traded funds as well as recent performance challenges of active U.S. large-cap managers. This may appear to reinforce the common investor belief that active managers cannot consistently generate positive excess returns in U.S. large-cap equities, which are considered to be among the most efficient equity asset classes. Although sentiment-driven trends are worth noting, investors also need to consider the facts underpinning these patterns before making investment decisions.

**Exhibit 1: Going With the Flow**

Cumulative Net Flows for U.S. Large-Cap Open Mutual Funds & ETFs
April 2010 - March 2015

In the current market environment, we see nascent signs of a shift in favor of active management, with a changing backdrop for the U.S. large-cap space. Specifically, three factors could position active U.S. large-cap equity strategies for significant alpha generation in 2015 and beyond:

- The end of quantitative easing in the U.S.
- Lower stock correlations
- Wider performance dispersion

We believe such a backdrop creates a solid opportunity for investors to break away from the passive herd. Here is a look at each factor and its potential impact on active investing.

**The End of Quantitative Easing in the U.S.**

In 2009, the U.S. Federal Reserve implemented a quantitative easing program (QE) in an effort to combat economic...
malaise and sluggish growth. This government stimulus effectively pumped new capital into the U.S. economy and exerted downward pressure on interest rates. Five years later, the Fed began normalizing policy by officially ending QE in October 2014.

During this period, the Fed achieved its goal of creating a wealth effect as interest rates plummeted to multi-decade lows while equity and bond markets appreciated considerably. However, this caused U.S. equities to move increasingly in tandem, making effective stock-picking more challenging.

This is evidenced by Exhibit 2, which shows that roughly 60% of active U.S. large-cap managers outperformed their benchmarks in both the 2000-2004 and 2005-2009 periods. However, with QE in full force during 2010 to 2014, only 22% of active U.S. large-cap funds outperformed.

**Exhibit 2: The QE Effect**

Active U.S. Large-Cap Equity Funds (Inst'l Shares)
Percentage of Active Managers that Outperformed/Underperformed Over Five-Year Annualized Periods

At this point, the Fed is signaling potential interest-rate hikes in late 2015 or early 2016. When this occurs, companies will likely have less access to cheap and easy capital, making it harder to finance more challenged business models and remain competitive. This should lead to more distinction between winners and losers across sectors, creating a more favorable backdrop for active U.S. large-cap managers to generate alpha. In fact, Exhibit 2 shows that 65% of active U.S. large-cap funds outperformed their benchmarks during the first quarter of 2015, which may represent a meaningful inflection point for performance trends.

**Lower Stock Correlations**

In recent years, stock correlations have been elevated as U.S. equities traded in tandem, largely because of QE and investors’ focus on macro influences. However, we have
occasionally witnessed brief periods in which investors shifted their focus away from macro factors toward company fundamentals and earnings, which caused stock correlations to break down.

For instance, this occurred in 2013, a year in which 51% of active funds outperformed their benchmarks. However, correlations rebounded in 2014 as investors centered on macro risks, such as the Russia-Ukraine conflict, ISIS in the Middle East, Ebola outbreaks and global growth concerns. This hindered actively managed large-cap funds, with only 21% outpacing their primary prospectus benchmarks for the year. (See Exhibit 3.)

Perhaps most importantly, correlations have been again breaking down after reaching highs in October 2014, which marked the end of QE. This highlights that QE’s impact on equities has been lifted, macro uncertainty is waning, and stocks have begun to trade more on companies’ fundamental merits and weaknesses. The positive impact of this dynamic has already been felt, with 65% of actively managed U.S. large-cap funds outperforming in the first quarter of 2015.

Wider Dispersion

Within the broader U.S. large-cap equity universe, inefficiencies exist across sectors, which are driven by large return-dispersion ranges in any given segment over time. Exhibit 4 illustrates that the average spread between top-quintile and bottom-quintile annual returns for the Standard & Poor’s 500 index was 79% from 2003 through 2014. The minimum annual spread was 61%, while the maximum was 134%.

Exhibit 3: The Ups and Downs of Correlations
CBOE S&P 500 Implied Correlation Indexes
January 2013 - March 2015

Source: Bloomberg
This spread between top and bottom performance is always present and can fluctuate based on underlying conditions. This highlights the level of inefficiency across all sectors that can be exploited by selecting winners and avoiding losers to generate alpha using active management.

As stock correlations continue their descent, performance dispersion is expected to widen across sectors, resulting in greater opportunity sets for actively managed large-cap funds.

Conclusion

Actively managed U.S. large-cap equity funds have exhibited weak relative performance over the most recent market cycle, which has fueled a sizable rotation into passive investment options. However, the end of U.S. quantitative easing is ushering in declining stock correlations, wider performance dispersion across sectors, and greater alpha opportunity for active managers. As such, investors should consider a shift to active U.S. large-cap equity funds as the rising tide that lifted all boats fades with the normalization of Fed policy. Overall, evading the passive tidal wave should enable investors to take advantage of a potentially strong inflection point for active U.S. large-cap outperformance in the years ahead.
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NM20150064CPJC01 Exp 12/2015  
BNYM-TBCAMWP-0715