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The Value of Active Management in Volatile Markets

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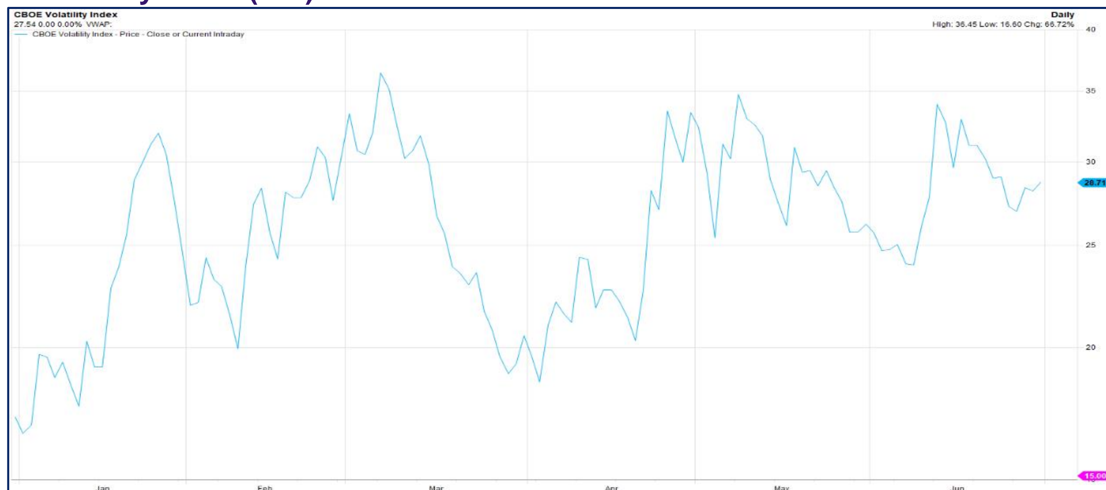
Active managers often claim to add protection and extract value for their clients in periods of volatility. The following analysis reviews this claim by evaluating the performance of active managers against their benchmarks in the current volatile period.

After a solid post-pandemic recovery through 2021, both equity and bond markets have been challenged in 2022. Financial conditions tightened early in the year as inflationary pressures pushed margins lower and the U.S. Federal Reserve switched to a more hawkish stance by moving interest rates higher. Adjusting to the new economic realities, market volatility has increased, as shown in the chart below.

CBOE Volatility Index (VIX)



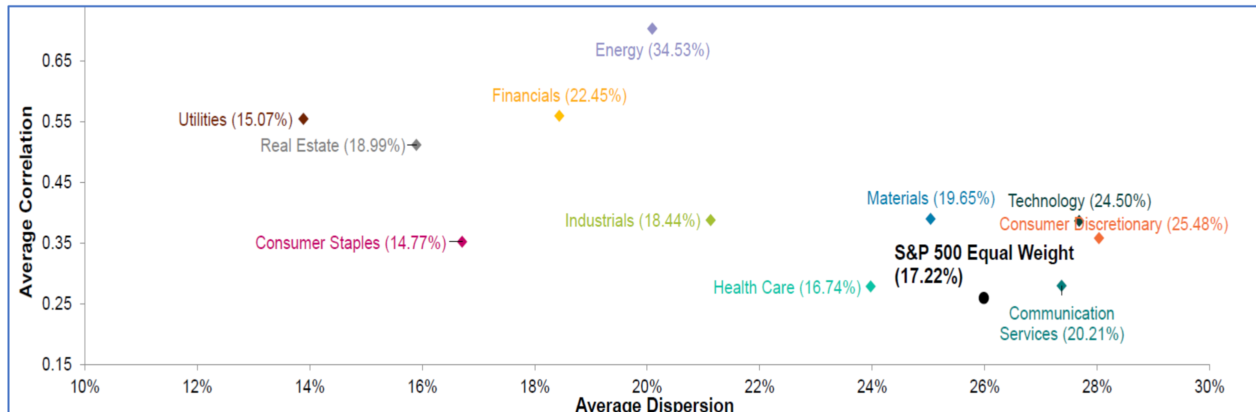
Source: FactSet Research Systems Inc. Data as of June 30, 2022

Volatility has also been trending higher. Taking a look at the VIX, a common measure of expected S&P 500 volatility, we can see a steady increase throughout the year, with a 67% increase YTD, as of June 30.

The Good News

Volatility, however, may have a silver lining—it may cause price dispersion across individual stocks and bonds, which allows active asset managers to take advantage of dislocations. The following data highlights the dispersion and correlation among the S&P 500 sectors over the trailing 12 months as of May 31.

S&P 500 Equal Weight Sector Average Correlation and Dispersion (Trailing 12-Month Volatility)



Source: S&P Dow Jones Indices LLC and/or its affiliates. Data as of May 31, 2022.

The S&P 500 equal-weighted index experienced increased dispersion, as many sectors had wider spread between highest and lowest performers as compared to the equal-weight index which showed 17.22% difference in return between highest and lowest performers. Correlations across stocks increased in classic value sectors such as energy and financials, with lower correlation within the broader index. Lower correlation means that stocks do not move in tandem, and generally helps active managers select companies more likely to outperform

Another example of dispersion can be seen in S&P 500 performance, where throughout 2021, the stock market became increasingly narrow as the top 10 companies by weight accounted for over 37% of index gains. However, many of those top-weighted companies joined the list of detractors in the index this year, and only one of the 10 top-weighted companies within the S&P 500 was a positive contributor to performance.

Domestic Equity Performance

Actively Managed Fund Performance
% of Funds Outperforming Index (Q2)

	Value	Blend	Growth
Large Cap	67%	79%	54%
Mid Cap	79%	86%	60%
Small Cap	79%	82%	49%

Source: Cetera Investment Management, Morningstar, FTSE Russell. The beat rate represents the percentage of actively managed funds outperforming the Russell asset class benchmark in the first quarter. Data as of 6/30/2022.

These grid charts show the percentage of active managers who outperformed their respective benchmarks in the second quarter of the year and year to date (YTD) as of June 30. We saw outperformance by active managers in Q2, and results continue to be strong across most categories YTD.

Actively Managed Fund Performance			
% of Funds Outperforming Index (YTD)			
	Value	Blend	Growth
Large Cap	64%	70%	43%
Mid Cap	81%	80%	57%
Small Cap	76%	78%	49%

Source: Cetera Investment Management, Morningstar, FTSE Russell. The beat rate represents the percentage of actively managed funds outperforming their Russell asset class benchmark. Data as of 6/30/2022.

Active domestic equity managers added value, as shown to the left. The YTD beat-rate numbers were above 50% in all categories except for Large Cap and Small Cap Growth. Greater dispersion in the broader markets likely helped, as active managers typically underweight the largest companies at the top of cap-weighted benchmarks. Additionally, as the focus has shifted back to fundamentals instead of price momentum, active managers, who tend to leverage their vast investment teams, were generally able to outperform their benchmarks across all sizes and styles, except for small cap and large cap growth so far this year. Through June, small cap growth managers just slightly underperformed, as we see 49% of these equity managers beating their benchmark.

Global Market Performance

Across global and international equity managers, the results this year have not been as strong. In the international space, a focus on fundamentals proved to be less beneficial, as there were several geopolitical surprises: the invasion of Ukraine, elevated global inflation, and China's zero-COVID policy all added volatility and impacted fundamentals. While increasing volatility typically benefits active managers, most international managers were not positioned for a war scenario. In our discussions throughout the year, we found that most active international managers believed the war would largely be avoided and did not anticipate a drawn-out conflict that has now impacted global food prices and supply chains. Given stronger fundamentals in energy, many managers had an overweight to Russia, an energy exporter, and thus positioned to grow before the war—positioning that did not come to fruition during the period.

Actively Managed Fund Performance				
% of Funds Outperforming Index (YTD)				
Foreign Large Value	Foreign Large Core	Foreign Large Growth	Global Equity	Emerging Markets
31%	33%	26%	57%	33%

Source: Cetera Investment Management, Morningstar, FTSE Russell. The beat rate represents the percentage of actively managed funds outperforming the asset class benchmark. Data as of 06/30/2022.

Actively Managed Fund Performance				
% of Funds Outperforming Index (Q2)				
Foreign Large Value	Foreign Large Core	Foreign Large Growth	Global Equity	Emerging Markets
67%	63%	39%	81%	46%

Source: Cetera Investment Management, Morningstar, FTSE Russell. The beat rate represents the percentage of actively managed funds outperforming the asset class benchmark. Data as of 06/30/2022.

While the YTD numbers are not as solid, many international active managers reversed course in Q2, as seen in the second chart. Global equity active managers tended to be overweight U.S. equities and have been the standout, as we have seen 57% outperforming their benchmark YTD. While we do not break out the month of May results in this view, note that international active managers were largely able to reverse course in May, as more than 60% of international managers outperformed amid the volatile month across all categories referenced.

Fixed Income Performance

Actively Managed Fund Performance					
% of Funds Outperforming Index (Q2)					
Intermediate Core Bond	Short Govt/Corp	Municipal - Intermediate	High Yield Bond	Emerging Markets Bond	Multisector Bond
32%	18%	18%	60%	39%	33%

Source: Cetera Investment Management, Morningstar, FTSE Russell. The beat rate represents the percentage of actively managed funds outperforming the asset class benchmark. Data as of 06/30/2022.

Actively Managed Fund Performance					
% of Funds Outperforming Index (YTD)					
Intermediate Core Bond	Short Govt/Corp	Municipal - Intermediate	High Yield Bond	Emerging Markets Bond	Multisector Bond
42%	55%	46%	65%	54%	57%

Source: Cetera Investment Management, Morningstar, FTSE Russell. The beat rate represents the percentage of actively managed funds outperforming the asset class benchmark. Data as of 06/30/2022.

Fixed income managers largely succeeded in adding value YTD, as most managers in categories to the left beat their benchmarks. Expectations of continued rate increases and slowing GDP growth caused results to be weaker, as rates rose and credit spreads widened, and only high yield managers, who tend to be more conservative, beat for the quarter. As rate increases and spread volatility moderates, we expect the relative outperformance of active fixed income managers may return. This is a function of several factors attributable to active management in bonds, including the recovery of mark-to-market losses as bonds get closer to maturity when defaults are subdued.

Duration management is key in bond portfolios, as higher duration positioning in a portfolio, will cause it to fluctuate more than shorter duration positioning, and consequently are more susceptible to the rising interest rates on the long end of the curve. In general, managers who anticipated rate increases and held their portfolio duration lower than benchmarks were rewarded this year.

Security selection was also a differentiator, as managers were able to opportunistically reallocate to specific sectors and securities. For example, while US corporate and high-yield issues lagged Treasuries and mortgage-backed securities late in the quarter, this may have offered an opportunity for managers to reposition into credits where fundamentals remained strong. Additionally, global fixed income managers who had overweighted US companies benefitted, as the strengthening U.S. dollar weighed on international and emerging market issues.

Lastly, specific yield curve positioning was beneficial, as managers that overweighted short-term and underweighted the longer-term bonds were generally more successful this year. This shows that fixed income active managers have been able to add value in a difficult year, implying they were able to position themselves effectively in a volatile period of rising interest rates.

Conclusion

We believe that the performance above is an example of the potential benefits of leveraging the expertise of active managers. Especially in times of increased volatility, active management can prove useful in mitigating the impact of weak market conditions. While broader markets have experienced many surprises throughout the year, most active managers we recommend have been able to add value to their clients by selecting better-performing securities at more opportune times. Going forward, given our expectation of more market volatility, elevated inflation levels, and threats of an economic slowdown, larger active managers, especially those with sizeable investment teams that can conduct stringent fundamental research and leverage their vast resources, should be best able to take advantage.

This report was created by Cetera Investment Management LLC. For more insights and information from the team, follow @CeteraIM on Twitter.

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Glossary

The **S&P 500** is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The **Bloomberg Barclays US Aggregate Bond** Index, which was originally called the Lehman Aggregate Bond Index, is a broad-based flagship benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate debt securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS and CMBS (agency and non-agency) debt securities that are rated at least Baa3 by Moody's and BBB- by S&P. Taxable municipals, including Build America bonds and a small amount of foreign bonds traded in U.S. markets are also included. Eligible bonds must have at least one year until final maturity, but in practice the index holdings have a fluctuating average life of around 8.25 years. This total return index, created in 1986 with history backfilled to January 1, 1976, is unhedged and rebalances monthly.