

# Going forward: Why you still want an active management strategy

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In the aftermath of last year's downturn in which active managers took a beating, some clients are asking their advisors whether they'd be better off moving to cheaper, more tax-efficient index funds, shifting their assets into treasuries or getting out of the market altogether.

But our research suggests that if investors turn passive now, they may miss out on what we believe could be a period in which active managers dramatically outperform their benchmarks. The past isn't always a prologue to the future. Looking ahead we believe that actively managed funds may, indeed, beat their respective indexes.

## A DIFFICULT YEAR FOR ACTIVE MANAGERS

There's no hiding the fact that most active managers didn't deliver in 2008. While the S&P-500 stock index fell 38% last year, the vast majority of actively managed stock funds—funds whose managers make specific investments, such as buying and selling certain stocks, with the goal of outperforming an investment benchmark index—fared even worse. The hurdles facing the market, and active managers, were significant ones. Following the Lehman Brothers bankruptcy in September 2008, the market was being driven primarily by investors' fears of further losses during the final three months of the year. Major disconnects occurred between the actual value of many stocks and their share prices, culminating in an across-the-board decimation of stock values.

As a result, active managers weren't rewarded for distinguishing between winners and losers because there were no clear winners. In an environment characterized by rising stock correlations, which essentially means that stock prices move in tandem regardless of quality, stocks got crushed irrespective of their individual fundamentals.

Active fixed-income managers faced an even bigger struggle than equities managers in 2008, as fear led investors to seek safety in Treasuries. Historically, non-Treasuries have done better than Treasuries the majority of the time. However, 2008 was an extreme exception to this rule as the flight to quality within the bond markets pushed the prices of Treasuries up substantially relative to other fixed income securities. The difference in yield (known as the yield spread) between non-Treasury bonds (i.e., mortgage-backed securities, corporates, asset backed securities) and Treasuries grew extremely wide, unlike anything we've seen before.

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## SO WHY ACTIVE MANAGEMENT NOW?

### Stocks

We believe that the present environment is ripe with opportunity for skilled active fund managers, and that, relatively speaking, several trends should make it easier to distinguish winners from losers than prior to the financial turmoil of the past 18 months.

The potential for excess return (the difference in performance of a portfolio versus a passive benchmark) depends on two things: one, the level of mis-pricing opportunities (current price of a security versus what it should be priced at based on the fundamental research and analysis of the manager) and two, a market that differentiates (through stock prices) between good companies and bad companies.

**An active manager's value lies in his or her ability to interpret commonly available information.** Some people believe that because all available information is “in” the market at any given time, the notion that good research can give an investor an advantage is a misconception. We strongly disagree. In fact, we believe that value is created through the process of synthesizing and interpreting that information and deciding which bits and pieces are relevant to the economic value of an enterprise. Two research analysts can meet with the same company management, pore over the same financial statements, and evaluate the same industry trends, yet reach vastly different conclusions about a company's growth prospects or stock valuation. Successful active managers can develop research opinions that differ from market consensus, with the potential excess return coming when, over time, new information comes to light that steers the consensus view towards their existing position.

In the present environment, many companies with adequate cash on their books, little to no pension liabilities, low debt and high-demand products (technology products, for example) have already begun to see their respective stocks perform better. In this return of a fundamentals-driven market—one in which the shares of solid, well-managed, well-capitalized companies outperform those of weaker companies—there is greater opportunity for skillful active managers to potentially exceed their particular benchmark index.

**A widening “performance differential” signals a good environment for active managers.** In the equity markets, we detect an increasing trend in the so-called “performance differential” between the very worst and the very best performing stocks. When this gap is large, it tends to signal a better opportunity for active managers to excel—they simply have a greater array of candidates to choose from. If all stocks were performing exactly the same, there is less opportunity. The current environment is ripe with opportunity for capable active managers. Active bets will result in bigger outcomes (good or bad), and while winning managers can shine, inferior ones can fail dramatically. Stock selection will therefore drive performance. Active managers' returns will increasingly become different from the market's, and from those of their peers. As fundamental differences become more significant, the potential relative excess return for skilled active managers is large.

**Russell is dedicated to research that identifies superior managers.** The trick then, is to find those managers who consistently generate excess returns over their respective benchmarks. Clearly, this is why we dedicate so many of our resources to manager research, trying to identify those managers who can differentiate between the prospects of one company over another.

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## Bonds

When it comes to fixed-income investing, Russell believes there are several good arguments favoring active management over indexing in the coming cycle.

**Passive management is not truly passive.** Due to certain restrictions placed on managers of bond index funds, a certain amount of active management is required of bond index funds. The use of active management techniques by passive managers means that such funds often do not mirror the performance of the benchmark.

**Index managers tend to underperform versus the benchmark most of the time.** A host of expenses, including trading costs, tax payments and fees, means that passive mandates typically cannot generate enough excess return to compensate for their “costs” and therefore will tend to underperform the index.

**Some investors believe that passive management is not synonymous with conservative management.** The Barclays Capital U.S. Aggregate Bond Index contains both credit and mortgage-backed securities, and both sectors significantly underperformed equal duration Treasuries over the past 18 months. In other words, passive management does not protect an investor during a flight to quality; bull markets may impose limits on upside potential.

**Values in the bond market.** Russell believes that the bond market currently offers some very compelling values that could turn out to be good investments down the road. Investors who go passive now could miss out on the potential return from some of these values.

## THE BOTTOM LINE: NOW IS NOT THE TIME TO BAIL ON ACTIVE MANAGEMENT

Going forward, we see the market moving into an environment in which good research and good stock picking will, once again, take center stage. With headwinds shifting to tailwinds at the backs of active managers, in our opinion now is not the time for investors to go all-passive, or worse, get out of the market. We believe that risk aversion, which protected some investors in the last market cycle, will cause investors to lose out on market opportunities in this cycle. Russell believes that we are embarking on a period that will favor active managers. Our advice is to stay invested, stay diversified and stick with your long-term investment strategy. We believe that risk will pay in this period.

Economic woes persist and the ride will stay bumpy for the foreseeable future. This will *accentuate* the differences between winners and losers, especially within a given industry, elevating stock selection to even more critical heights. In fact, avoiding losers may be even more important than picking winners. The final word: We believe investors will be compensated for making the active choice.

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No investment strategy can guarantee a profit or protect against a loss.

Diversification does not assure a profit and does not protect against loss in declining markets.

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Although stocks have historically outperformed bonds, they also have historically been more volatile. Investors should carefully consider their ability to invest during volatile periods in the market.

Bond investors should carefully consider risks such as interest rate, credit, repurchase and reverse repurchase transaction risks. Greater risk, such as increased volatility, limited liquidity, prepayment, non-payment and increased default risk, is inherent in portfolios that invest in high yield ("junk") bonds or mortgage backed securities, especially mortgage backed securities with exposure to sub-prime mortgages.

Indexes are unmanaged and cannot be invested in directly. Data is historical and is not indicative of future results.

S&P 500 Index: An index, with dividends reinvested, of 500 issues representative of leading companies in the U.S. large cap securities market (representative sample of leading companies in leading industries).

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