

When the Facts Collide with Conventional Wisdom



Kristof Gleich
President, CIO
Harbor Capital Advisors, Inc.

Looking at the environment for active managers, I generally try and evaluate two things:

- How many active managers are outperforming (opportunity) and
- What is the dispersion between stronger performing managers and weaker performing managers (reward)?

Conventional wisdom

When looking at active management, conventional wisdom goes a little something like this:

- 1) The more liquid the asset class, the more efficient price discovery becomes
- 2) The more efficient price discovery is, the more efficient the asset class becomes
- 3) The more efficient the asset class becomes, the less opportunity there is to find mispriced securities
- 4) The less mispriced securities there are, the less opportunity there is for active managers to distinguish themselves
- 5) When looked at together, this means that managers in large and liquid pools of public investing cluster together and, in aggregate, look like an expensive index fund, minus active fees

Conventional wisdom indicates the further you move away from large liquid pools of public investing the more likely you are to find inefficiencies. The closer you are to “alternatives” like private equity or hedge funds, the more manager selection matters.

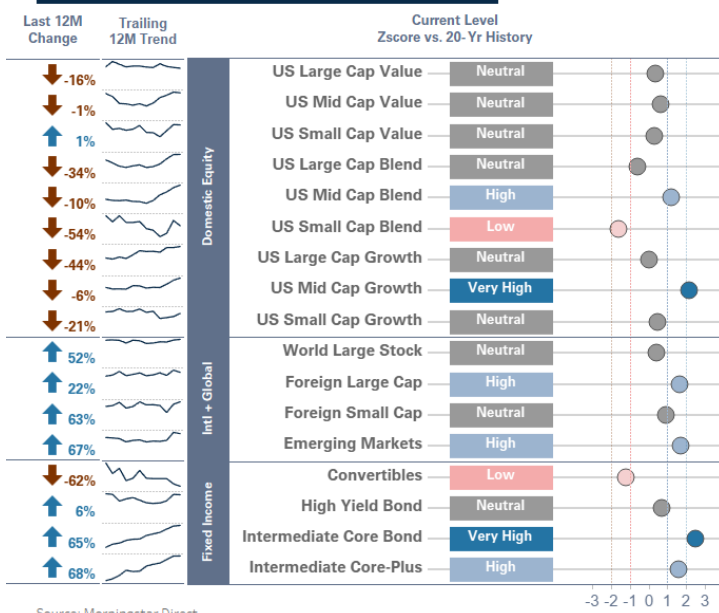
Evaluating the data

As I mentioned above, I believe to try and understand the environment for active managers you need to look at both the number of managers outperforming (**opportunity**) and how much they winning managers outperform the losing managers (**reward**).

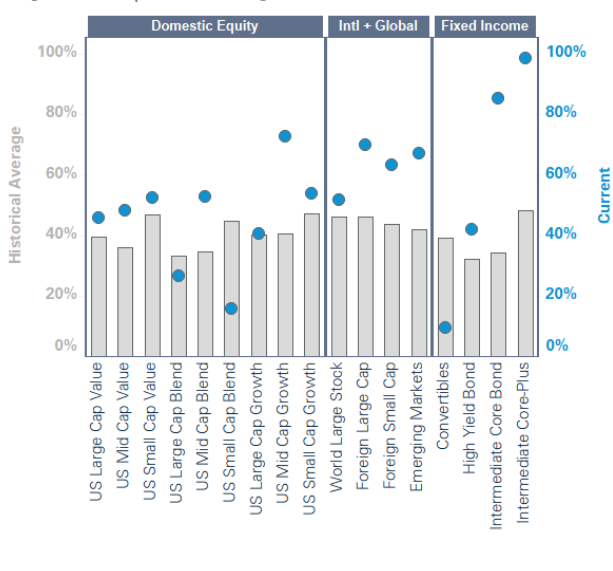
Let's look at the opportunity of active managers first. Remember, this is the *probability* of a manager outperforming net of fees. At Harbor, we look at this across every major asset class where we run money - this gauge is reading *about average* now. These numbers are all trailing 12 months compared to long-term averages (20 years). The following exhibits are all sourced from Morningstar, April 2021, and excess returns are all relative to the assigned Morningstar category benchmark.



Active Manager Hit Rate - Rolling 1 Year - April 2021



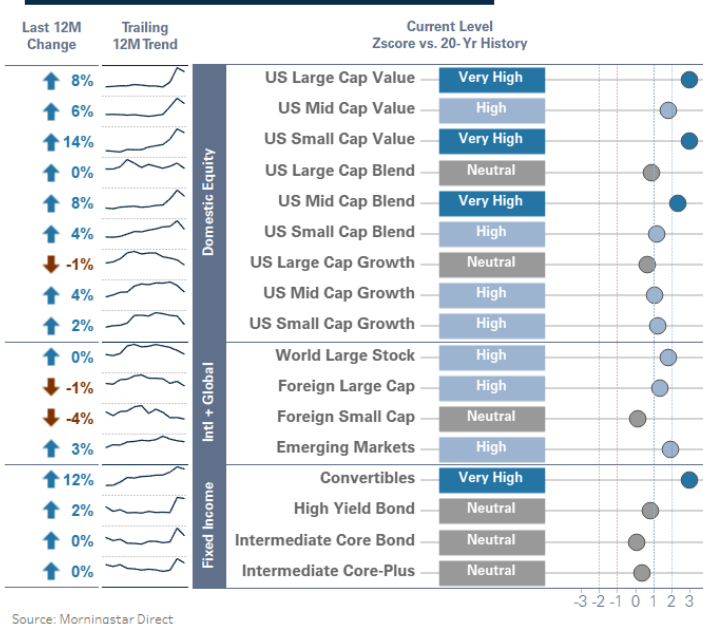
Morningstar Categories (Open-End) | % Outperforming



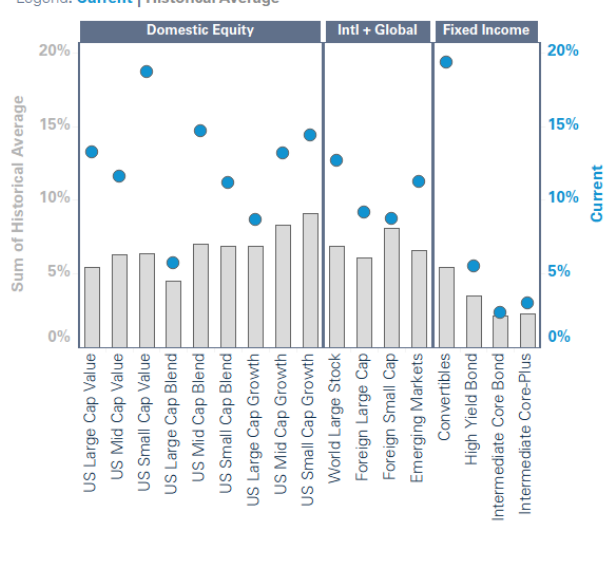
Most indicators point to “Neutral.” So far, so boring. The low readings for small cap blend can largely be attributed to the GameStop effect (source: “Long-Term, Short Squeeze,” Kristof Gleich, February 2021) and the convertible bonds, the Tesla effect, have accounted for nearly a quarter of the Indexes return.

Looking at our dispersion (this is the potential reward of active) indicator is where things start to get very strange. This chart shows how much differentiation there is between managers in these same asset classes:

Active Manager Dispersion - Rolling 1 Year - April 2021



Morningstar Categories (Open-End) | 25th-75th % Excess Return Dispersion

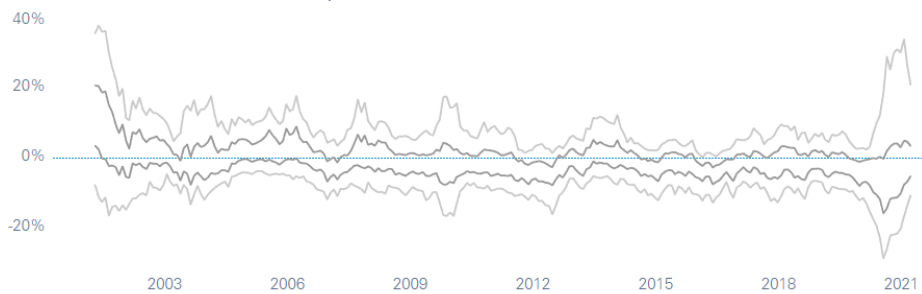


Most readings are at “Very High” according to Harbor’s gauges. This suggests that currently there is a lot of dispersion between active managers. Interestingly, across the different asset classes we have not seen dispersion like this in the last 20 years. The following are some notable highlights.



US Large Cap Growth | Distribution of Rolling 12M Excess Returns

Legend: 5th, 95th Percentile Excess Return | 25th, 75th Percentile Excess Return

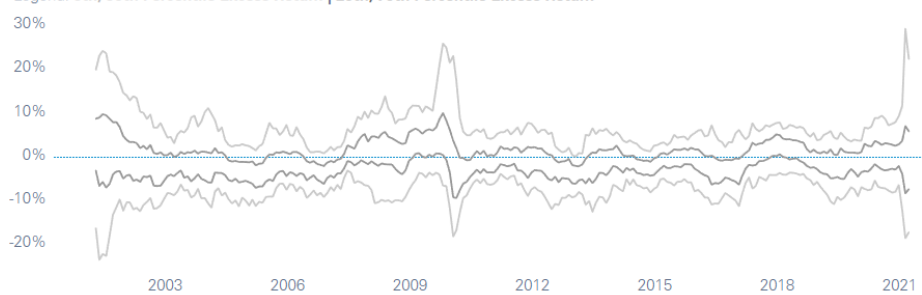


Source: Morningstar Direct

The top 5% of large growth investors are adding more value since the technology bubble of early 2000's.

US Large Cap Value | Distribution of Rolling 12M Excess Returns

Legend: 5th, 95th Percentile Excess Return | 25th, 75th Percentile Excess Return



Source: Morningstar Direct

Large value managers have quickly joined the party with value dispersion higher than I've ever seen it.

US Mid Cap Blend | Distribution of Rolling 12M Excess Returns

Legend: 5th, 95th Percentile Excess Return | 25th, 75th Percentile Excess Return

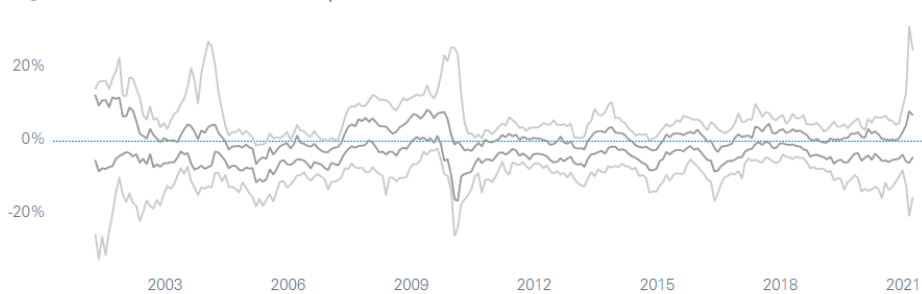


Source: Morningstar Direct

Medium size disruptive innovator names have propelled the success of mid growth managers.

US Mid Cap Value | Distribution of Rolling 12M Excess Returns

Legend: 5th, 95th Percentile Excess Return | 25th, 75th Percentile Excess Return

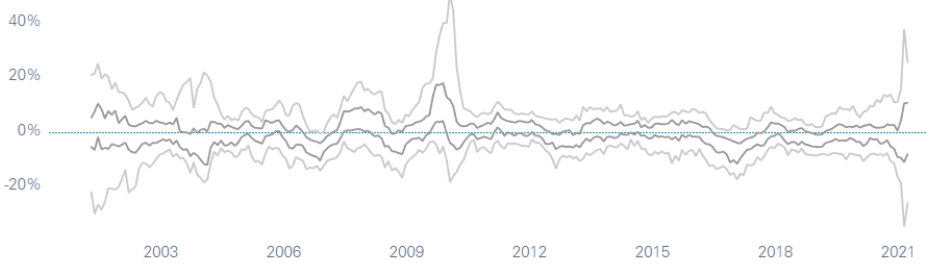


Source: Morningstar Direct

To date, mid value has never seen such a dramatic shift in dispersion.



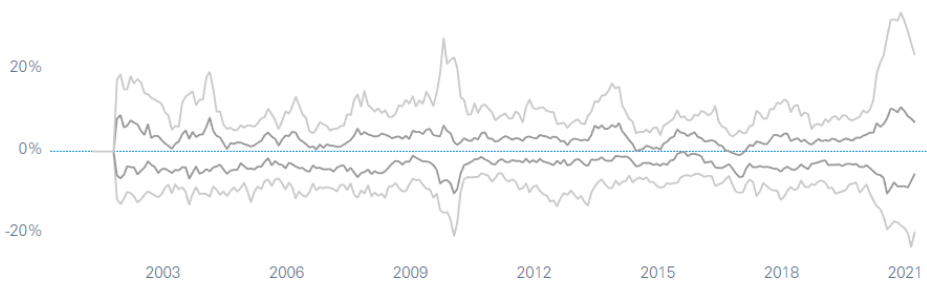
US Small Cap Value | Distribution of Rolling 12M Excess Returns
 Legend: 5th, 95th Percentile Excess Return | 25th, 75th Percentile Excess Return



Source: Morningstar Direct

Small value is only surpassed by the recovery post Global Financial Crisis.

World Large Stock | Distribution of Rolling 12M Excess Returns
 Legend: 5th, 95th Percentile Excess Return | 25th, 75th Percentile Excess Return



Source: Morningstar Direct

Investing in the widest opportunity set (Global) providing ample opportunities.

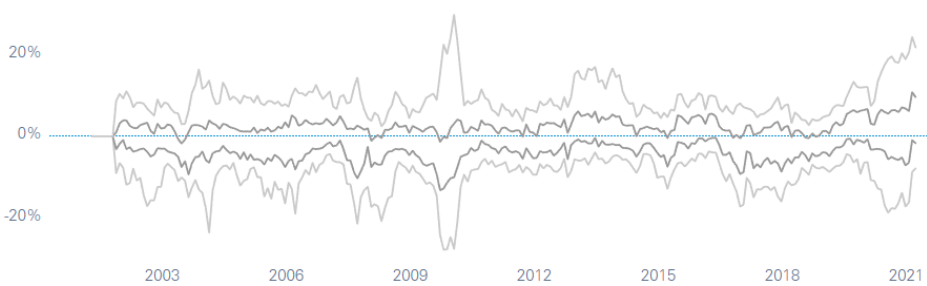
Foreign Large Cap | Distribution of Rolling 12M Excess Returns
 Legend: 5th, 95th Percentile Excess Return | 25th, 75th Percentile Excess Return



Source: Morningstar Direct

I'm seeing top quartile managers now generating more excess returns than the previous top 5% of managers.

Emerging Markets | Distribution of Rolling 12M Excess Returns
 Legend: 5th, 95th Percentile Excess Return | 25th, 75th Percentile Excess Return



Source: Morningstar Direct

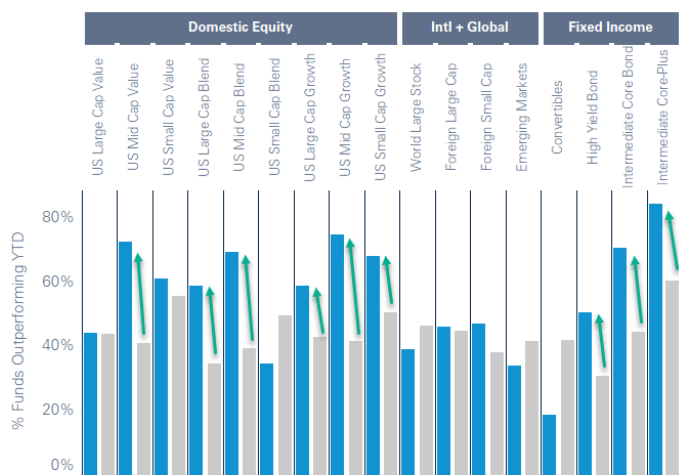
High quality emerging market managers are proving their worth throughout significant emerging market investing uncertainty.



We're researching more around these findings. We think it is some combination of more favorable stock dispersion (higher), more favorable correlations (generally lower) and larger opportunity set to hit home runs (great proportion of right tail stocks up over 100% relative to the benchmark). As our research develops, we'll report back with additional data and perspective.

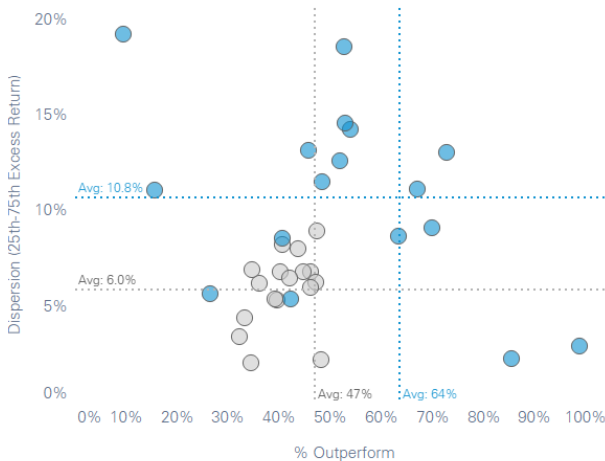
What is interesting so far **this year** is that the number of active managers outperforming on a year-to-date basis is quite high compared to where we normally are at this point of the year.

Morningstar Categories (Open-End) | % of Funds Outperforming YTD
Legend: 2021 YTD | Trailing 20-Yr Average April YTD



Source: Morningstar Direct

Morningstar Categories (Open-End) | Return Dispersion vs. % of Managers Outperform | Trailing 1 Yr
Legend: Current | Historical Average



Source: Morningstar Direct

If anything, this trend seems to be accelerating rather than winding down.

Unconventional wisdom

We appear to be in a new macro environment – the post GFC era of macro stability, low but steady growth, disinflation, and highly supportive interest rates and bond yields has ended.

Macro uncertainty and dispersion are as high as I have seen in 20 years of my career. Fiscal policy and monetary policy coordination represent a completely new backdrop facing investors. The recent past is not prologue. Indeed, investors have to look back to the late 1920's or 1930's to see a policy environment that most closely mirrors today's environment. Currency volatility and inflationary fears are creating new complexities we all must navigate. Disruptive innovation, driven by relentless and accelerating technology advances are creating new investment opportunities that have secular growth characteristics with less economic sensitivity – these are creating either new markets entirely or shaking up the market share pie of well-established industries. This environment seems to be bolstering more value creation and value destruction. Pulling this altogether, perhaps this is creating an environment where skilled stock pickers can once again add significant value for clients. We continue to monitor this dynamic for signs of mean reversion or whether we have entered into a different environment altogether.



What should investors do?

In this somewhat unprecedented environment, due diligence around manager selection is critical and active management, including actively managing passive index allocations, continues to be an important way to navigate the changing market landscape.

Expect larger dispersion of returns between your public market active managers while navigating this macro environment.

Recalibrate expectations around returns as the numbers are all over the map.

Look for managers that have higher idiosyncratic returns compared to factor-based returns.

Manager returns are more important in this environment. Higher idiosyncratic returns will likely be less correlated to other sources of returns and therefore likely be more valuable.

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