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INVEST WITH REASON

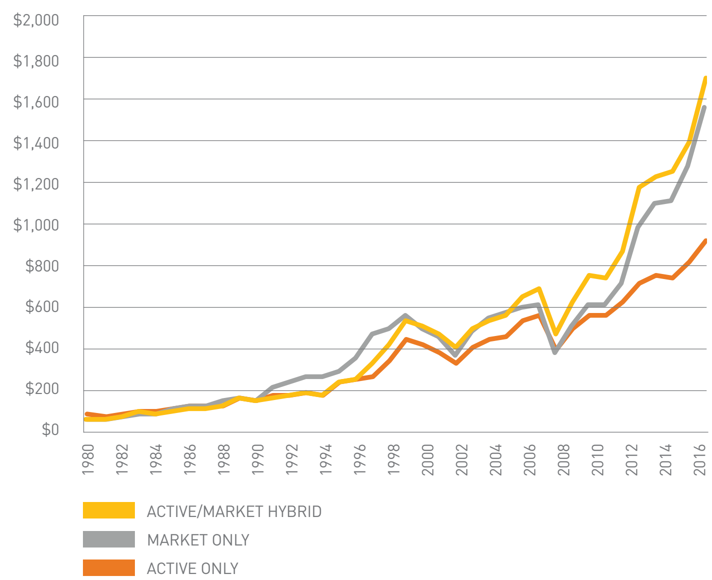
Exploring the Relationship Between Equity Correlations and Active Stock-picking Skill

t's no secret that managers of actively-run strategies struggle to beat passive indices over extended time periods.

For instance, an S&P Dow Jones Indices study found that, during the decade ending in December 2017, 90% of large-cap mutual fund managers underperformed the S&P 500 Index on a net-of-fees basis. I recently conducted research on the perennial active vs. passive question with my coauthor, Michael McDonald, an academic partner of ours and a finance professor at Fairfield University. Of particular interest to us was whether the relative performance of active strategies varies through time according to an influence such as changing correlations (how tightly—or how independently—stocks move with one another) among equities.

We conducted our research on (all) mutual funds, the market, and stocks from 1980 to 2017. Not surprisingly, we found that, across this 38-year time frame, the mean monthly return of mutual funds (0.52%) trailed badly behind that of the market (0.85%). Then we studied whether the relative performance of active funds (of which quantitative multi-factor funds are a subset) or strategies tends to improve during particular periods or market environments.

FIGURE 1: GROWTH OF $100



Source: Gerstein Fisher

We did this by examining the dispersion of betas (a measure of a stock's volatility in relation to the overall market) among equities—when there is greater variation in stock betas, the performance among equities is more dispersed.

In contrast to what we often hear from the industry and managers, we found that periods of greater dispersion of equity correlations (i.e., when stocks are not moving in sync) are associated with weaker performance by active strategies, and that performance improves dramatically when correlations are high but then decline rapidly (a sudden widening of dispersion could be due to an underlying factor such as the economy transitioning from a very stable to a less-stable state). This makes intuitive sense in that, if correlations across all equities were identical, then there would be very little value that active managers could add to a passive benchmark through stock picking.

A Time for Active and a Time for Passive

In short, there are periods in which active will outperform and times when passive indexing will reign. One possible method would be to use both (i.e., to diversify styles and strategies in your portfolio) but to switch between the two based on shifts in correlations. Figure 1 illustrates an example of such a strategy. *Active* in the exhibit is an equal-weighted portfolio invested continuously in all active mutual funds. *Market* is an equal-weighted portfolio continuously invested in the entire universe of stocks. *Hybrid* switches between actively managed mutual funds and the market based on changes in equity correlations in a particular month.

My grandmother always told me that too much of anything was no good. Maybe Grandma was right. Too much of any one thing is no good. As the graph shows, the best performer is not the active-fund portfolio (which includes multi-factor strategies) or the passive-market portfolio; it's the hybrid strategy balancing active and passive.

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