IS IT FINALLY BECOMING A STOCK PICKERS' MARKET? IS IT EVER?

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With all the volatility in the market, one refrain in the marketplace we often hear is that the time has come to abandon index tracking strategies in favor of active managers, who can become more defensive, go to cash and then find some ultimate bargains on sale. I had a great conversation with Craig Lazzara, Head of Index Investment Strategy at S&P Dow Jones Indices, about his research on dispersion—a factor he believes is very important in explaining the opportunities for active managers. Below are some notes from our conversation. ***Craig, tell us what started your investigation on this factor of dispersion?*** **Craig Lazzara:** We ultimately wanted to say something about market volatility. In very basic terms: The market's volatility can go up for two reasons:

1) The volatility of individual stocks goes up and correlation remains the same, or
2) The volatility of individual stocks remains the same but correlations between stocks go up. We think our measure of dispersion is a good way to measure and keep track of the average volatility at the individual stock level. ***Are today's dispersion readings suggestive that it is a good time to be a stock picker?*** **Craig Lazzara:** The current dispersion readings are actually quite low, so I would say there are fewer opportunities for active managers than usual. More broadly, the term "stock pickers' market" is something we typically put in quotes—there's no clear definition of what the term actually means. Dispersion lets us measure the spread between the best and worst stocks. In high-dispersion periods, the best and worst stocks have returns that are far apart. In low-dispersion periods, the returns are relatively close. As far as the opportunities for active management, there are intrinsically bigger opportunities with high dispersion. High dispersion does not mean more active managers will outperform or underperform. But if you have a certain level of skill—you could technically call it an information ratio—it will translate to a higher alpha for your clients in a higher dispersion environment than in a low dispersion environment. If you look at our S&P Indices Versus Active (SPIVA®) study that goes back a dozen years, comparing large-capitalization managers to the S&P 500—when you look at the spread between the top 75% active managers and bottom 25% active managers, there is a noticeable correlation between the spread between the best and worst managers and the level of dispersion in the market. When dispersion goes up, the spread between the best and worst managers tends to widen and when dispersion goes down, the spread narrows. What we very consistently find with SPIVA is the majority of active managers underperform benchmarks consistent with their style. A majority of large caps underperform the S&P 500, a majority of small caps underperform the S&P 600. There are years when that is not the case, but they are uncommon. This is just evidence of what William Sharpe called "the arithmetic of active management"—the average owner owns the average asset, and therefore the average of the owners' returns has to be the same as the average of asset returns. With SPIVA, there was no relationship we could detect between the level of dispersion and what percentage of active managers outperform—it is just random. The spread between the best and worst managers did widen or narrow with greater dispersion. That is what you'd expect -- with a wider band of stock returns, there is more opportunity to do well or perform badly from the active standpoint. Just to emphasize, today's dispersion readings are quite low. ***Your research note showed that from 2003 to 2012, that***

in eight of the 10 years, active managers underperformed the S&P 500. What does that say to you about active managers? **Craig Lazzara:** I'd start by asking: What is the market's capacity to generate alpha, and what is the market's capacity to generate beta? The North American stock market is worth $20 trillion[1]. The market's supply of beta is $20 trillion worth. It gets marked up and down with the market every day—but at any point in time, it's easy to measure. Now, what is the market's capacity to generate alpha? Zero. The only way I can be above average is if someone else is below average. The weighted average outperformance of the outperforming managers has to equal the weighted average underperformance of the underperforming managers. Given that there is no natural supply of alpha, and active management costs more than passive, it is not surprising that the majority of active managers underperform a passive index. ***When looking at dispersion across size segments, what did you find from large caps to small caps?*** The mid- and small caps consistently have greater dispersion than large caps. They tend to follow the same general pattern and are currently at the low end of their historical range—as are large caps. One way to interpret that: There is more market opportunity for managers who are picking stocks to outperform or to underperform in the mid- and small-cap stock segments compared to large caps. Does that dispersion lead to better performance for active managers trying to outperform in mid- and small caps? No. The mid- and small-cap stocks have about the same percentage of active managers underperforming as large caps. But there is a greater differential and range in returns between the best and worst active managers in the mid- and small-cap space. **Craig, thanks for taking the time to speak with us about your research.** For more information S&P Dow Jones Indices' research on active managers, please see its SPIVA study here and their note on dispersion here. [1]As of 01/31/2013.

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DEFINITIONS

Volatility : A measure of the dispersion of actual returns around a particular average level. .

Active manager : Portfolio managers who run funds that attempt to outperform the market by selecting those securities they believe to be the best.

Dispersion : A measure of the statistical distribution of portfolio returns.

Correlation : Statistical measure of how two sets of returns move in relation to each other. Correlation coefficients range from -1 to 1. A correlation of 1 means the two subjects of analysis move in lockstep with each other. A correlation of -1 means the two subjects of analysis have moved in exactly the opposite direction.

Alpha : Can be discussed as both risk-adjusted excess return relative to a specific benchmark, or absolute excess return relative to a benchmark. It is sometimes more generally referred to as excess returns in general.

Large-Capitalization (Large-Cap) : A term used by the investment community to refer to companies with a market capitalization value of more than $10 billion. Large cap is an abbreviation of the term “large market capitalization”. Market capitalization is calculated by multiplying the number of a company’s shares outstanding by its stock price per share.

S&P 500 Index : Market capitalization-weighted benchmark of 500 stocks selected by the Standard and Poor’s Index Committee designed to represent the performance of the leading industries in the United States economy.

S&P SmallCap 600 Index : Market capitalization-weighted measure of the performance of small cap equities within the United States, with constituents required to demonstrate profitability prior to gaining initial inclusion.

Beta : A measure of the volatility of a security or a portfolio in comparison to a benchmark. In general, a beta less than 1 indicates that the investment is less volatile than the benchmark, while a beta more than 1 indicates that the investment is more volatile than the benchmark.

Passive : Indexes that take a rules-based approach with regular rebalancing schedules that are not changed due to market conditions.

Mid-Cap : Characterized by exposure to the next 20% of market capitalization (after the top 70% have been removed) within the Value, Blend or Growth style zones with the majority of the fund’s weight.

Small caps : new or relatively young companies that typically have a market capitalization between $200 million to $2 billion.