PASSIVE INVESTING AND FOLLOWING THE HERD
Passive investing has grown materially over the past few decades with the advent of index funds and ETFs, and the low cost and ease of investing in such strategies. However, passive investments may now be near a pinnacle of popularity, and we suspect some investors may again fall victim to following the herd.
The surge in growth of passive investing over the past 10 years has come at the expense of active management. This appears to partially be the result of performance-chasing by investors looking in the rear-view mirror.

**EXHIBIT 1: CUMULATIVE FLOWS TO DOMESTIC EQUITY FUNDS ($ BILLIONS)**

Source: ICI
* Equity fund flows include new cash and dividend reinvestment.

Active management has underperformed passive management since 2011, but a longer-term look at the relative performance of active and passive management reveals that it ebbs and flows in a cycle.

**EXHIBIT 2: AVERAGE 3-YEAR ROLLING RETURN OF DOMESTIC LARGE-CAP ACTIVE VS. PASSIVE FUNDS**

Source: Hartford Funds, Morningstar
* Represents the difference in 3-year rolling returns of Morningstar’s large-cap blend active strategies and passive strategies. Past performance is not indicative of future returns.
While passive management has its advantages, they are offset by key differentiators of active management, including:

1. **Market Capitalization**: The favoring of small-cap versus large-cap securities

2. **Style Bias**: The selection of value over growth securities

3. **Cash Balances**: The propensity to carry “dry powder”

4. **Geographic Diversity**: The inclination to include international securities in the portfolio

On the whole, these characteristics leave passive strategies like S&P 500 Index funds more exposed to overvalued stocks with the highest market capitalizations and greatest weightings. The most visible examples of this were the weightings of the overvalued tech sector (35 percent of the S&P 500) during the 1999/2000 bubble and the financial sector (22 percent of the S&P 500) prior to the 2008/2009 financial crisis.

EXHIBIT 3: S&P 500 SECTOR WEIGHTS OVER TIME

Source: FactSet, Glenmede
By contrast, an active management approach is more likely to shun overvalued stocks and companies that have grown too big in favor of investments that offer cheaper valuations and greater future growth opportunities. Historically, such approaches have added value, but the recent period has been unkind in a bull market favoring larger growth companies domiciled in the U.S.

Further, as shown below, over the past 10 years stocks have exhibited relatively high cross-correlation, and are more likely to trade like one another than be differentiated based on underlying fundamentals. Interestingly, as also shown in this illustration, in the last year or so correlations have begun to weaken, suggesting change may be afoot.

EXHIBIT 4: CORRELATIONS INDICATE THAT IT COULD BE A STOCKPICKERS' MARKET*

Source: FactSet, Glenmede and The Wall Street Journal

* Correlations were calculated using a 3-month rolling average of S&P 500 21-day returns.
ACTIVE MANAGEMENT: DON’T JUST FOLLOW THE HERD

No one can say for certain how long the move toward passive management will continue, but growing evidence suggests we may see an ebb in its popularity after reaching a fairly substantial level.

We recommend investors be mindful of following the herd. Quite often, it can lead to poorly timed investment decisions.

EXHIBIT 5: INDEXED EQUITY MUTUAL FUNDS AND ETFS: NEARLY 40% OF TOTAL ETFS AND MUTUAL FUNDS