



Why higher rates won't spark a return of stock picking

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- Various studies have revealed that contrary to popular beliefs, the dispersion of equity market returns during the low-interest rate period was not unusually low.
- The argument that the underperformance of active managers can be blamed on monetary policy and a lack of opportunities to generate alpha is not supported by the data.
- True alpha is rare and investors seeking it are at risk of falling prey to hindsight and survivorship bias.
- We believe that the active/passive debate deserves to be led more nuanced, including acknowledging stock and bond pickers' role in ensuring efficient markets, the merits of differentiated, fairly priced products but also the value of having a substantial allocation to pure market beta as a portfolio's core.

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Active investment managers frequently blame underperformance on monetary policy and the long bull market, arguing that a lack of dispersion in returns made it impossible for skilled managers to demonstrate their talent [13]. It is consequently claimed that a more choppy macroeconomic environment with higher interest rates will finally reveal the flaws of index investing and vindicate alpha-seekers[2]. In our opinion, there is little evidence to support this hypothesis.

1 Did the rising tide lift all boats?

There is a popular narrative in the investment community that the market share grab of low-cost index tracking funds (ETFs) has been fueled by the long bull market and easy monetary policy following the Great Financial Crisis. Aphorisms such as Warren Buffet's "Only when the tide goes out do you learn who has been swimming naked" or John F. Kennedy's "A rising tide lifts all boats" are frequently used in this context, typically ignoring their initial meaning and context. The idea is that plunging interest rates decreased discount factors for all assets, creating a "rally of everything" that boosted stocks regardless of their quality, thus resulting in falling performance dispersion.

This in turn, so the story goes, benefited "passive" long-only products that "simply buy everything" to the detriment of active investment professionals who suffered from a lack of opportunity to generate alpha. If every asset increases in value indiscriminately, how can a skilled stock or bond analyst outperform the bench-



mark, right? Ironically, another school of thought states that low rates continuously drove certain stocks away from their true fair values allegedly known to the sophisticated investors, but covering this topic is beyond the scope of this article [4]. In any case, the argument goes, rising rates will finally make active investment, most importantly stock picking, finally worthwhile again. Proponents of the theory can point to the formula used to derive the Information Ratio, a metric describing a portfolio's excess return relative to its active risk. According to the "fundamental law of active management" by Richard Grinold and Ronald Kahn, an investor's information ratio is determined by his skill (Information Coefficient) and the opportunities available in the market (Square Root of Market Breadth)[1].

Market breadth also called the diffusion of performance, measures how broadly supported market movements are. Obviously, the potential outperformance a skilled manager can generate is highest when market breadth is lowest. In turn, the more similar the returns of all assets, the lower the outperformance produced by skilled selection. While there are different ways of defining and measuring market breadth, research on

the topic typically uses the cross-sectional standard deviation of asset performances during the relevant period. This metric can subsequently be weighted by the summands in the standard deviation calculation to account for the fact that portfolios are typically not equally weighted (see, for instance, the paper on "Dispersion: Measuring Market Opportunity" by S&P Global).

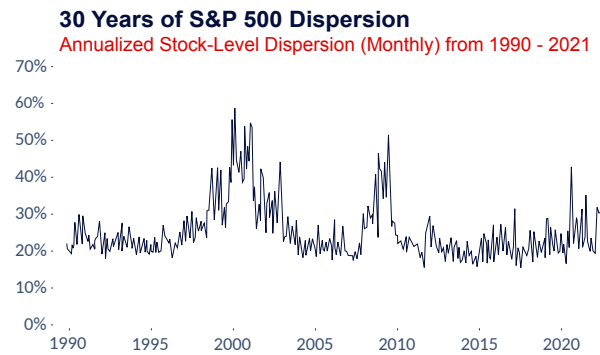
2 Checking the facts

It becomes clear from these points that the "rising tide" theory, while certainly intuitive at first sight, rests on a whole bunch of assumptions, raising several complicated questions:

- Dispersion Trends: First, was there indeed an increase in market breadth/decrease in return dispersion during the time of extremely easy monetary policy following the Great Financial Crisis?
- Dispersion and Rates: Secondly, if there was a decrease in return dispersion, can it be traced back to low-interest rates, and is it reverting now that rates have risen substantially again?
- Dispersion and Alpha Generation: Is there, indeed, a correlation between dispersion (opportunities available in the markets) and outperformance of active managers on aggregate?
- Alpha Generation and Performance Persistence: Finally, if skilled managers can shine during times of elevated dispersion, can they be determined ex-ante (introducing the problem of alpha persistence)?

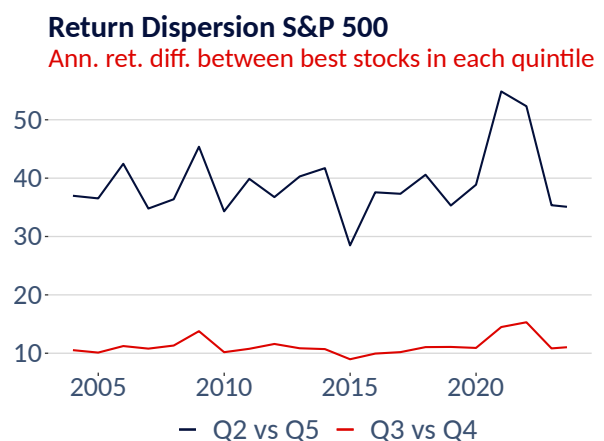
2.1 Dispersion Trends

While dispersion, as defined earlier, is not readily observable, numerous articles and papers have regularly been published on the topic, making it easy to obtain statistics, at least for the most important stock market index, the S&P 500, which is why we are subsequently focusing on this market here. (see for instance S&P Global in the [indexology blog](#)) for regular updates. The chart below from the Evidence-Based Investor blog collects the data for the S&P 500 for the past 30 years and pretty much agrees with the time series given by other sources (e.g. [S&P Global from June 2022](#)) While the graph shows a strong correlation between stock market dispersion and overall volatility, with return dispersion rising during phases of distress, it also reveals the utter lack of a long-term trend. An analysis we ran at Amadeus using a more straightforward metric confirms this. As illustrated in Figure 2, we calculated the return differential between security sort breakpoints. This was achieved by sorting all S&P 500 members according to their annual total returns and comparing the best stocks in the second and fifth quintiles, respectively, and third and fourth quintiles. Again, we cannot



Source: *The Evidence-Based Investor* [10]
Figure 1: Contrary to widely held beliefs, return dispersion during the post-financial crisis period was not particularly low.

detect a trend or meaningful difference between the QE and the pre-QE market environment. As the past year brought inflation back to investors' minds, we also searched for time series going back further and stumbled over research by the Federal Reserve Bank of Chicago, published in 1991 [12]. The paper showed dispersion figures for the US stock market between 1965 and 1987, thus covering the inflationary period of the 1970s and 1980s, and reveals similar patterns as the recent S&P Global analyses. Dispersion tends to spike during crisis times and is otherwise mean reverting with no underlying directional trend. Dispersion

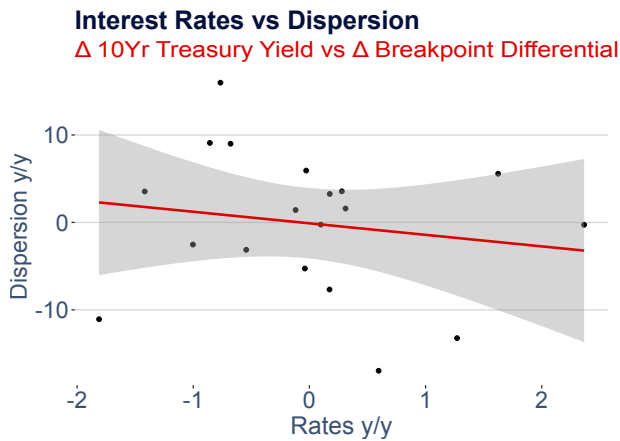


Source: *The Evidence-Based Investor* [10]
Figure 2: The difference between quintile breakpoints when sorting stocks according to their past 12-month performance shows no meaningful trend either.

during the years of quantitative easing and the alleged rally of everything (often defined as 2010-2020) was neither lower nor higher than during the early 2000s, the 1990s, and even the 80s, 70s, or 60s. In other words, the opportunity set available to stock pickers during the recent decade was no different from what they had to deal with before the crisis or at the end of the last century.

2.2 Dispersion and Interest Rates

Have lower rates reduced dispersion and thus diminished opportunities for active managers? The lack of a trend already suggests that this has yet to be the case. Nevertheless, a shorter-term correlation between rates and dispersion can be observed. When comparing rate increases and changes in dispersion, research by S&P published in 2015 already found that the "result was the opposite of our expectation, as the quartile in which rates increased the most (averaging 30 bps) was the quartile in which dispersion declined the most. Between 1991 and 2015, the correlation between the 10-year US Treasury yield and the dispersion of the S&P 500 was -0.06 " [5]. We obtained similar results when regressing the annual changes in our own dispersion indicator displayed in Figure 2 with the delta in the yield offered by 10-year US Treasuries. While this



Source: *The Evidence-Based Investor* [10]
Figure 3: The correlation between benchmark interest rates and changes in dispersion has been negative, defying the commonly held belief that lower rates tend to benefit all stocks equally.

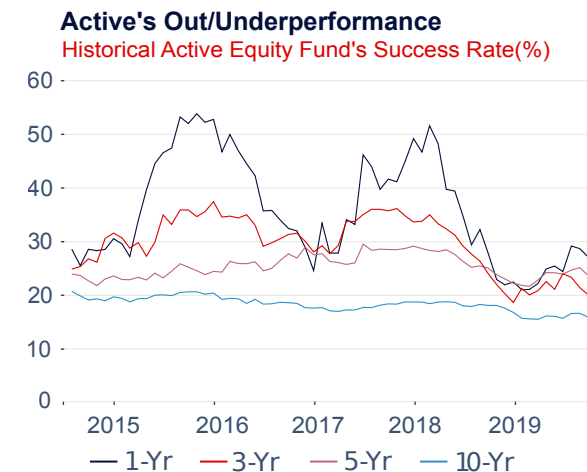
finding deals a blow to the popular belief of a positive relationship between rates and dispersion, it is not as counterintuitive as it may appear at first sight. Multiple papers demonstrated the strong correlation between dispersion and volatility, and the 1991 Chicago Fed paper found that it was a useful leading business cycle indicator. As interest rates tend to decrease when the economy weakens, while dispersion shoots up when the stock market declines, it is thus not surprising that dispersion and rates tend to be negatively correlated.

2.3 Dispersion and Alpha Generation

Arguably, dispersion tends to be higher during a crisis, meaning the "rising tide lifts all boats" analogy is not entirely off. So while dispersion during the 2010s was not lower than during previous bull markets, unhappy stock pickers could make the case that the FED's easy monetary policy successfully suppressed another financial crisis and indirectly prevented potential surges in dispersion one could have observed. This leads to

the third question raised at the beginning. Do active funds do better when dispersion is higher? Studies on the topic have provided mixed evidence. 2023, for instance, S&P Global could find no relationship between dispersion levels and the percentage of outperforming US equity funds between 2003 and 2012 [6].

On the other hand, a more recent Morningstar research indicates that over the past decade, a higher percentage of active equity funds survived and outperformed during years with more choppy markets like 2015, 2018, and 2020 [9]. Apart from the fact that 2022 was apparently less of a bright spot [11] [7], this is no reason to cheer, as these moments of glory were short-lived, and the research also demonstrates that even during the best years, success rates barely exceeded 50% (see Figure 4). Active fund outperformance during years with larger drawdowns also raises the question of whether the successful stock pickers truly generated alpha or whether the outperformance is attributable to the often higher cash quota of active mutual funds or factor tilts towards low-volatility and other defensive characteristics, for which tons of cheap smart beta products are available in the market.



Source: *Morningstar* [10]
Figure 4: According to Morningstar data, the percentage of outperforming U.S. equity funds, though embarrassingly low in the longer run, was relatively elevated during more volatile years. However, managers, praising themselves on their superior downside risk management, must confront the question of whether their stock-picking skills are better described as a low-beta tilt.

2.4 Alpha Generation and Performance Persistence

Another approach to the dispersion question was taken by Huij and Lansdorp 2012, who looked at dispersion levels not over time but in the cross-section of dispersion of asset classes (e.g. International Stocks, International Bonds, U.S. Large Caps...). They showed that

the spread between mutual funds' performances was more significant in asset classes with higher dispersion levels (unsurprising), but also that performance persistence was higher in these markets. In other words, the paper argued that stronger funds were more likely to continue to outperform their weaker peers in the presence of higher dispersion levels. The research was later quoted by Morgan Stanley, concluding that "talented managers need dispersion in order to play their skill"[14]. We would approach the findings more cautiously. Huij and Lansdorp 2012[8] measured mutual fund persistence by constructing funds portfolios based on their previous twelve-month returns every month. They found that the portfolio that bought into the funds with the best past performance outperformed those selecting the worst past performers. They concluded that there is persistence in mutual fund returns, indicating skill.

This method essentially applies typical momentum investing to the universe of active funds. While this is a legitimate investment strategy, it is a rather poor way to measure the persistence or skill of performance, given that it measures persistence over a very short time horizon. The results could be attributable to positive autocorrelation of their chosen strategy (e.g. specific factor exposures) without this being any indicator of skill. Second, Huij and Lansdorp do not adjust their results for exposure to common risk factors and therefore may measure the persistence of returns to factor beta rather than skill. An NBER working paper from 2020[3], studying U.S. mutual funds' performance persistence over time, found thin evidence for lasting alpha generation. Most importantly, examining more than 50 years of data, Choi and Zhao 2020 found that performance persistence declined over time, which explains why Carhart (1997) could still conclude that, to some degree, past performance was a predictor of future (relative) returns.

3 An ill-informed debate

Looking into several decades of data and various studies, we find that:

- Return dispersion in the U.S. stock market (and likely also in other markets) was **not** particularly low during the low-interest period
- There is no significant correlation between dispersion levels and interest rates. The argument that easy monetary policy lifted all stocks indiscriminately can not be supported (it also contrasts sharply with the finding that valuation multiple spreads increased sharply during this period as outlined in our [December 2021 article](#)).
- There is little evidence that higher dispersion levels lead to a higher share of mutual funds outperforming.

- Today's outperformers are seldom the outperformers of tomorrow, suggesting that good results are more often a function of luck or style exposure than true alpha. It also indicates that it is hard, if not impossible, for investors to successfully select future outperformers, although it is easy to get a different impression in the presence of hindsight and survivorship bias (how likely is it that a fund with poor past performance will be presented at an investor conference?).

Financial markets love good narratives, and a simple, intuitive story tends to be hard to kill, even if it is not supported by evidence. The idea that active managers fell victim to overly expansive central banks and star stock pickers simply couldn't demonstrate their skills in an environment dominated by price-insensitive flows and "dumb money" is one of these myths. Sadly, investors who bet on a return of active management in the higher-rate environment are setting themselves up for disappointment. More importantly, we believe that an often emotional and ill-informed active/passive debate doesn't serve them well in general. There is no doubt that true alpha is incredibly tough to find and unlikely to persist - the fact that its mere existence is debated is itself quite telling.

Eventually, the average cannot outperform the average, ETFs are introducing a free-rider problem, weak managers exit the market making it less likely for strong managers to maintain their competitive advantage, and the 1980s or 1990s still suffered from poor investor protection, meaning that some successful managers probably benefited disproportionately from insider trading and generous IPO allocations. This does not mean that there is no place for active management, most notably stock selection. After all, active managers are enablers of efficient markets. However, the ruling is still out on exactly how much fully discretionary decision-making is required to reach a reasonable level of market efficiency in the presence of pretty sophisticated index construction and smart beta ETFs (see our article on [the investment process behind the S&P 500 and the level of discretion involved as demonstrated by the controversy around Tesla's inclusion](#)).

Therefore, understanding the slim odds of beating the market in any environment remains absolutely crucial. A solid core allocation to market beta to ensure adequate participation in overall economic development and avoiding overexposure to active risk is the most appropriate strategy for most market participants. Of course, this does not imply there is no space for truly differentiated satellite strategies.

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