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MARKET VIEW

FOUR MYTHS IN THE ACTIVE/PASSIVE DEBATE

We take a deeper dive into key misconceptions about active investing.

There are, in our view, four myths often repeated in the active/passive debate.

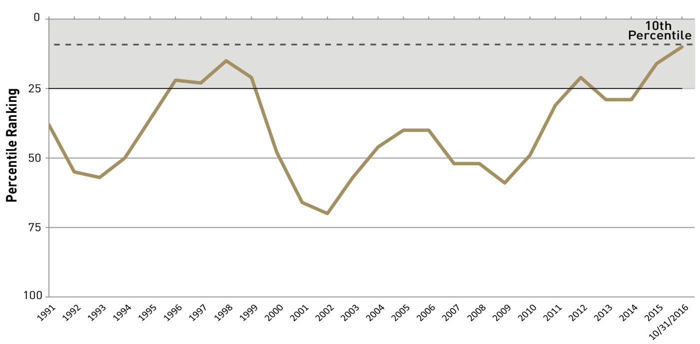
1) IT'S IMPOSSIBLE FOR ACTIVE MANAGERS TO BEAT INDEXES.

Five years ago, this would have been a straw man argument that no one would have taken seriously. But over the past few years, some investors have embraced this claim as a legitimate one. It's bolstered by overblown headlines such as the recent one in the *Financial Times*, which stated that "99% of actively managed U.S. equity funds underperform."

Many of these headlines treat passive outperformance as an inevitability. The truth is that passive strategies are enjoying a period of unprecedented performance relative to active peers. Chart 1 shows that, as of October 31, 2016, the three-year performance of the S&P 500® Index would rank in the tenth percentile of the Lipper Large-Cap Blend classification, the strongest ranking in 25 years.

CHART 1. INDEX PERFORMANCE IS UNUSUALLY STRONG RELATIVE TO ACTIVE MANAGERS

S&P 500 RANKING IN LIPPER LARGE-CAP BLEND CLASSIFICATION, ROLLING THREE-YEAR PERFORMANCE



Source: Lipper.
Note: Rolling three-year performance rankings tabulated on an annual basis; 2016 data as of 10/31/2016.
Past performance is no guarantee of future results. For illustrative purposes only and does not reflect any specific portfolio managed by Lord Abbett or any particular investment and should not be relied upon as investment advice. Indexes are unmanaged, do not reflect deduction of fees and expenses and are not available for direct investment.

A further look at the studies underlying the headlines shows some serious flaws in the methodology. One of the biggest is that the share class used for active performance measurement by the S&P Dow Jones in its SPIVA [Standard Poor's Index Versus Active] studies is the "largest share class." That most often is the 'A' share class, which tallies distribution charges in its management fees. The class is constructed in this manner because the users are often commission-based advisors, on behalf of their clients. This set of advisors does not charge an ongoing advisory fee, and so earns a living through shares of other fees, some of which are contained in mutual funds' management fees. Fee-based advisors, on the other hand, charge an annual fee to manage money, which is not included in the funds' management fees and not deducted from performance. Comparing share classes built for commission-based advisors with other classes built for fee-based advisors is to compare a net result to a gross result.

More carefully constructed studies don't grab the headlines like the SPIVA studies do, but they show more realistic results—such as, that a small majority of managers underperform indexes and some managers earn well in excess of their fees. Managers that focus on active stock picking, for example, have been shown to exhibit excess returns of 1.4%, on average, as indicated in research by Martijn Cremers and Anttii Petajisto, in their seminal paper on "active share," "How Active Is Your Fund Manager?"

2) PASSIVE FUNDS ARE ALWAYS SIGNIFICANTLY CHEAPER THAN ACTIVE FUNDS.

In another case of headline numbers not telling the whole story, the average management fee of passive funds is sometimes compared to the average management fee of active funds. Morningstar, for example, figures the average active fund fee at about 80 basis points (bps) and the average passive fund fee at about 20 bps—a disparity that is often cited to justify capital flight to passive strategies. However, it's important to understand that these are asset-weighted expense ratios and that the asset mix between active and passive is quite different in different asset classes and styles. The passive share of the Morningstar Large Blend category, for example, is 71%, while the share of the Morningstar Large Growth category that is passively managed is only 13%. Furthermore, when passive funds do compete in specialized sectors, the management fee is typically much higher than an asset-weighted average of all passive fees. In equity income, for example, the average ETF [exchange-traded fund] management fee is 47 bps while the average S&P 500 ETF is only 13 bps, according to Lipper.

In addition, active managers cannot all be grouped into a "high cost" bucket, as there are a wide range of fee structures available. Low-cost active funds can be a compelling investment proposition with the opportunity for alpha from active management at costs comparable to competing passive funds. Morningstar's most recent Active/Passive Barometer found that the lowest-cost quartile of active funds was likelier to survive, and enjoyed greater odds of success (success being defined as beating passive competitors) in every category versus the highest-cost quartile—and sometimes the difference was dramatic. In mid-cap value, for example, the lowest expense quartile of active funds had a 10 times higher success rate than the highest expense quartile.

3) ALL EQUITY ALLOCATIONS ARE GOING PASSIVE.

The headlines also suggest massive capital outflows from actively managed equity funds into passive strategies. While this directionally is true, the magnitude is often overstated. At the very least, the implications of these capital flows should be considered.

It has been well-documented that investors tend to chase performance, and that, historically, this tendency has been detrimental to investor returns when compared to asset-class returns. Many of the dollars flowing into passively managed equity strategies today may be performance-driven as well. Our concern is what happens when the performance and flows reverse. A recent study from Deutsche Bank revealed that the average holding period for equity ETFs was only 137 days. Passive investors choosing the ETF vehicle may be investing alongside short-term traders and others who are chasing "hot money" that could potentially flee quickly if performance rankings were to revert to the historical mean. Mutual fund investors, on the other hand, tend to invest for the long term, as supported by a recent ICI study that reported that 91% of mutual fund investors state that retirement is one of their investment objectives.

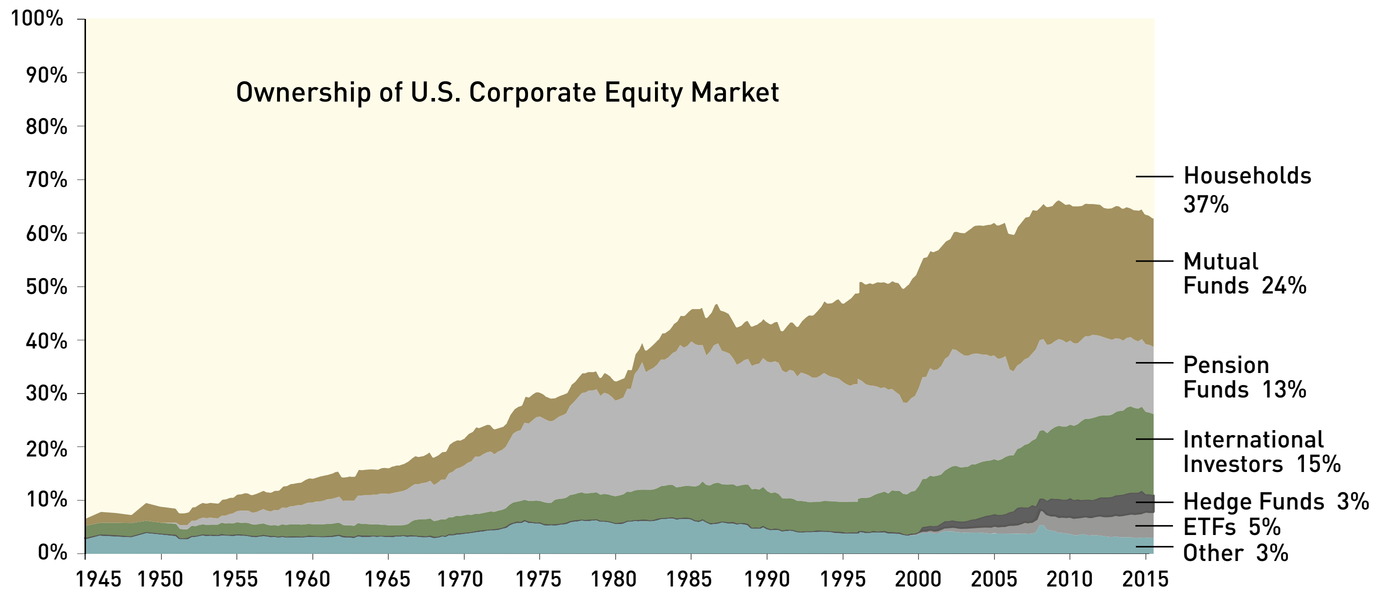
Finally, the headline numbers detailing the flows from actively managed equities overlook a critical distinction. Flows are only tracked for mutual funds, and are difficult to trace for less-transparent vehicles, such as collective investment trusts (CITs). As adoption of collective trusts by defined contribution plans accelerates, only the outflows are captured when investors transfer from actively managed mutual funds to actively managed CITs. In the week ended October 26, for example, investors redeemed $16.6 billion in equity funds, but $11.7 billion of that figure was due to a restructuring of an actively managed proprietary fund to a CIT structure, according to Lipper's Weekly FundFlows Insight Report.

4) ACTIVE MANAGEMENT IS A ZERO-SUM GAME, MATHEMATICALLY FORCING THE AVERAGE MANAGER TO LOSE TO LOW-COST INDEXES.

Mutual funds represent only 24% of the ownership of U.S. equities and, despite the asset-gathering binge in the last few years, ETFs still represent only about 5% of the market (see Chart 2). This means mutual funds can trade with many other types of active investors. Households, for example, are still 37% of the market, with pension funds and international investors representing other large, non-mutual-fund cohorts. Further, there is substantial evidence that some portions of this active market, especially retail investors, underperform the asset class returns systematically. So while active management may be a zero-sum game, institutional managers like mutual funds are not relegated to market returns minus fees, as is sometimes argued.

CHART 2. MUTUAL FUNDS REPRESENT ONLY 24% OF THE U.S. CORPORATE EQUITY OWNERSHIP

OWNERSHIP OF U.S. CORPORATE EQUITY MARKET ($36 TRILLION), AS OF JUNE 30, 2016



Source: Federal Reserve and Goldman Sachs Global Investment Research.

Note: Data as of June 30, 2016; market totals $36 trillion, which includes $7 trillion in foreign equity holdings.

For illustrative purposes only and does not reflect any specific portfolio managed by Lord Abbett or any particular investment and should not be relied upon as investment advice. Indexes are unmanaged, do not reflect deduction of fees and expenses and are not available for direct investment.

In this lies an opportunity for professional advisors. If it were easy to pick an outperforming manager at random, anyone could do it, and a large portion of an advisor's worth would be questionable. Fortunately, not all managers are the same. It takes some knowledge, some quantitative and qualitative research, and, indeed, some skill to choose those who will outperform going forward. A prudent investor will look for managers with a commitment to investment research, a long-term record of performance through a variety of market conditions, investment and risk-control processes that are repeatable and sound, and, of course, reasonable fees.

IMPORTANT INFORMATION

Risks to Consider: The value of investments in equity securities will fluctuate in response to general economic conditions and to changes in the prospects of particular companies and/or sectors in the economy. Historically speaking, growth and value investments tend to react differently during the economic cycle. Since value stocks are often cyclical in nature, they may benefit from the increased spending that usually occurs during an economic expansion. Growth stocks may also perform well during an expansion, but they may also be out of favor during market downturns, when investors pay more attention to price ratios. While growth stocks are subject to the daily ups and downs of the stock market, their long-term potential as well as their volatility can be substantial. No investing strategy can overcome all market volatility or guarantee future results.

Note: Statements concerning financial market trends are based on current market conditions, which will fluctuate. There is no guarantee that markets will perform in a similar manner under similar conditions in the future.

Lipper Large-Cap Blend portfolios are Funds that, by portfolio practice, invest at least 75% of their equity assets in companies with market capitalizations (on a three-year weighted basis) above Lipper's USDE large-cap floor. Large-cap core funds have more latitude in the companies in which they invest. These funds typically have average characteristics compared to the S&P 500 Index.

Morningstar Large Blend portfolios are fairly representative of the overall U.S. stock market in size, growth rates, and price. Stocks in the top 70% of the capitalization of the U.S. equity market are defined as large cap. The blend style is assigned to portfolios where neither growth nor value characteristics predominate. These portfolios tend to invest across the spectrum of U.S. industries, and owing to their broad exposure, the portfolios' returns are foten similar to those of the S&P 500 Index.

Morningstar Large Growth portfolios invest primarily in big U.S. companies that are projected to grow faster than other large-cap stocks. Stocks in the top 70% of the capitalization of the U.S. equity market are defined as large cap. Growth is defines based on fast growth (high growth rates for earnings, sales, book value, and cash flow) and high valuations (high price ratios and low dividend yields). Most of these portfolios focus on companies in rapidly expanding industries.

The S&P 500® Index is widely regarded as the standard for measuring large cap U.S. stock market performance and includes a representative sample of leading companies in leading industries.

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