Smith Group
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Then and Now

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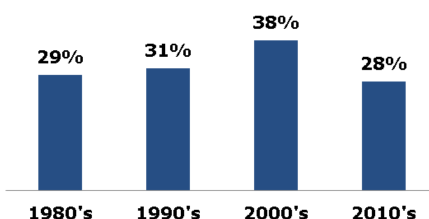
Five years have passed since the credit crisis first bubbled into our consciousness and many commentators believe the landscape has permanently changed. Following is an examination of how the overall structure of the stock market has changed, if at all, since 2008. This is particularly relevant to us as investment managers since we are often asked if our ability to find outperforming stocks has been permanently impaired by a variety of new forces that were not prevalent in the past. These vary from the seemingly permanent Fed intervention in monetary policy, to the rise of ETF's, or even the high-frequency trading boogeyman. Our analysis focuses on a comparison of decades in order to provide a broader historical context.

The first metric examined is the dispersion of returns among the largest 1000 stocks in the U.S., which measures the magnitude of return differences among stocks. This is critically important to anyone who picks stocks for a living since a lack of variety in returns among companies will be an impediment to a manager's ability to produce excess return. Exhibit #1 displays the average return dispersion by decade including the most recent period since 2009. While there has been a lower dispersion in the most recent period compared to the 2000's, the difference to the 1980's and 1990's is not meaningful. The relative difference between the 2000's and the current period are mostly due to the market dislocations during the bursting tech bubble and the 2008 credit crisis. Outside of those events, the 2000's and 2010's share a very similar pattern of return variety during normal market environments. In this analysis, the current period is the norm, while the anomaly is the 2000's.

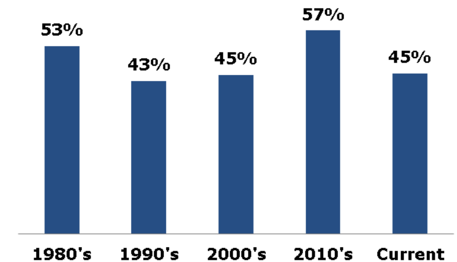
Exhibit #1: Return Dispersion of Russell 1000 Constituents*



The second metric observed is whether stock returns have become more statistically correlated, as is often quoted in the financial press. While this measure bears some relevance to a manager's ability to outperform it can be misleading, since it only reflects the co-movement of stocks rather than the actual variance in return magnitude.

Exhibit #2 indicates there has been a definite increase in the co-movement of stocks in the most recent decade. While there is no doubt that this has caught our attention, we find it very surprising that the 2010's correlations are similar to what they were in the 1980's, which pre-dates the prevalence of Long/Short funds, ETF's, and high-frequency trading. These are the typical explanations for high correlations. Some argue that the 1980's were the glory years of active management, when managers had more latitude to shift between styles, thereby accessing the best returns available. It's also worth noting that this pattern has been in sharp decline over the course of this year and the current level of correlations are at 45%, which is consistent with the prior two decades.

Exhibit #2: Cross Correlation of Russell 1000 Constituents



Our final analysis relates to the dispersion of returns among active managers themselves. If either of the preceding conditions were to significantly impair investment managers from differentiating themselves, one would expect to see a trend of compression around the range of returns among managers.

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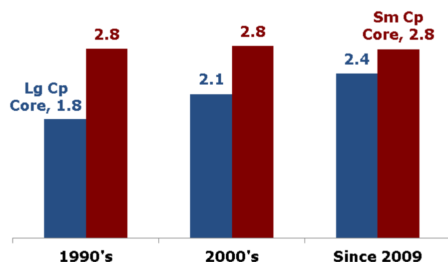
Exhibit #3 uses the Callan Institutional database to calculate the difference in returns between the top quartile manager versus the bottom quartile manager for both the large cap core and small cap core universes segmented by decades. The data suggests that there has been a fairly consistent pattern of return differences among good performing managers and poor performing managers. In fact, the gap between the best and worst large cap core managers is actually rising. The gap for small cap core managers is larger and has been relatively steady. This certainly does not look like returns for active managers are merging toward the median, nor are a homogenous group.



The investment landscape has changed since the 2008 credit crisis. But the 24/7 media blitz often implies "this time is different" and the changes will have a lasting impact on the ability of skilled investors to add value. A closer examination of the data tells a different story. While new investment vehicles are available, market complexity has increased, and more tools are available today, there is still opportunity in the basic business of constructing portfolios for excess return.