Retirement Market RECAP Q1 2021

HANYS Benefit Services

Wheels up for U.S. economy

The equity rally that began in November of last year with the much-anticipated Pfizer vaccine announcement continued in earnest in the first quarter of 2021, with the S&P 500 Index gaining 6.17% for the quarter and a near-record 56.35% for the one-year period ending March 31. For perspective, the best one-year return for the Index since 1973 was 61.00%, in June 1983. The panic selling in February and March of last year has dropped off of the trailing one-year performance statistics, resulting in exceptional performance for all segments of the global equity market as well as high-yield bonds. Most of the market trends first observed in late 2020 persisted through Q1, thereby ending market domination by select high-growth technology companies.

Technicians view these trends as signs of a healthy market:

- a broadening of the rally, with renewed investor interest in value stocks; and
- strong performance across the market capitalization spectrum: large, mid and small.

The resurgence of international developed and emerging markets seen in Q4 2020 did not continue into Q1 2021. The MSCI EAFE Index returned 3.48% in Q1 and the MSCI Emerging Markets Index posted a 2.29% quarterly gain for U.S. investors. Faced with new surges in COVID-19, parts of Europe have reverted to lockdowns and unfortunately, many emerging markets countries are slow to implement vaccination programs.

A shift in U.S. equity market dynamics in Q1 favored active management over passive, with 58% of U.S. large-cap active mutual funds outperforming their respective Russell 1000 Index (growth and value). The historical average is 44% of active managers outperforming, according to Bank of America. For core funds, which blend growth and value, 62% of active funds outperformed the Russell 1000 Index, their third-best quarterly performance since 1991 (see accompanying article on active versus passive investing).

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As Congress passed the American Rescue Act, the *Wall Street Journal* survey of 60 economists raised its prediction for the growth rate of the U.S. economy in 2021 to 5.95% (the economy contracted at an annual rate of 2.50% in 2020). The survey increased its prediction for 2021 growth three times during Q1, an indication of the rapidly improving economic conditions. The consensus view of the economists is for an accelerating growth rate during the year. They expect a surge in hiring in the second half of 2021, with the recovery particularly strong in the services sector. If the expectations prove accurate and the economy grows at 5.95%, it will represent the most powerful recovery since 1983 when the economy experienced a 7.90% burst of growth. The economists also lifted their forecasts for inflation, expecting consumer prices would rise by 2.48% by December from a year earlier. These predictions are consistent with a "V-shaped" recovery for the economy and a return to the long-term trend of 2.2% annual real GDP growth by the end of 2022.

The *Wall Street Journal* is not alone in its strong prediction for the U.S. economy. The Organization for Economic Cooperation and Development predicts the U.S. could grow at the higher rate of 6.5% in 2021, with the second-order effect of heightened demand for U.S trading partners: Canada, Mexico, China and euro area countries.

While stocks continued to rally on a strong economic outlook, the bond market sold off in Q1 with the BBgBarclays US Aggregate Bond Index posting a -3.37% return, the worst quarter for that index in 40 years. The dual concerns for bond investors are: how long will the Federal Reserve remain accommodative if GDP grows at ~6%, as predicted; and is the current rise in inflation cyclical or secular? If the Fed needs to shift to a restrictive monetary policy before the job market recovers or higher inflation takes hold, bonds will remain under pressure as investors demand to be compensated with higher interest rates. Therefore, savvy investors will keep close tabs on the data that are troubling the bond market: trends for inflation, interest rates and any revised signaling from

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the Fed and its chair, Jerome Powell, on monetary policy.

We will long remember the life-changing events of the last year — the stress in our lives, but also the stresses imposed on our economy and financial markets. At this writing, stocks are booming and valuations are stretched. We are not yet in "bubble territory" like the year 2000, before the "Tech Wreck," but this highly valued market is consistent with high volatility. Continued volatility in interest rates will also impact stock prices, especially for companies with the highest earnings growth rates and price/earnings ratios.

In closing, it is still too early to declare victory in the war against COVID-19. Any setbacks or surprises in the trajectory of the pandemic will have an immediate, and potentially significant, effect on the markets. "Past performance doesn't guarantee future results" isn't just a worn-out bromide; it is fundamental to thoughtful investing.

Active versus passive investing styles

In the previous article we noted a shift in mutual fund performance leadership in the first quarter of 2021 with a majority of active equity funds outperforming their respective index. The performance advantage of active vs. passive mutual funds has been debated for decades in academia and in the investment industry. Each style has its ardent supporters. HBS finds merit in both styles, according to the characteristics of the asset class in which a portfolio invests.

Active managers seek to exploit market inefficiencies by relying on analytical research, forecasts and their own judgement and experience to decide which securities to buy, hold and sell. They often seek to create less volatility (or risk) than the benchmark index with the goal of outperforming it.

Passive investing, on the other hand, entails building and maintaining a portfolio of securities with performance that closely tracks the selected, unmanaged index. The inherent advantages of passive over active include: minimal management fee, reduced trading costs afforded by very low portfolio turnover and reduced cash holdings (lower "cash drag" when the underlying index outperforms cash).

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The rationale for indexing is rooted in two theories from academia: the Efficient Market Theory and the Random Walk Theory. The former hypothesizes that asset prices reflect all available, public information, making it impossible to beat the market consistently on a risk-adjusted basis. Asset price changes are reactions to new information. The Random Walk Theory, first posited by Burton Malkiel in 1973, goes further. It focused on the unpredictability of the new information and the inability of investors to consistently forecast future asset prices based on the totality of available information.

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Active and passive outperformance trends are cyclical, with each experiencing periods of dominance. Many investors believe that the Morningstar large-blend category (stocks in the top 70% of the capitalization of the U.S. equity market, where neither growth nor value characteristics predominate) favors passive investing. The reasoning is that stocks in the large-blend category are widely followed by industry analysts. Therefore, temporary security mispricing is less common than with other segments, such as small-caps.

This makes it challenging for active, large-blend managers to add value. However, even the large-blend category shows the cyclical nature of active and passive performance. The current trend with passive large-blend funds outperforming active using rolling monthly three-year periods began in 2011. Investors took notice and almost simultaneously in 2011 net money flows into passive U.S. equity funds began to outpace active. This trend continued through 2019, when passive funds saw $162.7 billion in net inflows versus $204.1 billion in net outflows for active funds. *The Wall Street Journal* reported that equity index funds hit $4.27 trillion in assets in August 2019, outpacing assets under management by active equity funds for the first time.

The constant challenge for active managers is to overcome the fee advantage of passive strategies. It is challenging for active managers to consistently outperform their benchmark net of fees. Meanwhile, as assets continue to flow to passive strategies, leading providers such as Fidelity and Vanguard are able to capitalize on their scale advantage, further reducing fees for their passive funds.

WHERE IN THIS DEBATE SHOULD A PRUDENT PLAN SPONSOR LAND?

HBS believes that strategic utilization of both active and passive strategies within a retirement plan lineup permits sponsors to better fulfill their fiduciary duties and improve participant outcomes. Although indexing allows participants an inexpensive way to diversify and generate benchmark-like returns, we believe active management will prevail in certain market environments and asset classes. Active management tends to shine during extended periods of market uncertainty, high volatility and dispersion of returns (low correlations across index holdings), as was the case during the internet stock bubble, the 2007-2009 financial crisis, the onset of the COVID-19 pandemic and most recently in Q1 2021 on investor expectations for a powerful economic expansion.

HBS suggests that retirement plans consider offering passive index funds in the U.S. equity blend style boxes across the large, mid and small market capitalizations and complementing those with actively managed options in the growth and value style boxes. This design should appeal to the preferences of active and passive investors alike.

US EQUITY

	VALUE	BLEND	GROWTH
LARGE	Actively managed	Passive index	Actively managed
MID	Actively managed	Passive index	Actively managed
SMALL	Actively managed	Passive index	Actively managed

CONCLUSION

Once an objective analysis of the benefits of both active and passive investing is pursued, it can be asserted that no one strategy always triumphs. Each type should be deployed when building an optimal retirement plan lineup. HBS consults with fiduciaries to help them design a fund menu that will use the most appropriate investment style (active or passive) per asset class, customized for their plan's demographics. In addition, HBS recognizes that the selection and monitoring criteria of these strategies should be tailored to their inherent differences. We believe in helping fiduciaries craft an Investment Policy Statement that acknowledges these differences and establishes separate monitoring criteria so each investment style can be held to its own unique standards.

If you have any questions about this paper or would like to talk to a trusted advisor, please get in touch by calling (800) 388-1963 or by emailing hbs@hanys.org. hanysbenefits.com

EQUITY INDICES	3 MO	1 YR	3 YR	5 YR
S&P 500 TR USD	6.17%	56.35%	16.78%	16.29%
Russell 3000 TR USD (Broad Market)	6.35%	62.53%	17.12%	16.64%
Russell 1000 TR USD (Large Cap)	5.91%	60.59%	17.31%	16.66%
Russell Midcap TR USD	8.14%	73.64%	14.73%	14.67%
Russell 2000 TR USD (Small Cap)	12.70%	94.85%	14.76%	16.35%
MSCI EAFE NR USD (Int'l Equity)	3.48%	44.57%	6.02%	8.85%
MSCI Emerging Markets NR USD (E.M. Equity)	2.29%	58.39%	6.48%	12.07%
MSCI Emerging Markets NR USD (E.M. Equity)	0.85%	23.72%	6.84%	8.06%

FIXED INCOME INDICES	3 MO	1 YR	3 YR	5 YR
ICE BofA 3M US Trsy Note TR USD	0.05%	0.13%	1.56%	1.21%
ICE BofA 1-3Y US Trsy TR USD	-0.05%	0.24%	2.77%	1.71%
BBgBarc Long Term US Treasury TR USD	-13.51%	-15.80%	5.87%	3.13%
BBgBarclays US Aggregate Bond TR USD	-3.37%	0.71%	4.65%	3.10%
BBgBarclays US Gov't/Credit TR USD	-1.47%	7.54%	5.68%	3.86%
BBgBarclays High Yield Corp TR USD	0.85%	23.72%	6.84%	8.06%
BBgBarclays Global Aggregate TR USD (Global Bond)	-4.46%	4.67%	2.80%	2.66%

ICE BofAML – Intercontinental Exchange Bank of America Merrill Lynch; BBgBarc – Bloomberg Barclays; S&P 500 - Standard & Poors; MSCI – Morgan Stanley Capital International Sources: Morningstar as of March 31, 2021

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