FRANKLIN TEMPLETON INVESTMENTS

# ON THE RISE

## Eight Reasons to Take A Fresh Look at Active Management

Time softens the memory, but it's important to recall that 2008 brought an economic crisis and led us to the brink of a global financial meltdown. Dramatic measures were taken to stave off the worst, but ushered in an era of unprecedented monetary policy in the US and many regions of the world. After years of quantitative easing (QE) and low-interest-rate policies, we may be entering what appears to be a period of normalizing interest rates and a return to traditional monetary policy.

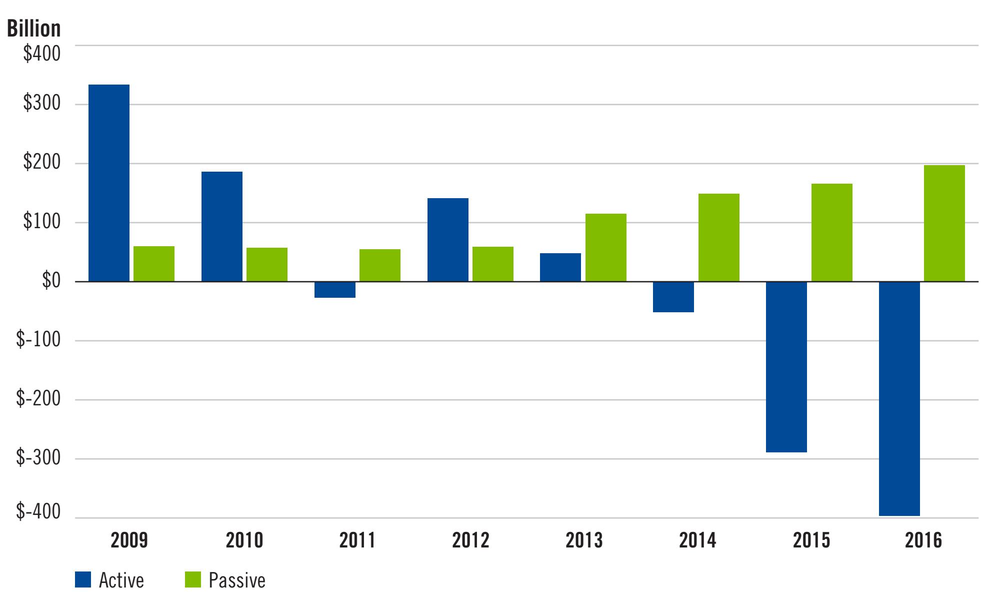
This unusual period fostered a number of market distortions that favoured a "rising tide" approach to investing that lifted all boats, a trend that favoured passive investments. Yet just as the tides are cyclical, the popularity of passive investing may recede as markets are influenced by a new set of factors. Eight illustrations follow that may give investors good reason to question the popular assumptions of the "passive crowd."

## 1 | A Crowded Trade

> *"Avoid the popular. When any method for selecting stocks becomes popular, then switch to unpopular methods."*
>
> **—Sir John Templeton**

The wisdom behind this famous quote has been validated numerous times over the years. Japan in the '80s, the momentum tech/dot.com arena in the late '90s, US financials in the mid-'00s. While an investment approach may not seem like a sector trade, consider the trend of passive flows and how they may be impacted in a market like that in 2008. More than USD $80 billion flowed into S&P 500 Index funds and ETFs in 2016, after an eighth straight year of positive returns. It was a herd mentality, just as with any other "sector" bubble. Historically, Sir John understood the potential value in being contrarian.

**Flows by Year into Active vs Passive Funds in the US**
2009–2016

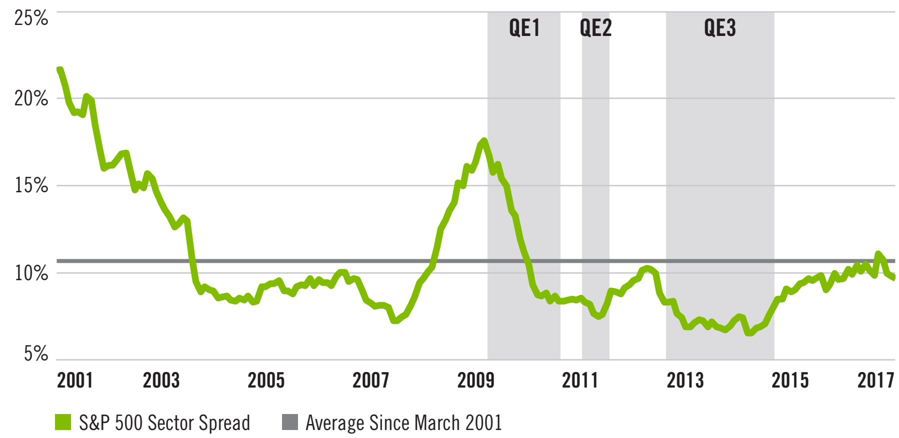



Source: Investment Company Institute, 3/2/17.

## 2 | Rising Dispersion

Unprecedented multiple rounds of quantitative easing (QE) in the US created an environment that favoured investments without discrimination. Easy money eliminated the need to distinguish strong enterprises from weak as low borrowing costs could mask inefficient operations. Using the US as an example, the historical difference between the best and the worst sectors in the S&P 500 Index illustrates a depressed separation during periods of QE and a more recent rising separation of returns that could allow active managers opportunity to distinguish their performance.

**S&P 500 Best-Worst Sector Spread**
March 31, 2001–March 31, 2017

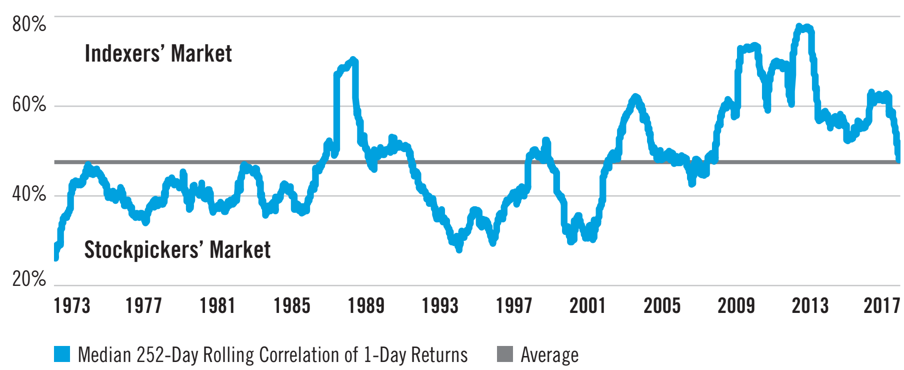



Source: Bloomberg, 3/31/17. Important data provider notices and terms available at www.franklintempletondatasources.com.

## 3 | Falling Correlations

As much as the low dispersion environment challenged active managers' ability to separate themselves from the crowd, high correlations among stocks have limited the ability to separate from the index environment. The chart below illustrates what appears to be a return to a lower, more normalized correlation environment.

**Correlation of S&P 500 Stocks**
January 22, 1973–March 31, 2017

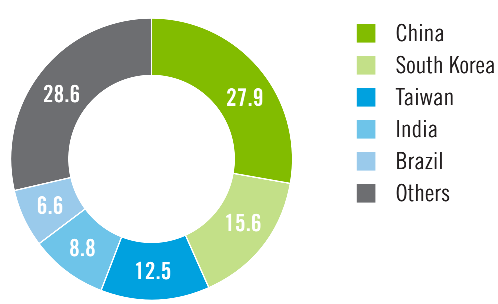



Source: Ned Davis Research, 3/31/17.

## 4 | Global Exposure May Be Too Concentrated

Passive indexes that are based on the market capitalization can expose portfolios to concentration risk. For example, the three largest countries in the MSCI Emerging Markets Index account for 53% of the index. This exposure sometimes results in concentrations in weaker economies. Active managers can deviate from capitalization based exposures to avoid these countries. Additionally, they can bolster returns by investing in rapidly growing nations that are not a part of foreign-stock benchmarks.

**MSCI EMERGING MARKETS INDEX**
**Country Allocation (%)**
As of June 30, 2017

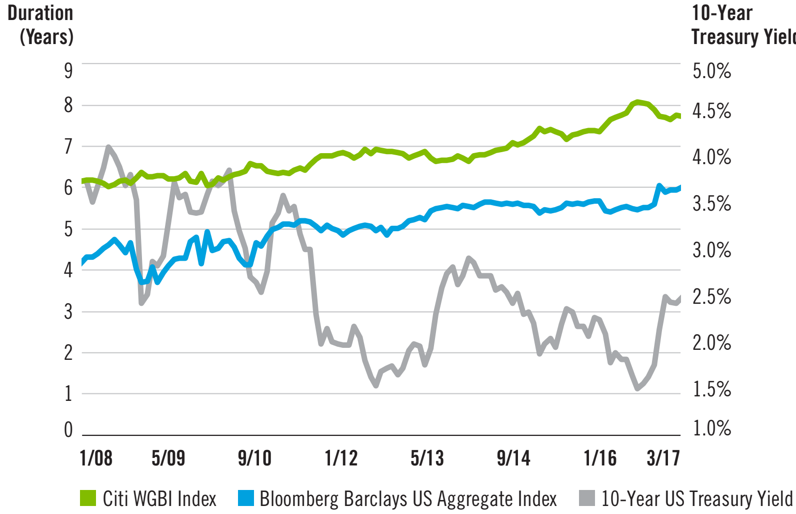



Source: © 2017 Morningstar, MSCI as of June 30, 2017.

## 5 | Bond Indexes: Rising Durations as Rates Fell

The same factors that favoured bond index returns for years as interest rates fell, could become a headwind if rates continue to rise. In the fourth quarter of 2016 alone, as the 10-year US Treasury rate rose by 86 basis points, the Citi World Government Bond Index (WGBI) declined by more than 8% and Bloomberg Barclays US Aggregate Index declined by almost 3%. While interest rates were falling, both indexes, as a function of their inflexible structures, were experiencing lengthening average durations and higher exposure to the risks of rising interest rates. At the same time, many prudent active managers in the US were decreasing their exposure to the potential price declines associated with rising rates.

**Rising Index Durations**
January 31, 2008–March 31, 2017



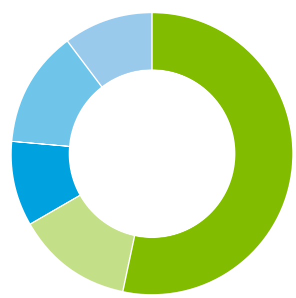

Sources: Citigroup, Bloomberg LP, US Federal Reserve, 3/31/17.

## 6 | Negative Yields = *Paying* Investors to Borrow

Bond markets have many different buyers, many of whom buy for reasons beyond income and diversification. As a result, bond indexes can be shaped by disparate forces, some of which seem to defy logic.

For example, indexes shaped by global issuance may hold negative yielding bonds. As of March 31, 2017, more than 16% of the Bloomberg Barclays Global Aggregate Index comprised bonds with negative yields.* Moreover, these bonds are issued by some of the most indebted nations in the world.

**Principal Value of Negative-Yielding Debt Globally***
As of March 31, 2017



| Billions | Country |
|---|---|
| $3,754 | Japan |
| $949 | Germany |
| $678 | France |
| $945 | Rest of Euro Area |
| $703 | Rest of World |

* Source: Bloomberg, 3/31/17. Includes market value of all bonds in the Bloomberg Barclays Global Aggregate Index.

## 7 | Indexes Have Often Failed to Measure Up to Active Bond Fund Performance

Many indexes have looked fairly average when measured against the active funds that use them as their benchmark. This is especially true in the bond arena, which historically has been a less efficient market. The table below illustrates how several major bond indexes' performance would have ranked against the Morningstar categories in which they would be compared. Once expenses are factored in, the rankings of index funds and ETFs based on these benchmarks could be even worse.

As of March 31, 2017

| Index | Morningstar Category | PERCENTILE RANKING 5-Year | 10-Year | 15-Year |
|---|---|---|---|---|
| Bloomberg Barclays US Aggregate Bond Index | Intermediate-Term Bond | 69TH | 56TH | 51ST |
| Bloomberg Barclays US Intermediate Gov't Bond Index | Intermediate-Term Government Bond | 66TH | 73RD | 78TH |
| Bloomberg Barclays Global Aggregate Bond Index | World Bond | 81ST | 75TH | 59TH |

Source: Morningstar, Inc. 3/31/17. Past performance does not guarantee future results. See www.franklintempletondatasources.com for additional data provider information.

All investments involve risks, including possible loss of principal. Stock prices fluctuate, sometimes rapidly and dramatically, due to factors affecting individual companies, particular industries or sectors, or general market conditions. Bond prices generally move in the opposite direction of interest rates. Thus, as the prices of bonds in a fund adjust to a rise in interest rates, a fund's unit price may decline.

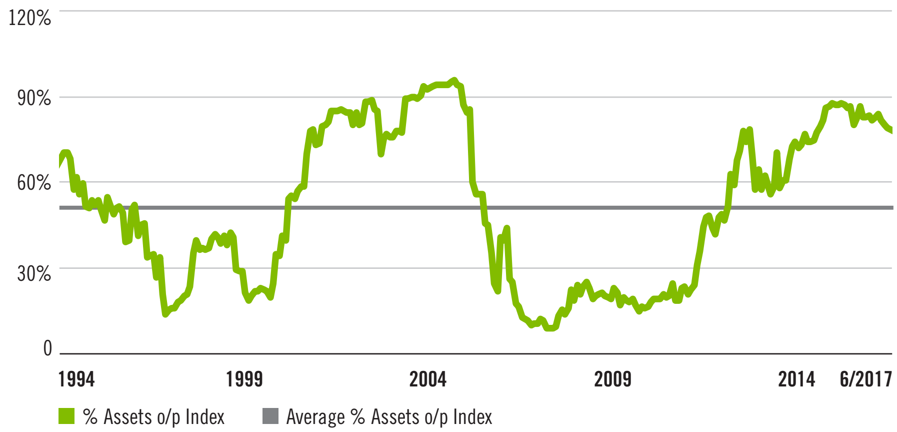
## 8 | Active Outperformance Has Been Cyclical and Has Generally Performed Better During Downmarkets

Historically, actively managed US and Canadian equity funds have had periods of outperformance and underperformance. A diversified portfolio comprised of active and passive products may help reduce risk.

**PERCENTAGE OF ACTIVE FUND ASSETS OUTPERFORMING THE S&P/TSX COMPOSITE TR INDEX**

**Rolling 5-Year Returns**

January 1, 1990–June 30, 2017




Source: Morningstar.

Shows the percentage of Canadian actively managed equity mutual fund assets that outperformed the total return of S&P/TSX Composite TR Index based on trailing five-year performance after fees. Percentage of fund assets outperformance is calculated as the ratio of total net assets of actively managed equity funds that outperformed S&P/TSX Composite TR Index over total net assets of all the actively managed equity funds.

Past performance does not guarantee future results.

**For more information on active investing and our actively managed solutions, please contact your investment manager or call us at (800) 367-0830.**

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*References to indices are made for comparative purposes only and are provided to represent the investment environment existing during the time periods shown. An index is unmanaged and one cannot invest directly in an index. The performance of the index does not include the deduction of expenses and does not represent the performance of any Franklin Templeton fund.*

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