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U.S. Large-Cap Equity: Can Simple Filters Help Investors Find Better-Performing Actively Managed Funds?

SPEAKER

Tim Cohen
Chief Investment Officer



Hello, I'm Tim Cohen, a chief investment officer in the equities division at Fidelity Investments, and I'd like to discuss some of our new research into the performance of actively managed equity mutual funds.

There's a persistent debate in investment circles about whether it's better to invest in active funds or passive funds. A commonly held belief is that active stock pickers have a harder time beating benchmarks in highly efficient markets like U.S. large cap stocks than they do in less efficient markets. If you look at average performance data for a few different markets, there's some evidence to

support this view.

Average One-Year Excess Returns

(Equity Mutual Funds, 1992–2014)

Basis Points of Excess Return (Basis Point = 1/100th of a percentage point)



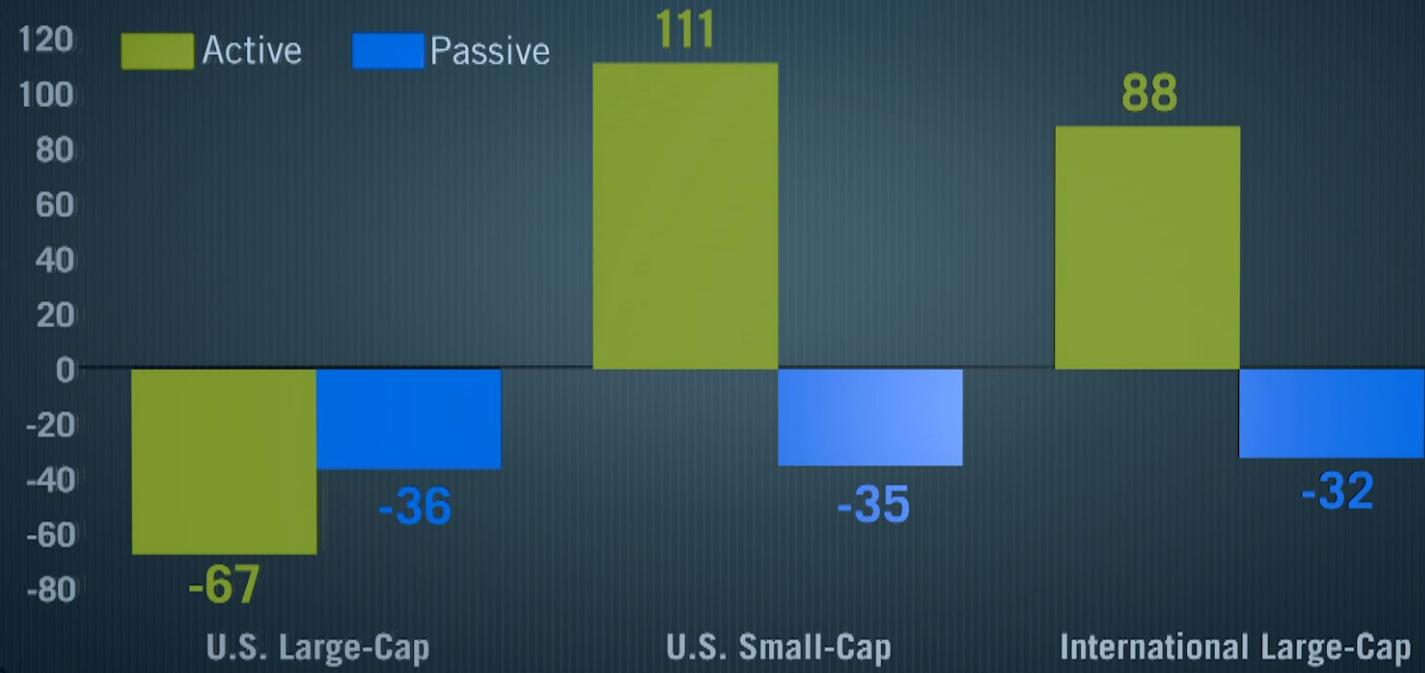
Fund data from Morningstar, including closed and merged funds. International funds labeled as "foreign funds" by Morningstar. Average excess returns: the average of all monthly one-year rolling excess returns for all funds in the set under analysis, using overlapping one-year periods and data from Jan. 1, 1992 to Dec. 31, 2014. Excess returns are returns relative to the primary prospectus benchmark of each fund, net of fees. Past performance is no guarantee of future results. This chart does not represent actual or future performance of any individual investment option. See end of video for complete methodology. Source: Morningstar, Fidelity Investments, as of Apr. 9, 2015.

For U.S. large-cap funds, the historical data show that the average actively managed fund has trailed its benchmark index after fees. But in other market segments, like U.S. small-cap or international large-cap, the average active fund has outperformed its benchmark. These markets are sometimes seen as less efficient than U.S. large-caps.

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Also notice that in all three fund categories, passive index funds have consistently trailed their market benchmarks. This underperformance isn't surprising, given that the objective of passive funds is to try to match the market before fees, while this data shows net returns after fees.

Looking at this history for U.S. large-cap funds, we wondered whether there was any deeper story behind the data in these averages.

Our first idea was to screen for funds with low fees. Fund fees are clearly disclosed, so this is a factor within investors' control.

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Not surprisingly, when we looked only at U.S. large-cap funds with fees in the lowest quartile, we saw that the average return for this subset was better than for the entire fund universe, for both active and passive funds. For passive funds, the main objective is to mirror the index before fees, so funds that charge lower fees should logically show better returns.

On the other hand, for actively managed funds, fees are important, but often not the most important factor driving net returns. Active fund managers are scouring the markets to search for stocks that will perform better than the benchmark index. That's why for any individual active fund, lower fees don't necessarily translate into better net returns.

With that in mind, we decided to ask: what happens if we focus on funds that may have the most resources to help identify better investment opportunities? For actively managed funds, we assumed that assets under management, or "AUM," would be a reasonable proxy for investment resources. We looked at an overall fund family's AUM within U.S. large-cap equity funds, because we assumed that all other things being equal, an active fund family with one hundred billion dollars in AUM would likely have greater resources it can apply to researching and trading stocks than a firm with only one billion dollars in AUM.

For our cutoff, we selected the top five fund families by AUM in U.S. large-cap, which together represent about 10 percent of the total number of funds in that category. For passive funds, there are fewer fund families overall, so the exact same filter didn't help the results very much. Instead we looked at the top 10 percent of passive index funds as measured by AUM in the funds, to make a fair comparison.

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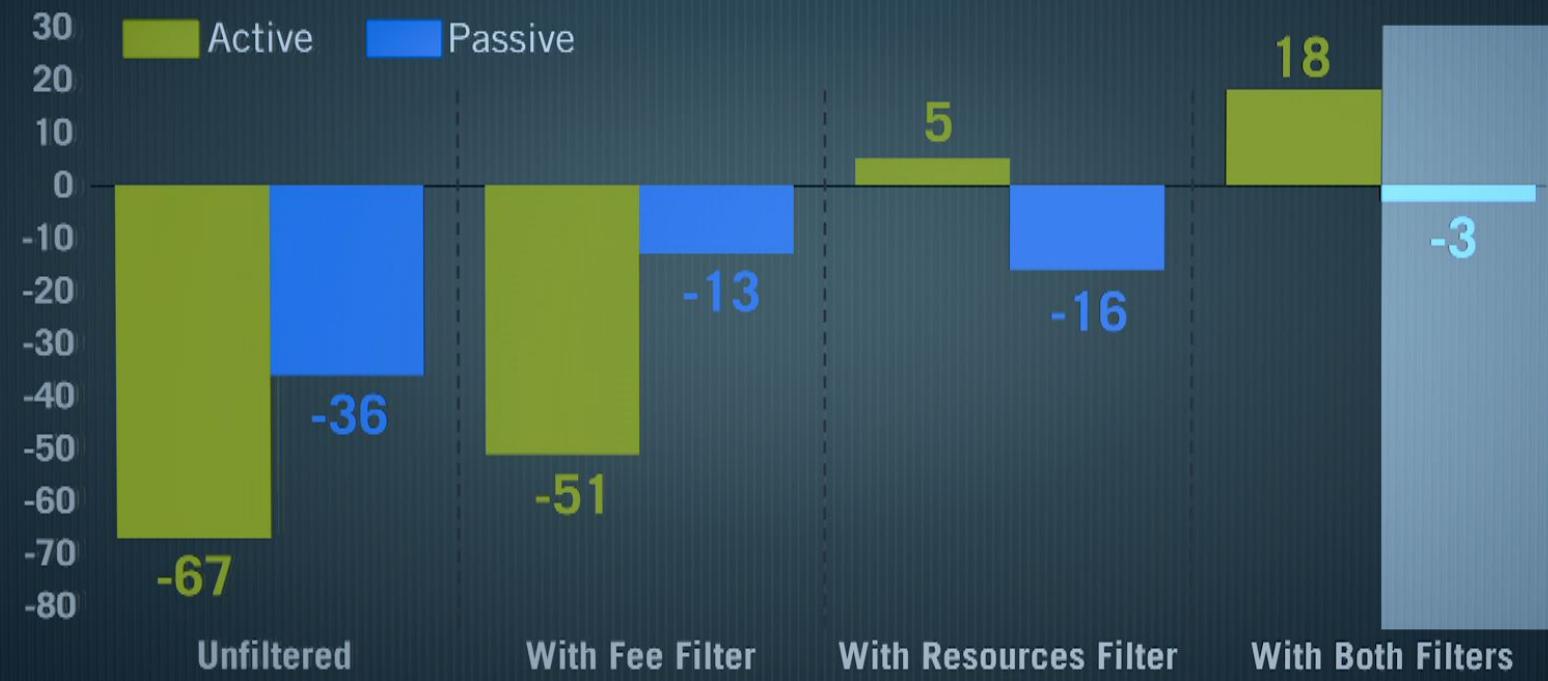
Once again, the filter had a positive effect for both active and passive, identifying a subset of funds with a higher historical average return than the full universe of funds.

And combining the two filters had a bigger impact, with an improvement for both types of funds, but particularly for actively managed funds.

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Choosing passive index funds with the lowest fees and the highest AUM resulted in improved performance that was only 3 basis points below the benchmark, a nice improvement over either individual filter alone.

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But for actively managed funds, the results of these combined filters were even more powerful. The average fund went from minus-67 to plus-18 basis points of annual return above the benchmark.

By simply applying these objective and intuitive filters, we identified a subset of active funds for which the performance of the average fund improved by 85 basis points, outperforming passive funds and the benchmark, after fees.

Bear in mind that these are historical averages, and past performance is no guarantee of future results. Any individual actively managed fund may do better than average, or worse, especially over the short-term, and our filters aren't the only way to try to identify superior actively managed funds.

But for investors who are concerned about selecting a good active manager, it may be useful to know that these simple, objective filters, based on low fees and high fund family AUM, have identified a subset of funds with better average historical performance.

We hope you found our latest research helpful. Thanks for watching.

Important Information

Basis point: 1/100th of a percentage point.

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Investment decisions should be based on an individual's own goals, time horizon, and tolerance for risk.

Past performance does not guarantee future results.

Stock markets are volatile and can fluctuate significantly in response to company, industry, political, regulatory, market, or economic developments. Investing in stock involves risks, including the loss of principal. Foreign markets can be more volatile than U.S. markets due to increased risks of adverse issuer, political, market or economic developments. Investments in smaller companies may involve greater risks than those in larger, more well-known companies.

Active and passively managed funds are subject to fees and expenses that do not apply to indexes. Indexes are unmanaged. It is not possible to invest directly in an index.

Methodology

Fund selection: Our main analysis focused on all U.S. large-cap, foreign large-cap (“international large-cap”), and U.S. small-cap equity mutual funds tracked by Morningstar between Jan. 1, 1992 and Dec. 31, 2014, including all blend, value, and growth funds within each category and including actively managed and passive index funds. We included funds that did not exist for the entire period (closed or merged funds), to reduce survivorship bias. We eliminated funds identified as passive that were labeled as “enhanced index,” and eliminated funds with tracking error greater than 1% (which are unlikely to be actual passive index strategies despite their identification in the database). For international large-cap funds, we eliminated funds benchmarked to a price index, for greater comparability. See below for benchmark indices included and definitions.

We selected the oldest shareclass for each fund as representative; where more than one shareclass was oldest, we chose the class labeled as “retail.” For U.S. large-cap equity, average fund counts for each subset of selected funds are as follows: Unfiltered (full set of funds available): active 814, passive 50. Fee filter only: active 216, passive 13. Resources filter only : active 79, passive 5. Both filters applied: active 46, passive 3. Total fund counts in sample over full period: active 1940, passive 115. Total fund counts for international large-cap equity funds: active 397, passive 25; average fund counts for performance calculation: active 213, passive 9. Total fund counts for U.S. small-cap equity funds: active 663, passive 40; average fund counts for performance calculation: active 292, passive 15.

Averaging excess returns: We used Morningstar data on returns from Jan. 1, 1992 to Dec. 31, 2014. We calculated each fund’s excess returns on a one-year rolling basis, relative to each fund’s primary prospectus benchmark and net of reported expense ratio, for each month, using monthly excess return data from Morningstar. We used an equal-weighted average to calculate overall industry one-year returns for each month. (We chose to equal weight the averages in order to represent the average performance of the range of individual funds available to investors, rather than asset weighting, which may introduce bias into the analysis.) For filtered subsets of funds, average excess returns ascribed were the one-year forward rolling returns, calculated monthly. All filtered subsets were rebalanced monthly. If a fund closed or was merged during a one-year rolling period, its returns were recorded for the months that it was in existence, and the weighting of the remaining funds in the subset was increased proportionally for the remainder of the year.

Filters: We used Morningstar data on fund expense ratios to represent fees. The fee filter is rebalanced monthly; over the full period, the average cut-off for lowest quartile of fees was 86 bps for active, 19 bps for passive. The resources filter is rebalanced monthly using Morningstar data on AUM, and used a different methodology for active and passive in order to generate comparable selectivity; for passive funds, using the same filter as for active funds produced an average annual excess return of -36 basis points for the filtered subset and selected approximately 60% of existing funds, while using a filter that selected for the top 10% of passive index funds by AUM (approximating the selectivity of the top five fund family filter for actively managed funds) produced a better average annual excess return of -16 basis points.

Indices: Funds in the study included active and passive funds tracked by Morningstar and benchmarked to the following indices: U.S. large-cap equity (all in USD): Russell 1000; Russell 1000 Growth; Russell 1000 Value; Russell 3000; Russell 3000 Growth; Russell 3000 Value; S&P 500. Foreign (international) large-cap equity (all in USD): MSCI ACWI Ex USA; MSCI ACWI Ex USA Growth; MSCI ACWI Ex USA Value; MSCI EAFE; MSCI EAFE Growth; MSCI EAFE Value; MSCI World Ex USA; MSCI World Ex USA Growth; MSCI World Ex USA Value. U.S. small-cap equity (all in USD): Russell 2000; Russell 2000 Growth; Russell 2000 Value; S&P SmallCap 600.

Index Definitions

MSCI ACWI (All Country World Index) ex USA Index is a market capitalization-weighted index designed to measure the investable equity market performance for global investors of large and mid-cap stocks in developed and emerging markets, excluding the United States. **MSCI ACWI (All Country World Index) ex USA Growth (Value) Index** is a market capitalization-weighted index designed to measure the investable equity market performance of growth (value) stocks for global investors of large and mid-cap stocks in developed and emerging markets, excluding the United States. **MSCI EAFE Index** is a market capitalization-weighted index that is designed to measure the investable equity market performance for global investors in developed markets, excluding the U.S. & Canada. **MSCI EAFE Growth (Value) Index** is a market capitalization-weighted index that is designed to measure the investable equity market performance of growth (value) stocks for global investors in developed markets, excluding the U.S. & Canada. **MSCI World ex USA Index** is a market capitalization weighted index that is designed to measure the investable equity market performance for global investors of developed markets, excluding the United States. **MSCI World ex USA Growth (Value) Index** is a market capitalization weighted index that is designed to measure the investable equity market performance of growth (value) stocks for global investors of developed markets, excluding the United States.

Russell 1000 Index is a market capitalization-weighted index designed to measure the performance of the large-cap segment of the U.S. equity market. **Russell 1000 Growth Index** is a market capitalization-weighted index designed to measure the performance of the large-cap growth segment of the U.S. equity market. It includes those Russell 1000 Index companies with higher price-to-book ratios and higher forecasted growth rates. **Russell 1000 Value Index** is a market capitalization-weighted index designed to measure the

performance of the large-cap value segment of the U.S. equity market. It includes those Russell 1000 Index companies with lower price-to-book ratios and lower expected growth rates. **Russell 2000 Index** is a market capitalization-weighted index designed to measure the performance of the small-cap segment of the U.S. equity market. It includes approximately 2,000 of the smallest securities in the Russell 3000 Index. **Russell 2000 Growth Index** is a market capitalization-weighted index designed to measure the performance of the small-cap growth segment of the U.S. equity market. It includes those Russell 2000 Index companies with higher price-to-book ratios and higher forecasted growth rates. **Russell 2000 Value Index** is a market capitalization-weighted index designed to measure the performance of the small-cap value segment of the U.S. equity market. It includes those Russell 2000 Index companies with lower price-to-book ratios and lower forecasted growth rates. **Russell 3000 Index** is a market capitalization-weighted index designed to measure the performance of the 3,000 largest companies in the U.S. equity market. **Russell 3000 Growth Index** is a market capitalization-weighted index designed to measure the performance of the broad growth segment of the U.S. equity market. It includes those Russell 3000 Index companies with higher price-to-book ratios and higher forecasted growth rates. **Russell 3000 Value Index** is a market capitalization-weighted index designed to measure the performance of the broad value segment of the U.S. equity market. It includes those Russell 3000 Index companies with lower price-to-book ratios and lower forecasted growth rates.

S&P 500 Index is a market capitalization-weighted index of 500 common stocks chosen for market size, liquidity, and industry group representation to represent U.S. equity performance. **S&P SmallCap 600 Index** is a market capitalization-weighted index of 600 small-capitalization stocks.

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