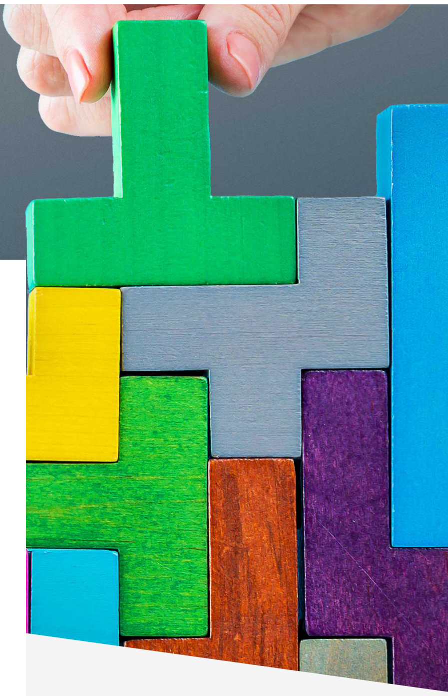


Why active equity selection in a recovery is important

June 9, 2020

Trying to make big-picture bets may result in missed opportunities.

There are many components that can contribute to portfolio return: exposure to asset classes, over and underweights to particular sectors or industries, and security selection, which is the active decision to include or exclude certain companies from a portfolio. Prior to the recent market downturn, one of the easiest and most cost-effective paths for many investors to gain market exposure was through passive ETFs that replicated market exposures. This type of approach can be beneficial when a rising tide (or market) is lifting all boats. But in a downturn, and through a recovery, it can mean that an investor's portfolio may lag. When stocks are declining, the performance of a purely passive benchmark strategy will match the loss of the index — there's no prospect of losing less. And when things begin to recover, variation in returns can mean lost opportunities.

For example, when sectors outperform, it's rare that every stock in those sectors beats the market; it's often dominated by the outsize results of one company or a small group of businesses. Conversely, for sectors that underperform, not all stocks in the category lag. This is one of the main reasons that we believe active portfolio management can make a difference during market recoveries. It's not sufficient to simply identify winning sectors. And it may be, to a certain extent, irrelevant. The best performing sectors do tend to have the highest number of stocks that exceed the performance of the S&P 500 over the same time period. But even the lowest performing sectors have a fair representation of companies that outperform the S&P 500.

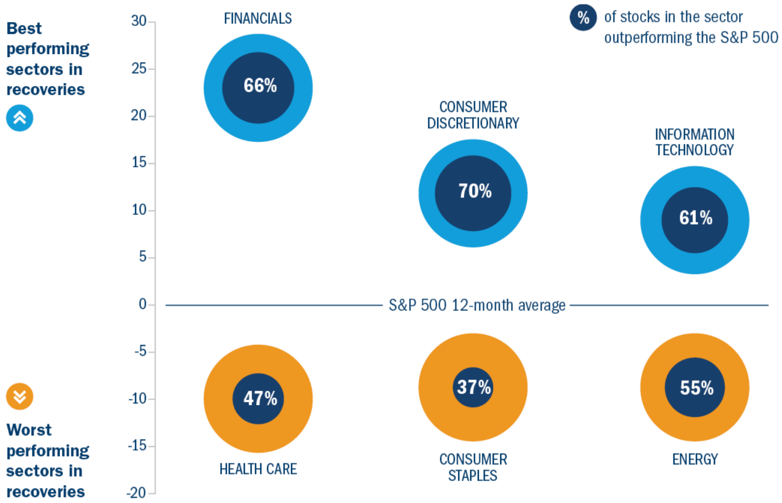
We looked at the recovery period following the last three bear market declines (defined as a 20% drop from all-time market highs based on total return of the S&P 500) and found a wide variation among the sectors that out- and underperformed the S&P 500 as a whole. Looking at the 1-year returns following the market trough, financials, consumer discretionary and information technology were winning sectors in aggregate. But hit rates — the percentage of stocks that outperformed — within those sectors were 66%, 70% and 61%, respectively, relative to the entire market over the 12-month post-trough period.

Healthcare, consumer staples and energy sectors underperformed in aggregate, but hit rates within those sectors were still 47%, 37% and 55%, respectively, relative to the entire market over the 12-month post-trough period.

Columbia Threadneedle Investments

Opportunity can vary within sectors that outperform and underperform

Average 12-month sector performance relative to the S&P 500 following the 1987, 2002 and 2009 market troughs.



Source: Columbia Threadneedle Investments. Market troughs defined as 12/04/87, 10/09/02 and 03/09/09. **Past performance does not guarantee future results.** It is not possible invest directly in an index.

While past performance is not a guarantee of future results, the historical data supports the notion of pursuing return at the company level, rather than the sector level, which a fundamentally-driven, actively managed fund or a thoughtfully constructed strategic beta ETF can provide.

Bottom line: Active equity selection may uncover opportunities during a market recovery

For long-term investors, an active approach or a strategic beta strategy (for investors who still prefer an index-oriented approach) may prove to be beneficial as markets recover. For many portfolios, these periods present an opportunity to add good long-term investments at attractive valuations, setting up the prospect for longer-term gains.

Disclosures

The S&P 500 Index tracks the performance of 500 widely held, large-capitalization U.S. stocks. It is not possible to invest directly in an index.

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