

Top 5 Reasons to Choose Active Over Passive Now



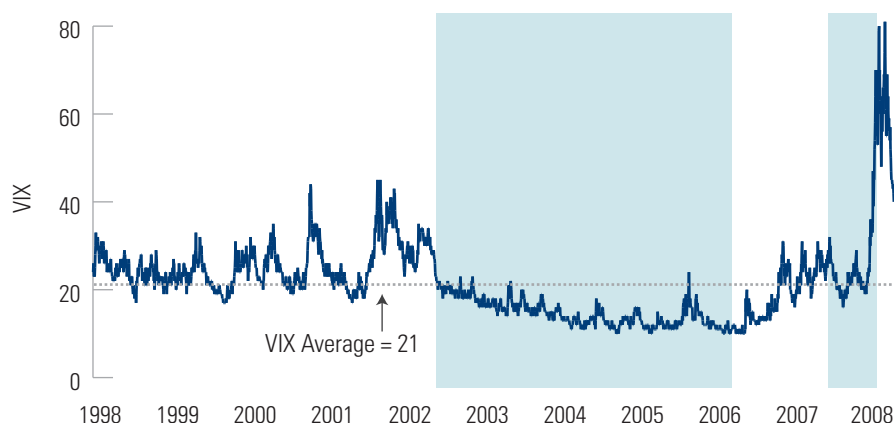
Many investors, recognising their now meaningful underweight to equities, are starting to consider how best to rebalance their portfolios. One key issue is whether to invest actively or passively. The extreme sell-off in the 4th quarter of 2008 did little to settle this debate as, on average, active managers failed to meet the expectations of delivering downside protection in the quarter. Frustrated, many investors are tempted to capitulate within equity and go passive. However, it is worth reflecting on the fact that all good investment decisions require a *forward-looking* thesis, and we believe there are several reasons why active management is poised to succeed.

1. Having Experienced Extremes, Volatility Should Continue Normalizing, Leading to Greater Stock-Level Dispersion

The past several years have been characterised by periods of volatility extremes, driven by sentiment that became decidedly one-sided. Optimism in the persistence of global growth fueled the low volatility environment of 2003-2006, while fear drove the high volatility environment of late 2008 (*Exhibit 1*). In each case, dispersion of returns at the stock level was low, as investors treated equities as an asset class rather than distinguishing between individual stocks. Going forward, as volatility declines over time from its current elevated level, average stock correlations should decrease, and we believe stock prices will be driven by company-specific fundamentals. This creates a fertile environment for stock picking.

Exhibit 1: Normalizing volatility allows fundamentals to drive stock prices

CBOE Volatility Index (Daily) – Trailing 10 years as of 31/12/08



Source: FactSet. Past performance is not indicative of future results, which may vary.

2. The Prospects for Broad Multiple Expansion Appear Limited

Consider the environment in August 1982, the start of a long bull market: The P/E of the market was approximately 7x, short rates were nearly 20% and the market’s dividend yield was 6%. In the ensuing years, rates fell from 20% to 1% and multiples quintupled, creating a tailwind for the broad equity market. Today, with the P/E averaging 16x in 2008 and Fed Funds near 0%, opportunities for broad multiple expansion seem limited (*Exhibit 2*). The challenge going forward will be in determining which stocks have opportunities for meaningful appreciation. As a result, stock selection is more important than ever.

Exhibit 2: Without broad multiple expansion, stock selection will be at a premium

	Price/Earnings ratio	Short term interest rates	S&P 500 Dividend Yield
August 1982	7x	20%	6%
February 2009	16x	>0%	3%

Source: Strategas Research Partners, January 2009

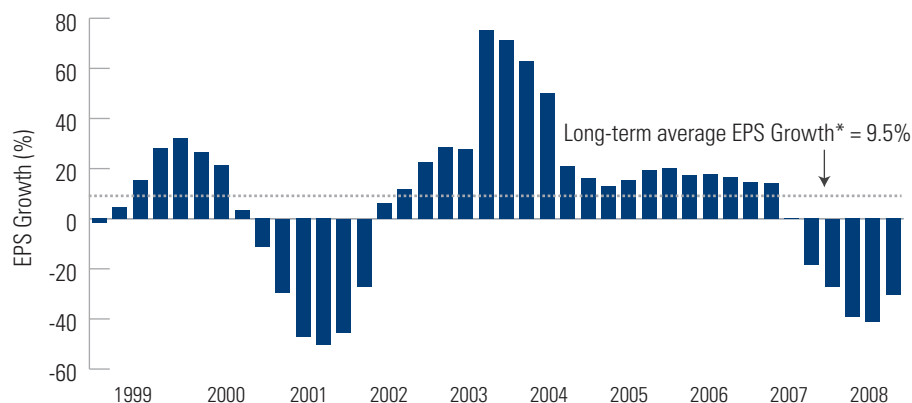
This information discusses general market activity, industry or sector trends, or other broad-based economic, market or political conditions and should not be construed as research or investment advice. Please see additional disclosures.

3. In This Economy, There Will Be Market Share Gainers and Losers

The strong global growth of the 2003-2006 time period created a “rising tide lifting all boats” phenomenon, as quarterly year-over-year earnings for the S&P 500 consistently grew at a high-teens rate, about two times its long-term historical average (*Exhibit 3*).

Exhibit 3: The economic tailwind that drove broad profit growth is now a headwind

S&P 500 Y/Y Quarterly EPS Growth (31/3/99 – 31/12/08), Long-Term Average (1936 – 3Q2008)*



Source: FactSet. *Source: Goldman Sachs Investment Research. Long term average is the S&P 500 year over year quarterly reported EPS Growth average from 1Q1936 – 3Q2008. This information discusses general market activity, industry or sector trends, or other broad-based economic, market or political conditions and should not be construed as research or investment advice. Past performance is not indicative of future results, which may vary. Indices are unmanaged. The figures for the index reflect the reinvestment of dividends but do not reflect the deduction of any fees or expenses which would reduce returns. Investors cannot invest directly in indices. Please see additional disclosures.

Economic sensitivity and a levered balance sheet were company characteristics rewarded by the market. To say the least, times have changed. Today, with end markets shrinking, companies are battling to gain share at the expense of their competitors, and we believe dominant business franchises are positioned to further expand their competitive advantage. Free-cash-flow generators who can continue to finance their growth, companies whose product or service is not commodity-like and therefore can maintain margins, companies whose growth is driven by secular trends rather than tied strictly to the economy, are all examples of potential market share winners in this environment. By performing in-depth, forward-looking, company-specific fundamental research, an active manager investing in the winners and avoiding the losers can outperform.

This information discusses general market activity, industry or sector trends, or other broad-based economic, market or political conditions and should not be construed as research or investment advice. Please see additional disclosures.

4. There Will Be Recovery, Though It Is Likely to be Different than the Last One

The sell-off during the latter half of 2008 was extreme, as the 4th quarter ranks as the 7th worst quarter for the equity market in 80 years. In the midst of this dramatic bear market it is important to acknowledge that what we are experiencing, while painful, is not unprecedented. Esoteric mortgages, banks holding “toxic waste,” the demise of several Wall Street firms – these are all events we have experienced before.¹ The point is, unless you believe we are in a permanent global recession, there will be economic and market recovery.

Popular thinking suggests that the experience of 2003 is a good proxy for understanding the next recovery. After all, 2003 was the most recent rebound from a recession and a bear market. In that sharp, V-shaped recovery, it is well documented that low-quality stocks led the way and that most active managers underperformed in this “junk rally.” As deep value and indexes outperformed in the last recovery, the consensus view is that they should outperform in the next one too. However, looking forward, we believe conditions today are quite different than 2003, as detailed in *Exhibit 4*.

Exhibit 4: Comparison between conditions leading to 2003 recovery and today

	2003	Today
Credit crisis	Primarily driven by corporate balance sheet health. Lower interest rates at the Federal Reserve immediately translated to quicker lines of corporate credit which remained accessible. As spreads collapsed, beaten down, lower quality companies rallied.	Primarily driven by commercial paper market and the financial sector itself. A real credit supply crisis exists, and record-low interest rates at the Federal Reserve not translating to cost of and access to credit. Higher quality, self-financing companies favoured.
Consumer spending	Strong US consumer spending driven by credit card debt and home equity credit extraction, based on rising home price expectations.	Consumers saving, deleveraging, and lack access to easy credit.
Equity valuations	After outperforming in 2000-2002, high-quality companies were afforded premium valuations compared to those of lower quality.	No meaningful premium for high-quality companies exists, as equities have broadly and dramatically sold off.
Margin expansion	High ex-US GDP growth, driven by US consumer spending, fueled corporate margin expansion from very low levels, particularly in lower-quality industrials and cyclicals.	Lower ex-US GDP growth expectations and current high margins for low-quality businesses dampen margin expansion opportunity.
Recession	Capital spending and corporate inventory recession – shorter recession type allowed economically-sensitive, lower quality companies to wait for the next expansionary period.	The over-leveraged consumer faces several challenges including destruction of asset value (homes, equities, retirement) and employment anxiety, leading to a sustained period of low growth. Less economically sensitive, higher quality companies should strengthen their franchise at the expense of weaker competitors.

Source: Bernstein Research, “The Junk Won’t Run – 2009 is Different Than 2003,” October 2008 Merrill Lynch, “The Frugal Future,” December 2008

Conditions today suggest that we should expect a more gradual, shallow-U-shaped recovery, an environment where high-quality share gainers can lead the market. Active managers with a high-quality bias should be positioned to benefit from this environment.

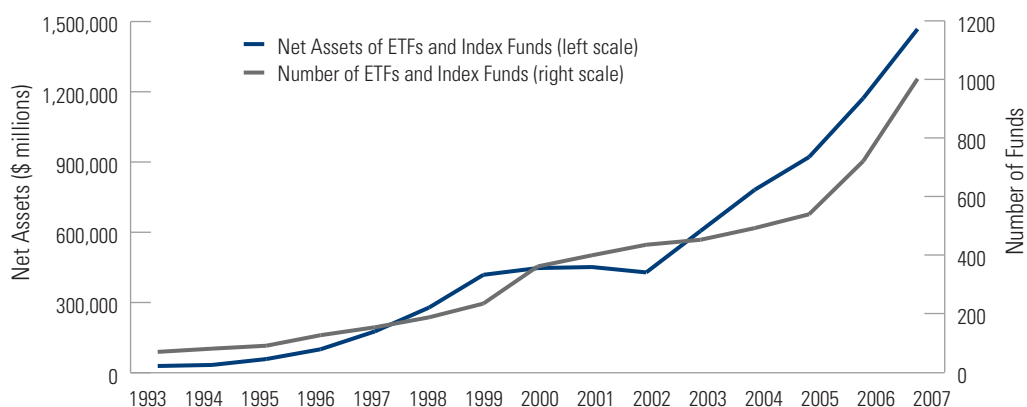
¹ Source: Goldman Sachs Investment Strategy Group

This information discusses general market activity, industry or sector trends, or other broad-based economic, market or political conditions and should not be construed as research or investment advice. Please see additional disclosures.

5. The Dramatic Growth in Indexed Assets Creates Stock-Level Inefficiencies

As detailed in some of the points above, in the past there have been specific catalysts that have buoyed the case for passive investing. As a result, there has been a dramatic proliferation of indexed products and a subsequent explosion in indexed assets (*Exhibit 5*).

Exhibit 5: Chart indicates the explosive growth of indexed products and assets



Source: Investment Company Institute 2008 Fact Book, 48th Edition

One of the implications of this growth in passive assets is that it has the potential to create inefficiencies at the stock level.² In other words, an investor who decides to allocate to an index is making an asset class decision rather than a company-specific investment decision. By allocating to stocks at current index weights, by definition that investor is not price sensitive at the stock level. At its extreme, this price insensitivity often leads to index imbalances, such as the weighting of technology stocks in the growth benchmarks in 2000 or the rise of financials in value benchmarks in 2006. Even outside of the extremes, these inefficiencies can be exploited by the bottom-up, valuation-sensitive active manager.

² Source: Journal of Asset Management, March 2003

This information discusses general market activity, industry or sector trends, or other broad-based economic, market or political conditions and should not be construed as research or investment advice. Please see additional disclosures.

Conclusion

While we believe there are several compelling reasons to choose active management today, more than ever it is important to choose the right manager. Too often, the active vs. passive debate is based on the performance of the average manager compared to the index return. Will the average manager outperform going forward? It is hard to say. What we can say confidently is that in this highly uncertain environment, there are important characteristics that will give certain managers an advantage. First, a manager must have **deep research resources** to navigate and process all the new information that is coming at an increasingly fast rate. Second, a manager must have a **forward-looking investment process**, a fundamental discipline that allows for the anticipation of change as opposed to reliance on the historical growth rates and valuation ranges that are now largely irrelevant. Finally, a manager should be **truly active**, building portfolios based on research conviction and not diluting those ideas by hugging the benchmark. With these characteristics and good execution, we believe today's environment has never been better for the right active manager.

This information discusses general market activity, industry or sector trends, or other broad-based economic, market or political conditions and should not be construed as research or investment advice. Please see additional disclosures.

Definitions

ETF – An Exchange Traded Fund or ETF is a security that tracks an index, a commodity or a basket of assets like an index fund, but trades like a stock on an exchange, thus experiencing price changes throughout the day as it is bought and sold.

S&P 500 Index – The S&P 500 Index is the Standard & Poor’s 500 Composite Index of 500 stocks, an unmanaged index of common stock prices. The Index figures do not reflect any deduction for fees, expenses or taxes. It is not possible to invest directly in an unmanaged index.

CBOE Volatility Index (Daily) – The CBOE Volatility Index® (VIX®) is a key measure of market expectations of near-term volatility conveyed by S&P 500 stock index option prices. Since its introduction in 1993, VIX has been considered by many to be the world’s premier barometer of investor sentiment and market volatility.

Disclosures

This material is provided for educational purposes only and should not be construed as investment advice or an offer or solicitation to buy or sell securities.

Indices are unmanaged. The figures for the index reflect the reinvestment of dividends but do not reflect the deduction of any fees or expenses which would reduce returns. Investors cannot invest directly in indices.

This information discusses general market activity, industry or sector trends, or other broad-based economic, market or political conditions and should not be construed as research or investment advice.

This material has been prepared by GSAM and is not a product of the Goldman Sachs Global Investment Research (GIR) Department. The views and opinions expressed may differ from those of the GIR Department or other departments or divisions of Goldman Sachs and its affiliates. Investors are urged to consult with their financial advisors before buying or selling any securities. This information may not be current and GSAM has no obligation to provide any updates or changes.

Although certain information has been obtained from sources believed to be reliable, we do not guarantee its accuracy, completeness or fairness. We have relied upon and assumed without independent verification, the accuracy and completeness of all information available from public sources.

Opinions expressed are current opinions as of the date appearing in this material only. No part of this material may, without GSAM's prior written consent, be (i) copied, photocopied or duplicated in any form, by any means, or (ii) distributed to any person that is not an employee, officer, director, or authorised agent of the recipient.

Views and opinions expressed are for informational purposes only and do not constitute a recommendation by GSAM to buy, sell, or hold any security. Views and opinions are current as of the date of this presentation and may be subject to change, they should not be construed as investment advice.

IMPORTANT NOTICE: In the United Kingdom, this material is a financial promotion and has been approved solely for the purposes of Section 21 of the Financial Services Markets Act 2000 by Goldman Sachs Asset Management International, which is authorized and regulated in the United Kingdom by the Financial Services Authority.

Copyright © 2009, Goldman, Sachs & Co. All rights reserved.

WP-129 / 19870-MF Date of First Use: 27 February 2009