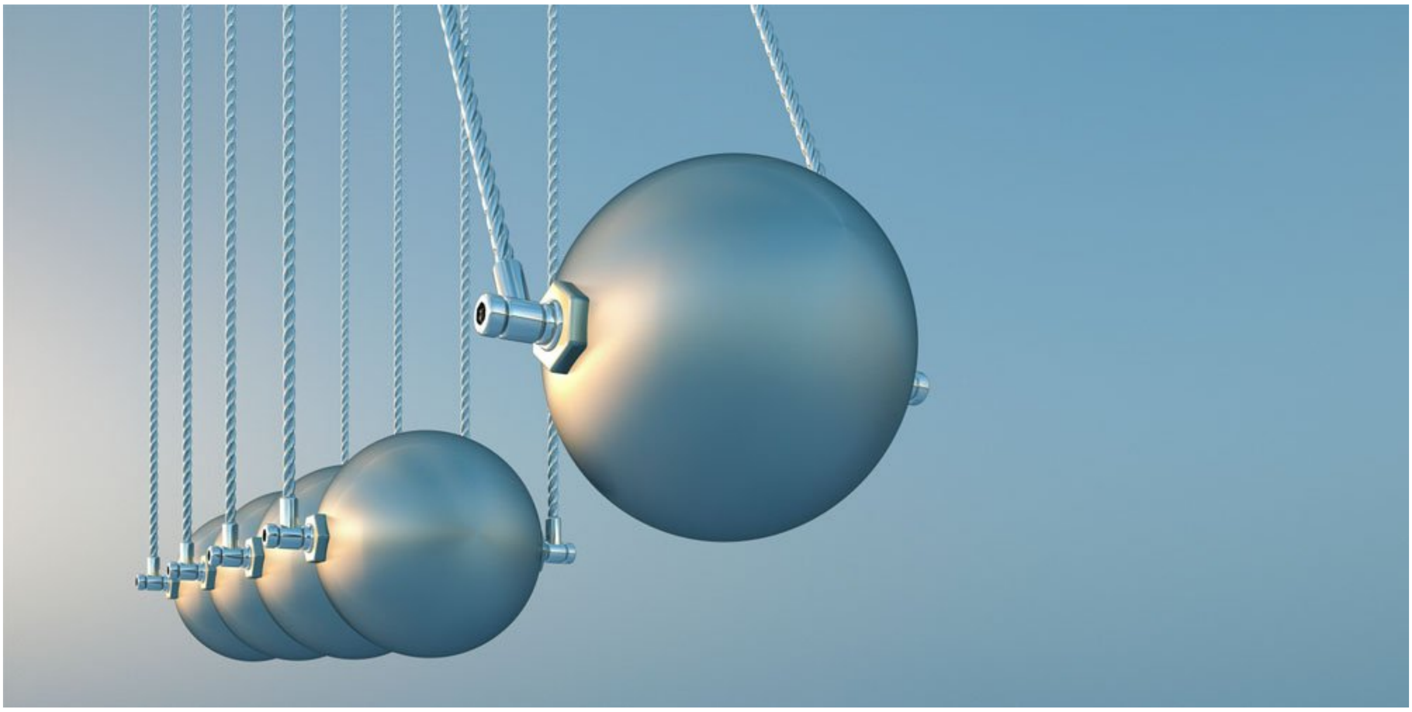

Flight to Passive Creating Opportunities for Active

October 19, 2016

A few weeks ago, my colleague David Ricci wrote about the short-term focus of the market right now, explaining why we, as large-cap growth managers, prefer a different approach. But one thing he didn't touch on was the fact that the problem is compounded for passive investors.

As David explained, many managers tend to react to short-term events such as Brexit. Many are chasing dividend yield in a flight to safety. As a result, certain stocks, such as consumer staples, have become momentum stocks even though their growth prospects aren't very appealing.

That may work for now, but ultimately there will be a reversal. And consider the result for passive investors. If you're buying an index, and consumer staples are a significant part of that investment, you're buying a lot of consumer staples at all-time highs.

That was the case with technology back in 1999, when technology was half of the Russell 1000 Growth Index. Buying that index wasn't a smart move, as we learned over a two- or three-year period when the technology bubble burst.

We're happy with the strength of our own active strategy relative to passive strategies, but as more investors go passive, even more opportunities should arise for active managers. Money pouring into index funds creates inefficiencies in the market. That's because this money is blindly buying an index.

There is no research being done by passive investors to understand the investment. They are simply treating every stock, every company, as a commodity.

We believe this approach is misguided because companies are not commodities; every company is different. Our approach, in contrast, focuses on structurally advantaged, quality growth companies that we believe are substantially better than the average company.

We do a lot of work to understand our investments and the mispricing of the stock in the market. By taking a long-term view, we believe we can generate better-than-index returns for our investors with this approach.

Certainly, it's been a tough environment for active managers over the past five years. However, we believe this will revert, creating even more opportunities for active managers.

We're already seeing this a bit on the institutional side, where money that's been passive is now interested in active because some institutional investors realize that the flight to passive just can't continue at its current pace.

When the pendulum swings too far in one direction, eventually it will correct itself. As the environment for active managers improves, those who have a defined philosophy and process stand to benefit. That's where the William Blair Large Cap Growth strategy operates.

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