Zacks INVESTMENT MANAGEMENT

Mitch on the Markets

Portfolio Manager Investing Insights

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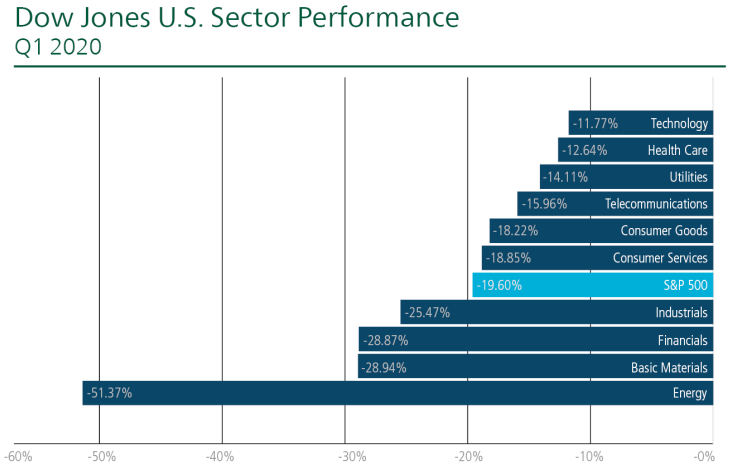
Why Active Management is Key Right Now

During the S&P 500's -34% plunge followed by its sharp "v-shaped" rally, it became apparent to me that almost every sector of the US economy had varying levels of exposure to this crisis. We have never seen an *induced* recession in the name of public health like we're seeing now, with government-mandated shutdowns and social distancing restrictions. Not all industries are being impacted equally by this economic reality – some have been affected badly, others are weathering the storm, and some are actually *thriving*.

You can see the different levels of impact in the Q1 performance numbers. The S&P 500 finished down -19.6% for the quarter, but an investor's participation in the downside had everything to do with exposure: Energy (-51.37%), Financials (-28.87%), and Industrials (-25.47%) got clobbered on the way down, while Technology (-11.77%), Health Care (-12.64%), and Utilities (-14.11%) outperformed on a relative basis.[1] A handful of strong technology companies even finished the quarter in positive territory. If an investor had equally weighted all S&P 500 sectors in their investment portfolio from January 1 to March 31, they would have been down -30.08% versus the S&P 500's actual -19.6% (cap-weighted) finish.[2] Allocation decisions matter.



Source: BlackRock[3]

A passive manager who owns the entire stock market, or specific sectors via ETFs, probably has exposure across the board – owning the good, the bad, and the ugly. An active manager can work to limit exposure to the latter two.

Long-time readers know that when it comes to growth and wealth building over time, I'm a

die-hard advocate for owning a diversified portfolio of equities for long stretches (20+ years) of time. But that does not mean just blindly owning the entire market equally, or simply allocating an equity portfolio perfectly in-line with the S&P 500's cap-weighted allocations. I believe that an active manager can help to determine how much relative exposure to allocate to each sector based on that sector's outlook. Additionally, in my view, an active manager can go a step further and attempt to examine every single stock available to determine earnings potential, credit risk (very important in the current environment), earnings estimate revisions vs. actual results, valuation, historical dividend payments, and so on. An active manager can work to separate the bad and the ugly from the strong and the good.

At present, the "April Zacks Industry Ranks" produced a "stay-at-home" macro assessment of different sectors across the economy, and finds that Utilities, Communication Services, Information Technology and Health Care are the leaders. On the negative side, we see Materials, Industrials, and Energy on a continued lag. Computer-Office equipment and software/cloud sales are strong, as remote offices get set up. Continued weakness in global manufacturing PMIs and WTI oil price declines will likely persist as a drag for Energy, Industrials, and Materials. It is still way too early to call, but current Zacks earnings estimates for full-year 2020 shows spots of positivity from Information Technology (+6.0% y/y), Health Care (+4.7% y/y), Consumer Staples (+2.7% y/y), and Communications Services (+2.0% y/y).[4]

I believe size is another arena where active management can help you navigate the recession. Because of the 'full-stop' on economic activity that characterizes the current recession, large-cap companies – which tend to have stronger balance sheets, better technology, established relationships with banks, and more diversified sales channels – are 'weathering the storm' better than smaller and mid-size counterparts that do not have similar financial positions. Large-cap has been outperforming small-cap and mid-cap across the globe, across the growth and value (style) spectrum.[5] This setup is another area where active managers can smartly position accordingly.

Finally, from a stock-specific standpoint, I believe active managers should be looking at credit risk on every company's balance sheet in the portfolio. Reports this week showed the $350 billion Paycheck Protection Program was already out of money, and though Congress is poised to add more funds, not every business will benefit from bridge loans needed to keep the doors open. Energy companies in particular face acute credit risk as oil prices have plunged. Companies with strong balance sheets and cash positions will still hurt from falling demand, but their chances of surviving are much higher – and life after the crisis might mean less competition.

Bottom Line for Investors

Stock market volatility continues apace and is likely to remain elevated for the next few months as the world fights to contain the Covid-19 outbreak. The economic hit will also continue as shutdowns and restrictions on movement persist, with some sectors and industries feeling acute pain while others weather the downturn or even thrive. A passive investment approach in the current environment means owning some or many of the companies that are not likely to do well or potentially will not survive, in my view. An active approach to investing – like what we do here at Zacks Investment Management – means taking a more analytical approach to owning stocks that can survive the crisis and perhaps even emerge stronger during the recovery. That's why I think it's a good time to be an active manager.

ABOUT MITCH ZACKS

Mitch is the CEO & Senior Portfolio Manager at Zacks Investment Management. Mitch has been featured in various business media including the Chicago Tribune and CNBC. He wrote a weekly column for the Chicago Sun-Times and has published two books on quantitative investment strategies. He has a B.A. in Economics from Yale University and an M.B.A in Analytic Finance from the University of Chicago.

[1] BlackRock, Benchmark returns comparison, March 2020.

[2] Google Finance, April 21, 2020
https://www.google.com/search?client=safari&rls=en&q=INDEXNYSEGIS:+SPXEW&ie=UTF-8&oe=UTF-8

[3] BlackRock, Benchmark returns comparison, March 2020.

[4] Zacks Investment Management Stock Market Outlook Report. April/May 2010.

[5] The Wall Street Journal, April 202, 2020. https://www.wsj.com/articles/the-winner-takes-all-stock-market-rally-11587374851?mod=djem10point

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