INSIGHT FROM POLEN CAPITAL

Outperformance in the Next Bear Market?

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Executive Summary

In a recent commentary for the Polen Focus Growth strategy, we highlighted our thoughts around changes in market structure that may impact the relative performance of our portfolios during the next significant drawdown in equities. In the commentary, we raise the prospect that our relative investment performance in the immediacy of the next major market drawdown may not be as strong as we have seen in past bear markets, when we saw our Focus Growth portfolio protect substantial capital. Protecting our clients' capital is at the core of our investment philosophy and represents the crux of our mission statement.[1] To be clear, our expectations that the advantages of our portfolio of high-quality businesses will continue to be evident during the next bear market in equities and beyond remain unchanged. Rather, what concerns us is that the market structure has changed due to the massive surge of capital flows into passive indices, ETFs and other trend-following strategies over the past several years. These changes have implications for our portfolio performance that may not be apparent until the next significant pullback in the equity market inevitably occurs. The focus of this paper is this shift in market structure and its potential short-term effects on our relative investment performance.

Historical Context

We initially broached this subject in the Q3 2018 commentary for our Focus Growth portfolio. In that commentary, we noted that the rise of passive investing, high-frequency trading and other trend-following strategies may have fundamentally changed the structure of equity markets such that "the next downturn may not be as discerning as in the past."[2] By the past, we are specifically referring to the previous two bear markets in equities from 2000-2002 and from 2007-2009. During each of these drawdowns, our Focus Growth portfolio meaningfully outperformed the broader market, as measured by the S&P 500. But the nature and pattern of that outperformance requires some context and can be better understood by analyzing both market events.

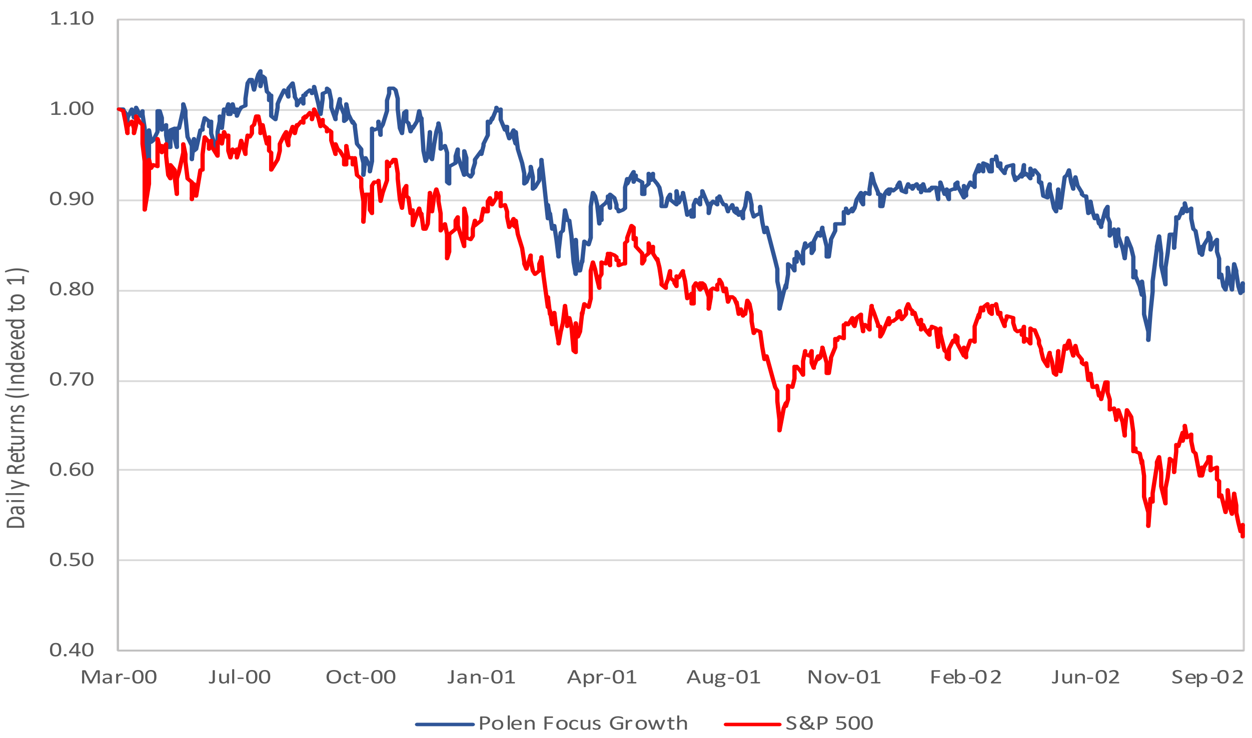
First, let's look at the bear market that began on March 24, 2000 when the tech bubble peaked. This

[1] Polen Capital Mission Statement: "Preserve and grow client assets to protect their present and enable their future."
[2] Polen Focus Growth Q3 2018 Commentary

particular downturn lasted roughly two and a half years, bottoming on October 10, 2002. The chart in Figure 1 shows the performance of our Focus Growth portfolio relative to the S&P 500 during that time frame. On a total return basis, the S&P declined 47% from peak to trough during this cycle. Comparatively, as can be seen in the chart, our Focus Growth portfolio performed well, declining 20% over the same period and protecting capital for our clients. In this bear market, returns between stocks were less correlated with much of the losses concentrated in the technology sector and in the largest capitalization stocks. Thus, equity managers had the ability to differentiate their returns relative to the market. For example, while the cap-weighted S&P 500 declined 47% from peak to trough, the equal-weighted S&P 500 only declined 26%, a notable divergence.[3]

Figure 1

Polen Focus Growth Portfolio vs. S&P 500 – Daily Returns 3/24/2000-10/9/2002



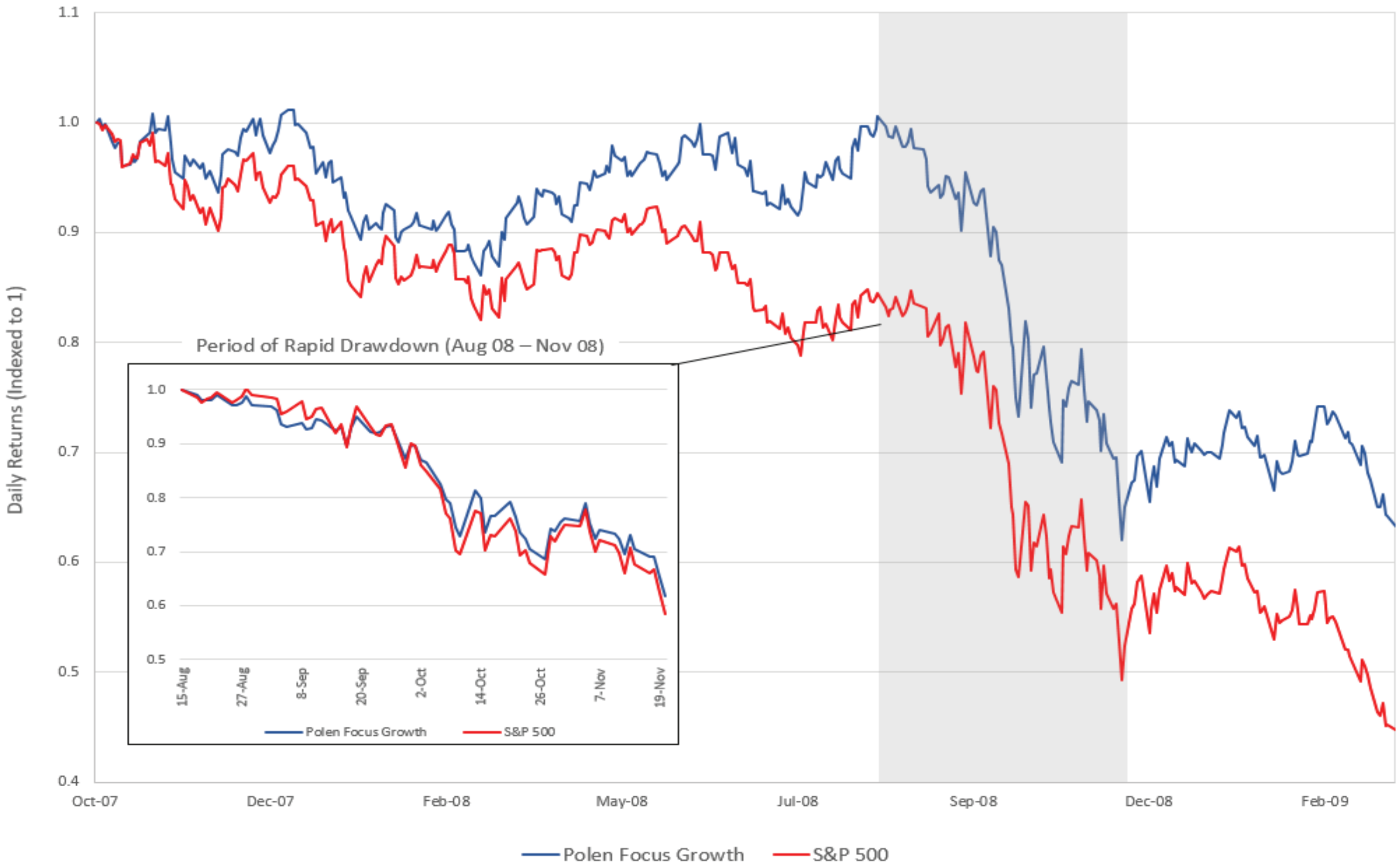
Source: Polen Capital, Factset

The second major drawdown occurred during the Global Financial Crisis (GFC) and began on October 9, 2007 when the S&P 500 made its closing high for that cycle. The downturn lasted about a year and a half, bottoming on March 9, 2009. The chart in Figure 2 shows the daily returns of both our Focus Growth portfolio and the S&P 500 during this period with the index declining 55% from peak to trough compared to a 37% decline for our portfolio. Our portfolio again protected capital well in this drawdown, though not quite as well as in the 2000-2002 bear market as price weakness was more widespread during the GFC. As a proof point, the equal-weighted S&P index declined 59% from peak to trough during this drawdown compared to the 55% decline for the cap-weighted version. Furthermore, the GFC was marked by a violent sell-off starting in September 2008, in the wake of the Lehman bankruptcy, which caused asset price correlations to spike. During this period, which is highlighted in the inset chart in Figure 2, stocks were liquidated without regard to fundamentals and our portfolio essentially declined tick-for-tick with the market. *Given the further changes in market structure since this time, which are discussed in the next section, we remain concerned that a similar occurrence is possible when the next bear market in equities inevitably arrives, and we want our clients to be prepared for this possibility.*

[3] Source: Factset

Figure 2

Polen Focus Growth Portfolio vs. S&P 500 - Daily Returns 10/9/2007 - 3/9/2009



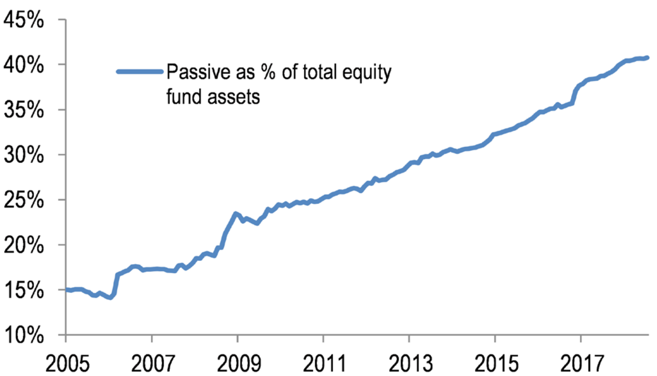
Source: Polen Capital, Factset

Changes in Market Structure

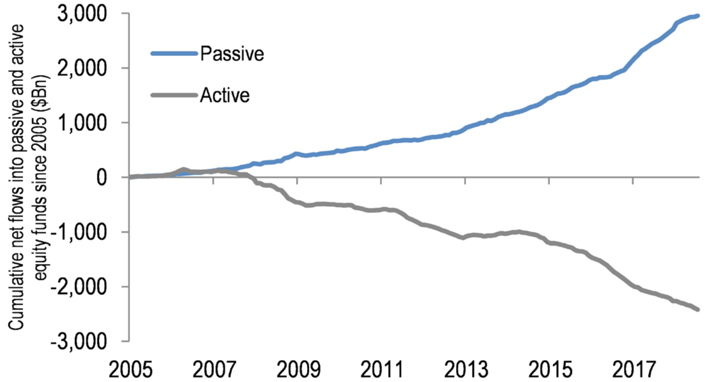
While the nature of the next bear market in equities is up for debate, the influence of passive assets on the current marketplace is indisputably large. The charts in Figure 3 show that passive fund AUM as a percentage of total global equity fund AUM has moved meaningfully higher since 2005 driven by an enormous flow of capital out of actively-managed funds into passively-managed ones.

Figure 3

Passive funds' (i.e. ETFs + mutual funds) share of global equity fund AUM



Cumulative net flows into passive and active equity funds since 2005



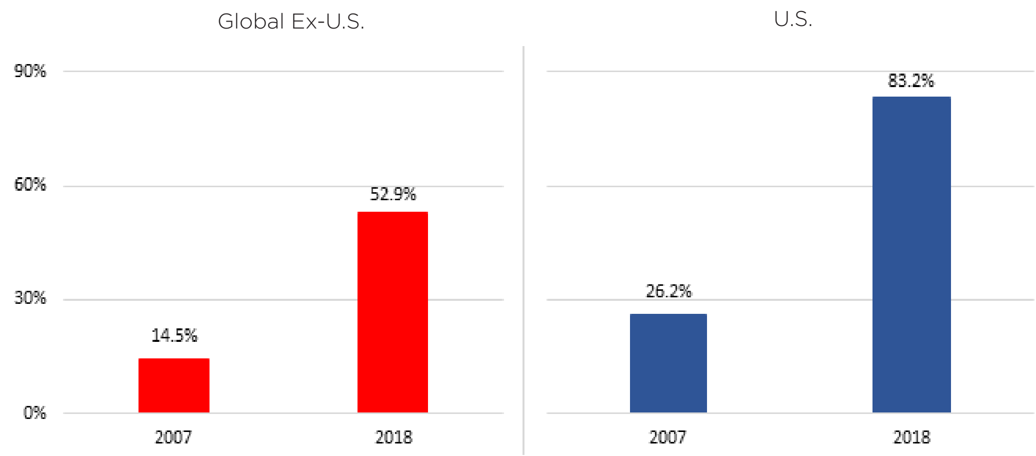
Source: J.P. Morgan

Another way to visualize the magnitude of growth in passive investing is in the charts in Figure 4, which show the percentage of passive AUM relative to active AUM for large/all cap funds. Relative to actively-managed funds, the AUM of passive indices has risen dramatically over the past ten years, a trend seen both inside and outside of the U.S.

Regardless of one's opinion about the merits of passive investing, we believe there should be little debate that they are essentially "momentum" strategies, systematically buying when money flows in and selling when money flows out. The concern we have as active managers is that, in the next bear market, this passive capital will not discriminate between the high-quality businesses that comprise our portfolios and the lower quality businesses that we believe populate many of the largest index funds.

Figure 4

Passive AUM as a % of Active - Large/All Cap Funds

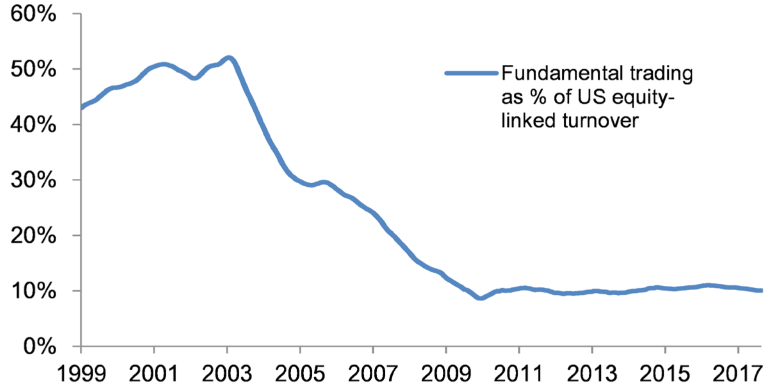


Source: Polen Capital, J.P. Morgan

J.P. Morgan also estimates that 90% of current equity trading volume comes from what we view as "trend-following" traders (quant, index, ETFs, futures and options-related strategies) whose trading decisions are often driven by algorithmic or programmatic reasons rather than fundamental ones. The remaining 10% is comprised of active traders, i.e. active managers, who act as a natural floor for equity prices because they often buy into share price weakness. As the chart in Figure 5 shows, the decline in fundamental, active traders as a percentage of U.S. equity volume began in earnest around 2003. This fact may also help explain why correlations in price returns were much higher in the 2007-2009 bear market compared to the 2000-2002 bear market, as the percentage of equity trading volume derived from true "active" traders declined substantially in the period between these two market drawdowns.

Figure 5

Percentage of equity trading volume estimated to come from "active" traders



Source: J.P. Morgan

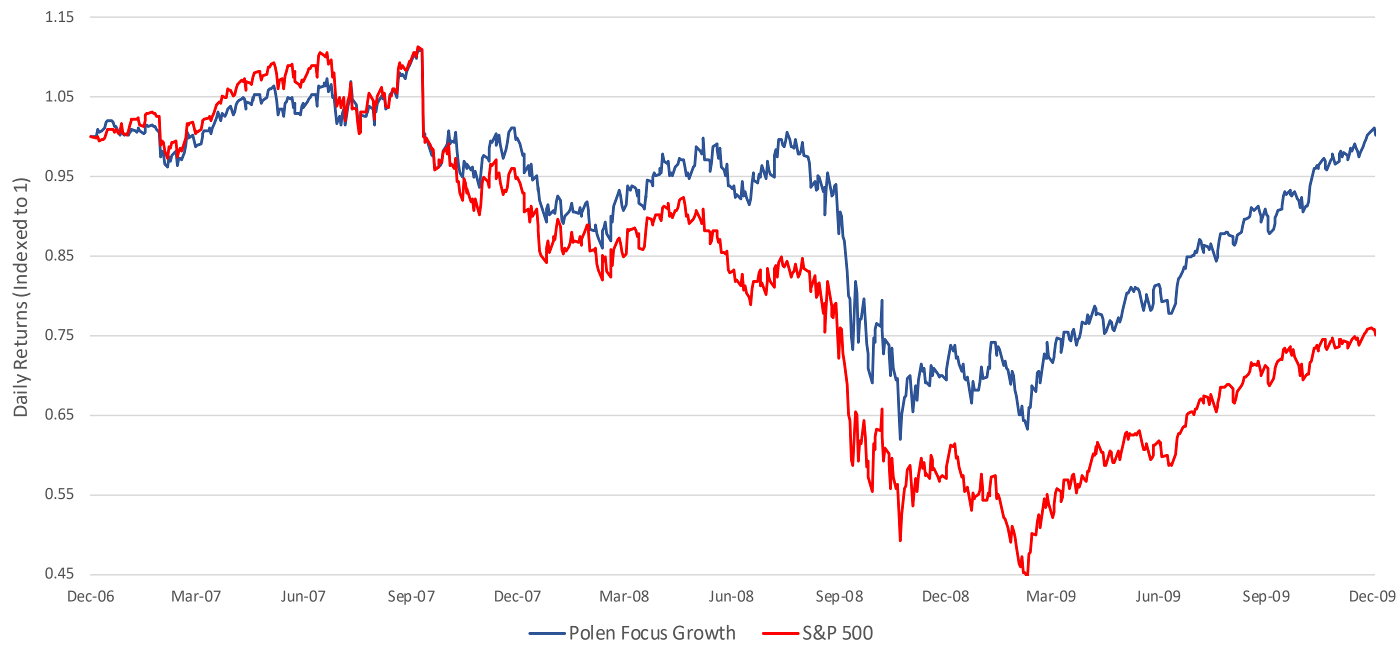
[4] Please see our previous white paper on credit risks in the S&P 500

Widening the Lens

We should reiterate here that our concerns are primarily with how our portfolios might perform over short time horizons, particularly in light of the structural changes previously discussed. As always, we believe longer-term context is important. With that in mind, the chart in Figure 6 shows the performance of our Focus Growth portfolio vs. the S&P 500 during the GFC, but in this example, we extend the timeframe to include the entire three-year period from 2007-2009, thus encompassing the months leading up to the peak in equity prices, the peak to trough decline and the initial recovery period. Over this three-year window, our Focus Growth portfolio cumulatively outperformed the S&P 500 by 28% (2800 bps) on a total return basis.

Figure 6

Polen Focus Growth Portfolio vs. S&P 500 - Daily Returns 12/31/2007 - 12/31/2009



Source: Polen Capital, Factset

The main takeaway here is that we believe our short-term concerns, however valid they end up being, should not overshadow the value we see a high-quality portfolio add once you widen the lens to include the periods before and after a drawdown. When one takes the longer view, we believe the power of our competitively-advantaged, high quality portfolio companies becomes evident and underscores our mission to "preserve and grow" our clients' assets.

Conclusion

At Polen Capital, we are proud to have fulfilled our mission to preserve and protect our clients' capital in the last two major equity drawdowns. However, changes in market structure due to the proliferation of passive and other trend-following strategies could mean that our relative performance during the next significant drawdown in stocks may not look like the last two. While it's possible that our portfolio returns could decline tick for tick with the market in a sharp sell-off in equities, we remain confident that over the course of a bear market cycle, including the decline and recovery periods, our high-quality portfolios are well-positioned to deliver the similarly strong relative performance that we've seen in the past.

About The Author

Stephen Atkins, CFA, Portfolio Strategist & Analyst — Large Company Growth, joined Polen Capital in 2012 after a 12-year tenure as a portfolio manager at Northern Trust investments—including eight years as a mutual fund co-portfolio manager. Mr. Atkins also spent two years at Carl Domino Associates, LP. He received his B.S. in Business Administration from Georgetown University and a General Course degree from the London School of Economics. Mr. Atkins is a CFA Charterholder and a member of the CFA Institute and CFA Society of South Florida.

About Polen Capital

Founded in 1979, Polen Capital is a global investment management firm that provides high value-added quality growth investment strategies to sophisticated clients around the world. The Firm is committed to attracting experienced, disciplined investment professionals to add value to client portfolios. Polen Capital's Large Company Growth Team oversees a global equities universe of high-quality growth companies and manages the flagship Focus Growth strategy, as well as the Global Growth and International Growth investment strategies. The Firm also has an autonomous Small Company Growth Team that manages a U.S. Small Company Growth. Polen Capital's strategies are offered through various investment vehicles to accommodate a broad range of client mandates. For more information visit **www.polencapital.com** and connect with us on **LinkedIn**.

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