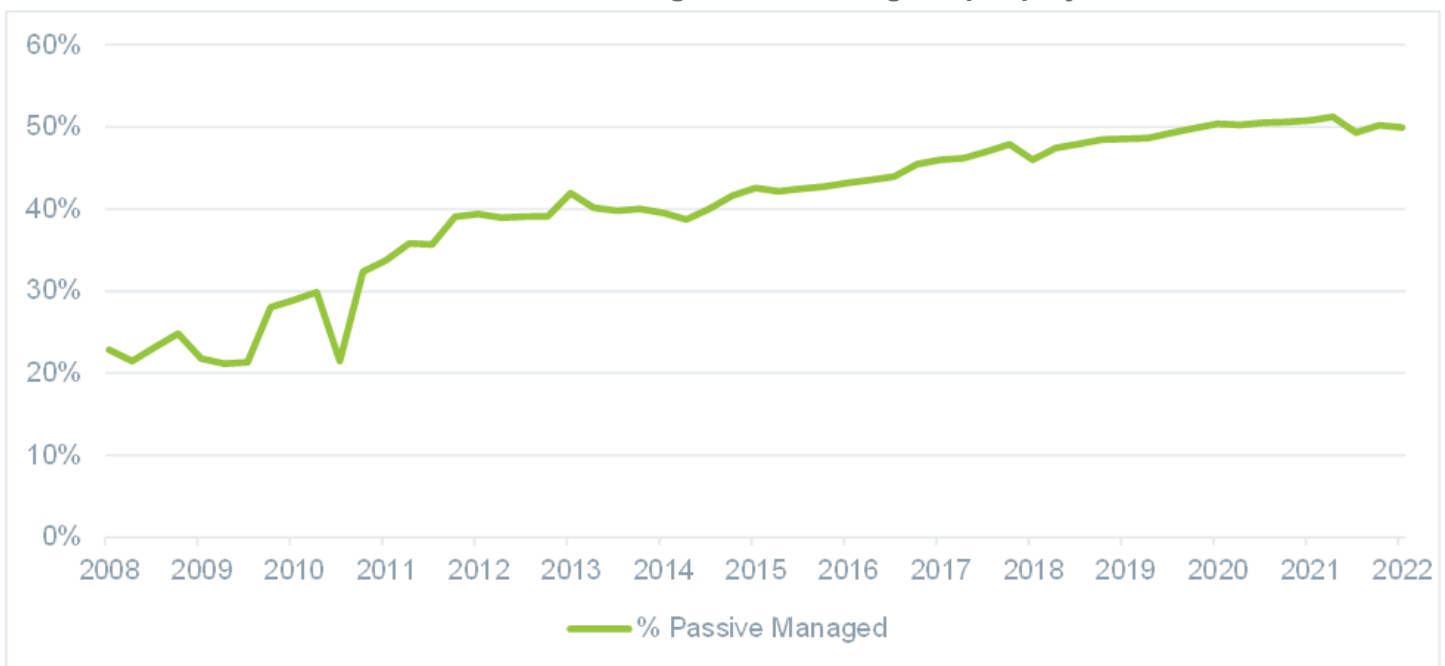


## The Fed Balance Sheet and Active Public Equity Management

The shift to passive management of public equities is well documented in the institutional investing landscape (see Figure 1). Although numerous rationales exist for this trend, the most common explanations include lower fees or lack of outperformance of active managers over the recent past. There is no disputing that passive mandates carry materially lower fees, and therefore offer a head start over active managers.

Figure 1

### Shift to Passive Management: US Large Cap Equity



Source: eVestment.

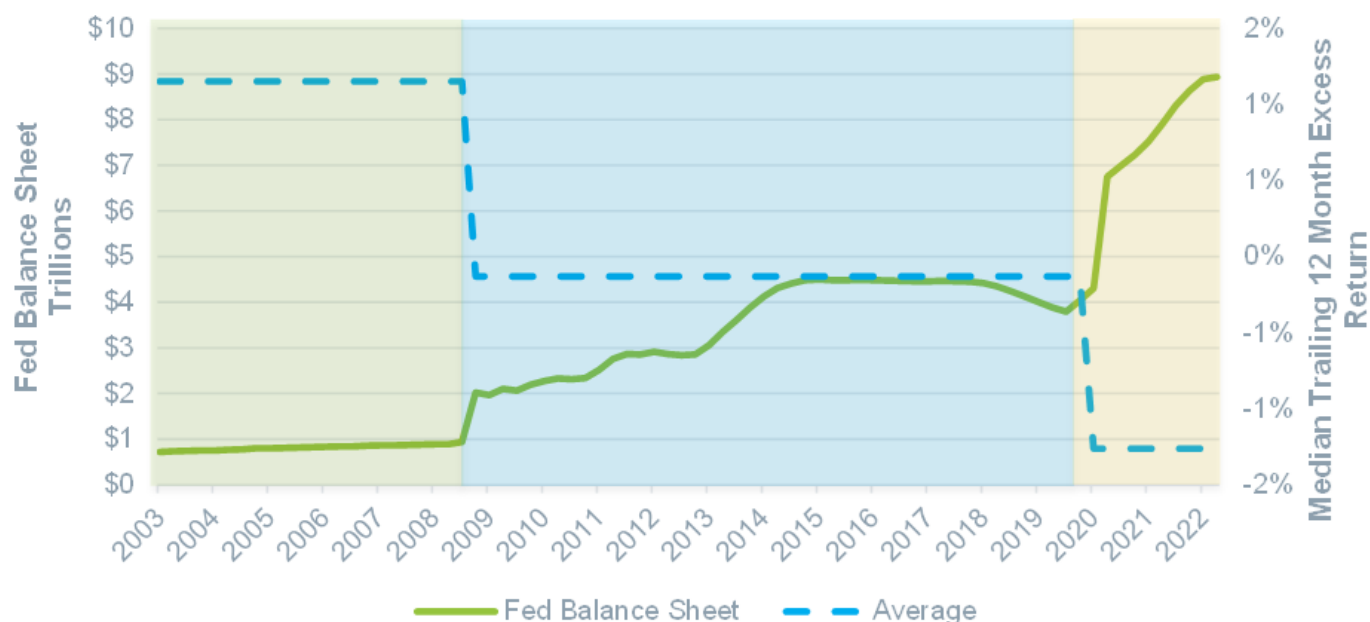
However, when evaluating the decision to reduce or eliminate the use of active mandates, past performance does not necessarily translate to future outcomes. The market environment in which past results were generated, as well as the expectations of the future market environment, must be taken into consideration. While passive outperformance has generated a series of academic research, one potential factor appears to be quantitative easing. Large expansions in the Fed's balance sheet appear to correlate with the lack of success among active US equity managers over the last 15 years. While correlation does not equal causation, we find it plausible that the Fed's expanding balance sheet could influence active manager underperformance via broad market improvements (rather than company-specific improvements). And thus, if the Fed shrinks its balance sheet as projected, the market environment for active managers may improve going forward.

Figure 2 shows the relationship between the Fed's balance sheet and the excess return generated by active large cap core US equity managers. The green line shows the Fed balance sheet. We break this into three regimes. First, the pre-Great Financial Crisis (GFC) period (green); second, the post-GFC period (blue); and finally, the post-COVID period (yellow). As seen, both period transitions begin a new phase of quantitative easing (QE) and rapid balance sheet expansion.

The blue line shows the average of rolling 4-quarter median excess return for the large cap core US equity peer group during each of the three periods. Prior to the GFC, the median excess return for this period was 1.2% (starting in 2003). The median excess return for the period between the GFC and COVID fell to -0.1%. Finally, and while a shorter time period, the average has fallen to -1.3% since the onset of the COVID QE. The drop-offs in excess returns are material and the difference between the first period and the third period is significant at 2.4%.

**Figure 2**

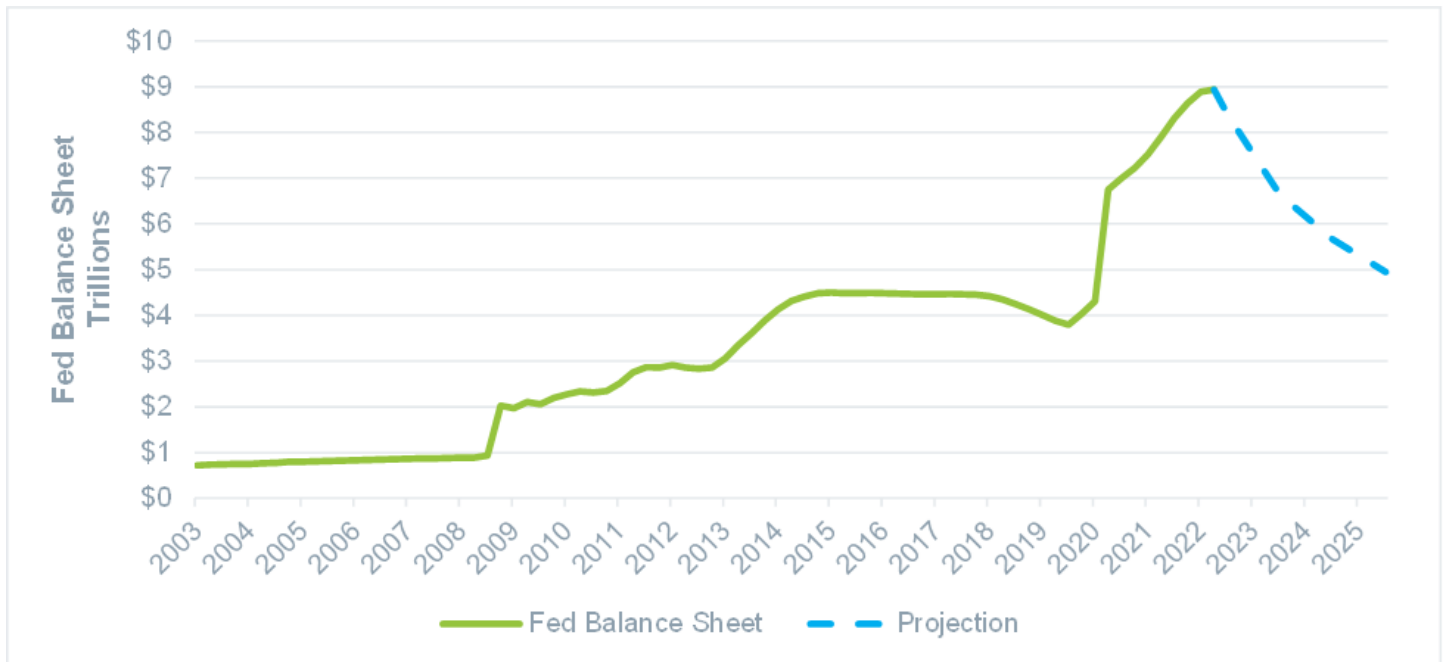
**Fed Balance Sheet and Median Active Large Cap Core US Equity Performance**



Performance shown is gross of fees. Source: eVestment and Board of Governors of the Federal Reserve System (US), Assets: Total Assets: Total Assets (Less Eliminations from Consolidation): Wednesday Level [WALCL], retrieved from FRED, Federal Reserve Bank of St. Louis; <https://fred.stlouisfed.org/series/WALCL>, June 22, 2022.

Given generational inflation and statements by the Fed, it is entirely plausible that balance sheet reductions arrive in the near future. Figure 3 shows current Fed projections. While many factors will dictate future Fed balance sheet levels, if these projections come to fruition, they may provide enhanced opportunities for active managers to generate excess return.

**Figure 3**  
**Fed Balance Sheet Projections**



Source: Ennis, Huberto M.; and Kirk, Kyler J. (April 2022) "Projecting the Evolution of the Fed's Balance Sheet" Federal Reserve Bank of Richmond Economic Brief, No. 22-15.

Of course, other factors also drive the ability of active managers to provide excess return. The level of interest rates, which could prove to be highly connected to the Fed's balance sheet, also likely play a material role. Other factors include the level of volatility in the market, dispersion levels of individual securities, and the market cycle to name a few. This short piece is not intended to suggest the Fed's balance sheet is the sole source of active management shortcomings but rather to remind investors to look forward, to the extent possible, before deciding to move to passive simply based on past performance.

### Disclaimer of Warranties and Limitation of Liability

*This document was prepared by RVK, Inc. (RVK) and may include information and data from eVestment.com, Board of Governors of the Federal Reserve System (US), and Federal Reserve Bank of Richmond Economic Brief. While RVK has taken reasonable care to ensure the accuracy of the information or data, we make no warranties and disclaim responsibility for the inaccuracy or incompleteness of information or data provided or for methodologies that are employed by any external source. This document is not intended to convey any guarantees as to the future performance of investment products, asset classes, or capital markets.*

### About RVK

RVK was founded in 1985 to focus exclusively on investment consulting and today employs over 100 professionals. The firm is headquartered in Portland, Oregon, with regional offices in Boise, Chicago, and New York City. RVK is one of the five largest consulting firms in the world, as reported by Pensions & Investments' 2021 Special Report—Consultants. Additionally, in April 2022, RVK received a notable award as a Coalition Greenwich Quality Leader among large US investment consultants, based on Greenwich's 2021 study. Coalition Greenwich is an industry-recognized third-party firm which asks plan sponsors to rank their consultants on a series of key metrics. Notably, RVK is the only firm among large US consultants to receive an award for a fifth consecutive year.<sup>1</sup> RVK's diversified client base of over 200 clients covers 30 states, and covers endowments, foundations, corporate and public defined benefit and contribution plans, Taft-Hartley plans, and high-net-worth individuals and families. The firm is independent, employee-owned, and derives 100% of its revenues from investment consulting services.

<sup>1</sup>Between July and October 2021, Coalition Greenwich conducted phone interviews with 811 individuals from 661 of the largest tax-exempt funds in the US—including corporate and union funds, public funds, and endowments/foundations with either pension or investment pool assets greater than \$150 million. Study participants were asked to provide quantitative and qualitative evaluations of their asset managers and investment consultants, including qualitative assessments of those firms soliciting their business and detailed information on important market trends. RVK is one of three firms recognized in the large investment consultant category. The ratings may not be representative of any one client's experience with RVK; rather they are representative of those clients that chose to participate in the survey. The results are not indicative of RVK's future performance. To read the Greenwich press release, please refer to the following URL: <https://www.greenwich.com/institutional-investing/investment-consultants-strengthen-role-top-advisors-us-asset-owners>.