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The alpha opportunity in U.S. equities

BlackRock®

An underappreciated portfolio building block

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Growth in passive strategies has presented asset allocators with more options for building their U.S. equity exposure. The active/passive debate is not new, but 2023 marked a milestone when total assets in global index equity funds overtook active for the first time, according to data from LSEG Lipper.[1]

We've increasingly seen portfolio construction principles tout the merits of indexing core allocations to large-cap U.S. equities and building specialty allocations around them, often in the form of active positions in more complex or nuanced markets and asset classes where manager skill is more richly rewarded.

The rationale is that public market large-cap U.S. stocks operate in a highly efficient and transparent marketplace where data is abundant and quickly priced, leaving little opportunity for alpha generation from off-benchmark calls. There is also a widely held and empirically grounded view that the median U.S. active manager does not outperform consistently, thus arguing for indexing of the U.S. equity exposure.

Our analysis challenges this thesis and instead suggests that **avoiding an active allocation to large-cap U.S. equities means forfeiting important portfolio return potential.**

Quick read:

A U.S. alpha imperative?

Attractive top-quartile alpha and outsized index representation give U.S. large caps an alpha edge.[2]

Why now?

Increased market dispersion means greater potential for skilled stock selection to generate alpha.

What to consider

Time horizon and manager track record are important considerations for allocators.

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Alpha potential is abundant in the U.S.

Large-cap U.S. stocks historically have provided a meaningful alpha opportunity on the global stage. This is a function of the excess returns of the top quartile of managers alongside large relative representation in global markets.[1] While top-quartile managers in less-efficient markets may generate a higher percentage of alpha, their impact on a whole portfolio could be less than a top-quartile U.S. large-cap manager given their smaller allocation in the index.[2] This is illustrated in the table below.

Alpha analysis by region

Region	Current All Country World Index (ACWI) weight	Top quartile average excess return	Total alpha opportunity
U.S. Large Cap	63%	3.2%	2.02%
Emerging Markets	10%	5.5%	0.55%
EMEA	15%	4.7%	0.71%

Source: BlackRock Fundamental Equities, with data from FactSet, MSCI and eVestment, as of April 2024. eVestment universes cited are U.S. Large Cap Equity, All Emerging Markets and All Europe. ACWI weights are as of March 31, 2024, and top quartile excess returns are averages over the 20-year period from 2004-2023. Total alpha opportunity represents the current weight times the top quartile excess return. **The figures shown relate to past performance. Past performance is not a reliable indicator of current or future results.** Index performance returns do not reflect any management fees, transaction costs or expenses. Indices are unmanaged and one cannot invest directly in an index.

A deeper look at the U.S. shows that while median alpha has been negative in 67% of rolling one-year periods over the past 10 years, the top quartile of alpha generators remained positive even through challenging market environments, as shown in the left chart below.

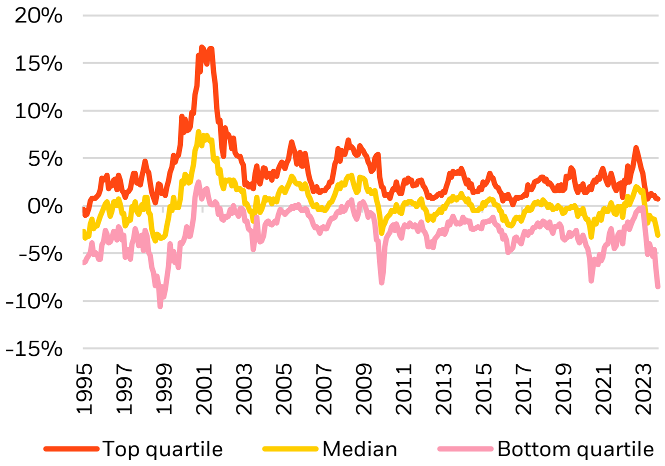
The right chart shows that U.S. stocks comprise a growing share of global market indices, representing 63% of the MSCI All-Country World Index (ACWI) as of March 31, 2024, up from 37% in 1995.

Taken together, this suggests that relegating not only U.S. but global exposure to index strategies can translate to a significant sacrifice of potential return.

Consider that the MSCI USA Index enjoyed cumulative returns of 543% over the 20-year period ended Dec. 31, 2023. Yet assuming top-quartile U.S. alpha potential of 3.2% annualized excess returns, equivalent to the average for the 25th percentile in the U.S. Large Cap Equity category over the past 20 years, would have brought that cumulative return to 1,042%.[3]

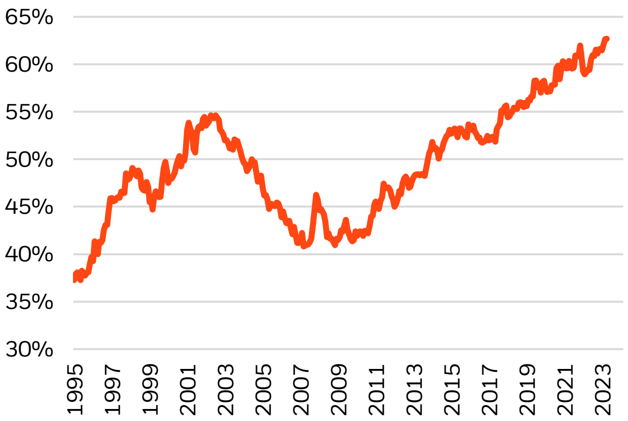
Top quartile has delivered across time

Excess returns, U.S. large-cap stocks, 1995-2023



A growing U.S. share

U.S. large-cap share in MSCI ACWI, 1995-2024



Sources: **Left chart:** BlackRock Fundamental Equities, with data from eVestment as of Dec. 31, 2023. Chart shows the one-year excess returns for the eVestment U.S. Large Cap Equity category, gross of fees, compared to primary prospectus benchmark. **The figures shown relate to (simulated) past performance. Past performance is not a reliable indicator of current or future results.** Index performance returns do not reflect any management fees, transaction costs or expenses. Indices are unmanaged and one cannot invest directly in an index. **Right chart:** BlackRock Fundamental Equities, with data from FactSet and MSCI as of March 31, 2024. Chart shows the weight of U.S. large-cap stocks within the MSCI ACWI over time.

[1] Top quartile managers in the eVestment U.S. Large Cap Equity category have delivered average excess returns of 3.2% annually from 2004-2023, compared to their primary prospectus benchmark. U.S. large cap equities have also increased their weight in MSCI ACWI, as can be seen in the chart at right. [2] Refers to the fact that U.S. large caps comprise the largest share of the MSCI ACWI Index. [3] MSCI USA returned 9.75% from 2004-2023. 25th percentile manager delivered 3.2% annualized alpha in excess of primary prospectus benchmark during this period. Results do not reflect the deduction of management/advisory fees and other expenses; management / advisory fees and other expenses will reduce a client's return. 9.75%+3.2% = 12.95%, which equates to 1,042% cumulative return from 2004-2023.

Research from the BlackRock Investment Institute (BII) has further found that alpha from top-quartile large-cap U.S. equity managers has increased in the post-COVID era (2020-2023) relative to the three years prior. Dispersion in alpha also has edged higher, according to BII, suggesting manager selection has become more important. The resurgence of U.S. active managers has continued in 2024, with 64% of active managers outperforming their benchmark in Q1, the best quarter since 2007.[1]

Challenges and myths

One of the challenges to our argument is that U.S. active managers have not had a record of consistent outperformance, sometimes failing to earn their higher fees. While the median manager has underperformed, there clearly are opportunities for alpha to be had in U.S. equities in the hands of skilled managers. And we believe the return for skill is set to rise.

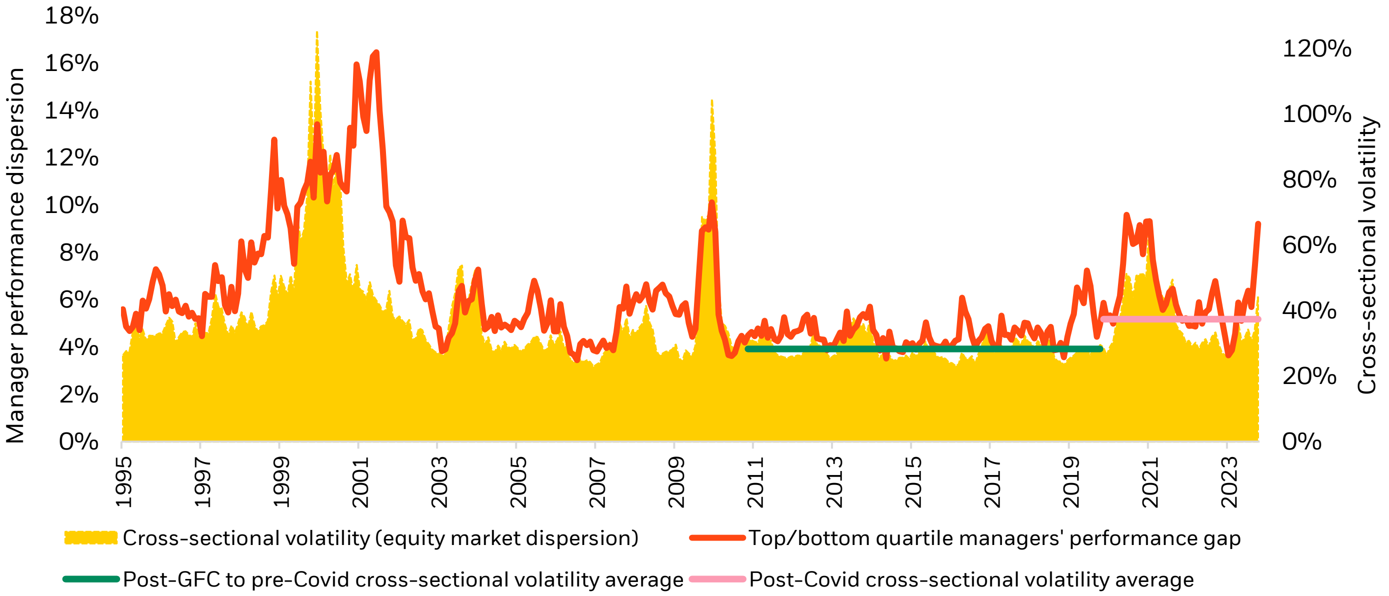
One reason is the observed increase in market dispersion in the post-COVID investment regime and the opportunity this creates for active managers to parse winners and losers in pursuit of above-market returns. We also found dispersion to be higher in the U.S. compared to Europe and the APAC region.

Using cross-sectional volatility — a measure of the standard deviation of security returns over rolling one-year periods — as a yardstick for market dispersion shows that equity dispersion increased in the U.S. during the post-COVID period. Our analysis also found the one-year performance difference between top- and bottom-quartile managers (shown below) is wider during the periods of higher equity dispersion, indicating the skillset of top managers is accentuated in a high-dispersion environment. The market dispersion may serve as a barometer for active management success, with the potential for greater rewards for those who can effectively navigate the complexities of a dispersed market.

As seen in the orange line below, the manager performance gap between the top and bottom quartile has widened since COVID. This reinforces that the post-COVID period (pink line), due to higher cross-sectional volatility, may be a prime environment for skilled active managers to add value.

Elevated U.S. manager dispersion

Top- vs. bottom-quartile manager performance and cross-sectional volatility, 1995-2023



Source: BlackRock Risk and Quantitative Analysis, with data from FactSet, April 2024. Chart shows manager performance dispersion in top versus bottom quartile of the eVestment U.S. Large Cap Core category (orange line) and cross-sectional volatility (yellow) using security returns of Russell 1000 index constituents.

[1] Bank of America Mutual Fund Performance Monitor, April 3, 2024.

The reality of active investing is that it is not a straight line. There will be periods of outperformance and periods of underperformance. We believe the goal should be a steadier experience across time that results in alpha gains over a 5- to 10-year time horizon. This requires sourcing a manager with a sufficiently strong investment process and fundamental research capabilities to offer consistency across time, alongside a track record of providing an investment experience aligned to its stated objective.

Final thoughts

Ultimately, the active/passive decision should be based on individual client goals. Yet the impact of alpha in the U.S. on the whole portfolio is significant and potentially misunderstood. Even lower U.S. alpha is meaningful in a whole-portfolio context given the outsized U.S. representation in global indices. For investors and asset allocators seeking to increase their portfolios' alpha potential, large-cap U.S. equities may be an underappreciated place to target that exposure.

Manager selection considerations

Manager researchers may use various inputs to assess a manager's alpha potential. For example:

Magnitude: Absolute value added through active management.

Persistency: Record of delivering alpha over time in an asset class.

Drivers of return: Factors play a meaningful role in explaining fluctuations in manager returns and contributed to increased volatility in recent years. It is important to separate factor exposure from stock picking to understand which is being paid for.

Prevalence of alpha: Assessment of median manager performance and portion of managers that have delivered outperformance versus benchmarks.

It is also important to assess the relative attractiveness and feasibility of passive products:

No passive option available: Applies mostly to alternative asset classes: private equity, private real estate, and hedge funds.

Do passive strategies deliver benchmark returns? Some asset classes have benchmarks that are difficult to track due to illiquidity or high transaction costs, which may make passive strategies less attractive.

How cheap is passive? Not all passive strategies are cheap. For some asset classes, passive may only be slightly less expensive than active management.

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