Great-West Lifetime Funds

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Pity the stock picker?

It's easy to feel sorry for the old-school portfolio manager. Time was, these wizards of active management had one of the best jobs on the planet — they were paid (sometimes exorbitantly) to fly all over the globe and rub elbows with the business glitterati, to dive deep and sort out the investable from the merely provocative or interesting. But now, the days of jet-setting portfolio managers are being threatened by a new (and not always human) breed of investor — the passive one. This is of course nothing new; the rise of passive investing and the displacement of a meaningful percentage of active management capacity that followed have been in place for a decade or more. But in a post-COVID market environment that has grown so extreme, it's hard not to wonder if things may finally be swinging back their way (see inset box).

That's not to say the job of actively managing investment portfolios has somehow grown easier as a result of the pandemic. In fact, in some ways it's grown more difficult (and, as a result, perhaps even more valuable). Take, for example, the case of a large-cap growth manager trying to outpace the Russell 1000 Growth Index. Anything less than an 11% stake in Apple, Inc. represents a significant risk of underperformance given the company's outsized presence in the benchmark. Expand the list to include the other so-called FAANGs (Facebook, Amazon, Netflix and Google), and you're

Revenge of the stock-pickers:

Active managers may be taking back the lead from passive

In some asset classes, passively managed strategies have been beating active managers with a surprising degree of consistency for years. In others, the indices have, at a minimum, doggedly held their own against active management.

			INDEX % RANK	
ASSET CLASS	INDEX	BATTING AVERAGE*	10 YEARS (AVG)	3Q20
Hard-to-beat				
Large-cap blend	S&P 500	0.860	41%	37%
High-yield bond	B/Barc Corp. HY Bond	0.814	39%	48%
Mid-cap blend	Russell Mid Cap	0.744	41%	28%
Large-cap growth	Russell 1000 Growth	0.698	42%	21%
Hold-their-own				
Real estate	DJ U.S. REIT	0.535	63%	**79%**
U.S. large value	Russell 1000 Value	0.535	47%	36%
Core U.S. bond	B/Barc U.S. Aggregate	0.442	52%	**85%**
Non-U.S. stock	MSCI EAFE	0.419	51%	**74%**

Source: Morningstar Direct

Numbers in bold signify asset classes where active managers outperformed the index.

But as recent market events stretch capital markets to extremes, those who spend time carefully selecting investments on their individual merits might be ready to enjoy a comeback. During 3Q20, passive indices suddenly became much less competitive in key areas like core bonds, non-US stocks and high-yield bonds. And that's one of the reasons we steadfastly maintain exposure to both styles.

*Represents the percentage of quarters the index has bested >50% of active managers approaching a full one-third of the fund's assets in a very small handful of stocks, a "decision" made entirely by an index committee or formula with little interest in, or talent for, separating the wheat from the chaff. That's a level of concentration that would make any old-school portfolio manager blush and in our view represents an under-appreciated risk of investing only in passive strategies. That risk — together with our long-held belief that there are talented investors capable of beating their benchmarks over the long haul — is also among the reasons we deliberately maintain exposure to both active and passive management styles within the Lifetime suite of target date funds.

But single-name concentration is only part of the story. With so much capital distributed among such a small number of assets, other capital market distortions are inevitable — especially when something as unpredictable as a global pandemic is creating massive economic uncertainty and fostering an "all-in or all-out" mentality among investors. Such herding behavior has almost certainly helped exacerbate some of the defining characteristics of markets in recent periods: namely, a strong preference for growth over value and avoidance of stocks that are merely large or mid-size in favor of mega-cap behemoths. Little wonder, then, that in at least a few cases, active managers staged something of a comeback during the third quarter.

Meanwhile, fears that the novel coronavirus isn't quite done ravaging the global economy have kept short-term interest rates pegged near zero, leaving longer-term bonds and corporate credit as some of the best-performing segments of the fixed-income market. These same fears about a resurgence of the virus have also caused investors to continue to place an even greater emphasis than usual on U.S. assets given the perception that our economy, for all its warts, remains perhaps the most flexible and durable on the planet (and is therefore in a better position to weather what might still lie ahead with COVID).

Performance of the Great-West Lifetime Funds

These trends, some of which have pressured returns within the Lifetime Funds for several quarters running, showed hopeful signs of reversing during the last few weeks of the third quarter. For example, valuation discipline seemed to return in fits and starts during late August and early September, with lower-priced, cyclically oriented stocks occasionally besting the return of the hyper-large, hyper-growth stocks that have dominated for so long. Smaller-cap stocks, too, have recently shown a little more moxie than in the recent past, actually outperforming large-caps by a small margin during September (a month during which equity markets as a whole retreated for the first time since they began bouncing off the market lows this spring).

Even more encouraging was strong manager selection across a wide range of underlying funds and asset classes. We saw benchmark- and peer-beating returns from individual holdings such as the Great-West Large- and Small-Cap Growth Funds, Great-West Emerging Markets Equity Fund, and Great-West Multi-Sector Bond Fund, among others. It's particularly gratifying that these successes came across such a wide cross-section of the market — something we believe illustrates our core competency: identifying and investing with talented managers across asset classes.

But these trends, even when taken together, were not enough to propel the Lifetime Funds, which finished the third quarter behind both their benchmarks and their peers. From a peer-relative perspective, the reasons for our underperformance reads like a list of usual suspects: We tend to carry slightly more exposure to value than some of our peers, which continued to act as a headwind despite a partial reversal of that long-established trend late in the period. Ditto for our emphasis on mid- and smaller-capitalization and international stocks, which also kept our returns more muted than some of our peers'.

Among the individual holdings that worked against us were a set of passively managed index funds in areas such as international equities, mid-cap stocks, core bonds and real estate. This is consistent with the discussion above regarding active and passive management styles, since in at least some of these cases, the indices against which these funds are managed suddenly became a little less competitive than they have been in the past. Perhaps the most obvious example is the Great-West Bond Index Fund. Like other index funds in the category, the fund maintains a larger allocation to U.S. Treasury bonds and other relatively low-risk securities than its actively managed peers. This allowed the fund to score toward the top of its peer group during the height of the pandemic-related volatility earlier this year, but it has since become a liability as capital markets have rebounded, causing the fund to fall toward the bottom of its own peer category. While the details of each case are slightly different, other passively managed funds in the Lifetime lineup suffered a similar fate, including the Great-West International Index Fund, the Great-West Real Estate Index Fund and the Great-West S&P Mid Cap 400 Index Fund — all of which scored in the bottom quartile of their respective peer groups during the third quarter.

Rather than an indictment of these individual funds — each of which performed exactly in line with our expectations for index-tracking returns — the relative underperformance of the passively managed strategies in the Lifetime suite serves as a reminder of why we maintain exposure to both active and passive strategies within the lineup. It has also left room for some of the actively managed funds in the roster to shine.

In fact, a handful of other examples from third-quarter returns illustrated the trade-off between actively and passively managed performance just as well as the four funds mentioned above. These funds failed to keep pace with their respective benchmarks but nonetheless comfortably bested a majority of their peers. Examples include the Great-West Ariel Mid Cap Value Fund and the Great-West Mid Cap Value Fund, both of which underperformed the Russell Mid Cap Value Index but ranked near the top of the mid-cap value peer group. The same can be said for the Great West High Yield Bond Fund, which beat more than 80% of its competitors during the quarter despite falling short of its own benchmark. That juxtaposition between benchmark- and peer-relative returns put each of the above-mentioned holdings in the curious position of contributing in a positive way to the Lifetime Funds' manager selection and peer-relative performance but negatively to the Lifetime Funds' index-relative results.

Meanwhile, other reasons for the Lifetime Funds' shortfalls relative to their own benchmarks included a lack of dedicated exposure to long-term bonds and commodities — two asset classes that are explicitly represented in the Morningstar Lifetime Indices' asset allocations against which the Lifetime Funds are measured, but are represented in the funds only as ancillary exposures inherited from underlying managers in other areas of the portfolio.

With regard to the lack of long-term bond exposure, as mentioned above, uncertainty related to the pandemic and the global recession it spawned has kept short-term rates pegged near zero for months as a result of the aggressive response by monetary authorities worldwide. The initial performance bump that naturally accrued for short-term bonds has since run its course, allowing long-term bonds to outperform short-term bonds significantly during the second and third quarters of 2020 and creating an advantage for our benchmarks that the funds don't necessarily enjoy. The same is true for commodities, which benefited from COVID-related uncertainty primarily via a strong rally in precious and industrial metals as well as the tailwind provided by rebounding agricultural prices amid an improving outlook for trade and inflation. We understand why some asset allocators are drawn to the asset class, but we have thoughtfully and deliberately avoided making a dedicated allocation to commodities and do not intend to do so in the future.

Outlook

While the recent underperformance of the Lifetime Funds is perhaps more understandable in the context of the environment discussed above, it goes without saying that we are disappointed with our results over this and other recent periods. That said, we are confident that our reasoning is sound with respect to the various biases and exposures we maintain within our asset allocation framework. Moreover, we are proud of the Lifetime Funds' strong long-term track records and offer them as an endorsement of our approach. We are also encouraged by recent developments in the capital markets, some of which suggest a reversal of some of our most intense headwinds may finally be on the horizon.

But rather than try to predict what might lie ahead in this unusually uncertain environment — buffeted as it is by a global pandemic, an extremely contentious U.S. election, and growing civil unrest here and abroad, we instead choose to stick to what we know — identifying world-class investment managers and allocating assets among them in a thoughtful and deliberate way. It is our belief that this is — and will remain — the best way to invest your retirement assets for the long term.

Morningstar ratings and rankings as of September 30, 2020

Rating based on risk-adjusted returns and ranking based on total return

FUND NAME	TICKER	INCEPTION	CATEGORY	RATING/ TOTAL # OF FUNDS OVERALL	RATING/ TOTAL # OF FUNDS 3-YEAR	RATING/ TOTAL # OF FUNDS 5-YEAR	RANK[1]/ # OF FUNDS 1-YEAR
Great-West Lifetime 2015 Instl	MXNYX	5/1/15	U.S. Fund Target-Date 2015	★★★ 120	★★ 93	★★★ 68	(81/120)
Great-West Lifetime 2020 Instl	MXAKX	4/28/16	U.S. Fund Target-Date 2020	★★★ 200	★★★ 171	N/A	(109/200)
Great-West Lifetime 2025 Instl	MXQBX	5/1/15	U.S. Fund Target-Date 2025	★★★ 218	★★★ 186	★★★ 146	(145/218)
Great-West Lifetime 2030 Instl	MXAYX	4/28/16	U.S. Fund Target-Date 2030	★★ 228	★★ 194	N/A	(161/228)
Great-West Lifetime 2035 Instl	MXTBX	5/1/15	U.S. Fund Target-Date 2035	★★★ 211	★★ 183	★★★ 143	(157/211)
Great-West Lifetime 2040 Instl	MXBGX	4/28/16	U.S. Fund Target-Date 2040	★★ 222	★★ 194	N/A	(163/222)
Great-West Lifetime 2045 Instl	MXWEX	5/1/15	U.S. Fund Target-Date 2045	★★★ 211	★★ 183	★★★ 143	(165/211)
Great-West Lifetime 2050 Instl	MXBSX	4/28/16	U.S. Fund Target-Date 2050	★★ 222	★★ 194	N/A	(174/222)
Great-West Lifetime 2055 Instl	MXZHX	5/1/15	U.S. Fund Target-Date 2055	★★ 211	★★ 183	★★ 140	(174/211)
Great-West Lifetime 2060 Instl	MXGUX	5/1/19	U.S. Fund Target-Date 2060+	N/A	N/A	N/A	N/A

Fund performance as of September 30, 2020

FUND NAME	TICKER	INCEPTION	NET EXPENSE RATIO (%)[2]	GROSS EXPENSE RATIO (%)	1-YEAR RETURN (%)	3-YEAR RETURN (%)	5-YEAR RETURN (%)	SINCE-INCEPTION RETURN (%)
Great-West Lifetime 2015 Instl	MXNYX	5/1/15	0.45	0.49	7.07	5.56	7.04	5.41
Great-West Lifetime 2020 Instl	MXAKX	4/28/16	0.48	0.51	7.00	5.62	N/A	7.13
Great-West Lifetime 2025 Instl	MXQBX	5/1/15	0.50	0.52	7.33	5.89	8.03	5.97
Great-West Lifetime 2030 Instl	MXAYX	4/28/16	0.52	0.54	7.03	5.92	N/A	8.23
Great-West Lifetime 2035 Instl	MXTBX	5/1/15	0.55	0.56	7.05	6.00	9.10	6.57
Great-West Lifetime 2040 Instl	MXBGX	4/28/16	0.56	0.57	6.42	5.80	N/A	8.85
Great-West Lifetime 2045 Instl	MXWEX	5/1/15	0.57	0.58	6.38	5.68	9.30	6.63
Great-West Lifetime 2050 Instl	MXBSX	4/28/16	0.57	0.58	6.04	5.50	N/A	8.89
Great-West Lifetime 2055 Instl	MXZHX	5/1/15	0.57	0.58	5.95	5.37	9.17	6.41
Great-West Lifetime 2060 Instl	MXGUX	5/1/19	0.59	0.60	5.95	N/A	N/A	4.85

The date in the name of the target date fund is the assumed date of retirement. The asset allocation becomes more conservative as the fund nears the target retirement date; however, the principal value of the fund is never guaranteed.

1 A lower percentile ranking is more favorable (higher relative returns).

2 The net expense ratio reflects contractual fee waivers or reimbursements that expire on April 30, 2021. Absent waivers or reimbursements, the performance would have been lower.

Performance for institutional class shares before their inception is derived from the historical performance of initial class shares, which has not been adjusted for the lower expenses; had it, returns would have been higher.

Current performance may be lower or higher than performance data shown. Performance data quoted represents past performance and is not a guarantee or prediction of future results. For performance data current to the most recent month-end, please visit greatwestfunds.com. The investment return and principal value of an investment will fluctuate so that, when redeemed, shares/units may be worth more or less than their original cost.

Please consider the investment objectives, risks, fees and expenses carefully before investing. For this and other important information, you may obtain mutual fund prospectuses from your registered representative or by visiting greatwestfunds.com. Read them carefully before investing.

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Morningstar Percentile Rankings are based on the fund's actual rank within its category, total return and the number of funds in that category. The returns assume reinvestment of dividends and/or capital gains, do not include any applicable sales charges or redemption fees, but include 12b-1 fees. Rankings for each share class will vary due to different expenses. The highest (or most favorable) percentile rank is 1, and the lowest (or least favorable) percentile rank is 100. Had sales charges or redemption fees been included, total returns would be lower.

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