Great-West Profile Funds

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Pity the stock picker?

Imagine the plight of the large-cap growth portfolio manager trying to beat 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 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 emphasize active management within the Profile series 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

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.

ASSET CLASS	INDEX	BATTING AVERAGE*	INDEX % RANK 10 YEARS (AVG)	INDEX % RANK 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 of markets in the last several years: 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. These trends continued to define U.S. markets 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 Profile Funds

These trends, some of which have pressured returns within the Profile series 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, only partially benefited the Great-West Profile Funds, which finished the third quarter with mixed results. All five funds finished toward the middle of their respective Morningstar peer groups, but the three most aggressive Profile Funds fell short of their benchmarks.

At least some of this shortfall was driven by the way our benchmark indices are constructed. Specifically, each fund's entire U.S. equity allocation is benchmarked to the broad-based Wilshire 5000 Index, which performed exceptionally well during the third quarter. By contrast, we divide our U.S. equity allocation into six separate, more nuanced exposures, choosing what we believe to be best-in-class asset managers in asset classes such as large-cap growth, mid-cap value and so on. Of the six U.S. equity asset classes represented in our allocation framework, only two — large-cap growth and small-cap growth — were able to outperform the Wilshire 5000 during the third quarter, owing at least in part to the index's relatively high correlation to large-cap stocks. That, together with continued large-cap dominance over other U.S. equity styles during the third quarter, placed the U.S. equity investments that fall outside the large-cap blend universe at a relative disadvantage compared to the Profile Funds' equity benchmarks.

Of course, this dynamic had a more profound impact on the funds within the Profile series that hold a proportionally large share of their assets in equities, namely the moderate, moderately aggressive and aggressive Profile Funds. But on the fixed-income side of the ledger, things worked a little differently. As with our equity exposure, the Profile Funds' fixed-income exposure is benchmarked against a single index — one designed to capture a broad segment of the U.S. bond market (in this case, the Bloomberg Barclays U.S. Aggregate Bond Index). Meanwhile, the funds themselves follow a more granular allocation strategy by allocating fund assets across various sub-asset classes within the fixed-income universe — not unlike the nuanced way we spread our U.S. equity exposure across multiple sub-asset classes.

But rather than acting as a liability to performance, this fact actually worked to our advantage with regard to our fixed-income investments during the third quarter. The reason is simple. Because the Bloomberg Barclays U.S. Aggregate Bond Index is heavily weighted toward U.S. Treasury and other high-quality bonds, it tends to perform best during periods of market stress, when uncertainty is highest. By contrast, when markets are in "recovery mode," other sub-asset classes within the fixed-income universe tend to perform better. Investing in areas like global bonds, high-yield credit and other so-called "plus sectors," the Profile Funds tended to have an advantage over their benchmarks, which have more modest exposures to these areas of the fixed-income market.

This trade-off between the broadly allocated Profile Funds on one hand and their narrowly defined benchmarks on the other probably helps explain why the more conservative Profile Funds were able to outperform their benchmarks during the third quarter while the more aggressive funds underperformed. But beyond the mechanics of index construction, a few other performance trends were noteworthy as well. For example, the Great West High Yield Bond Fund performed exceptionally well compared to its peers, beating more than 80% of its competitors. The fund's recently added ability to invest in convertible bonds has added an element of equity-like exposure to the fund's return profile, a clear benefit in an equity-centric market environment like today's. In any case, the fund's strong relative performance, together with the tailwind created by the outperformance of high-yield bonds in general, made the Great West High Yield Bond Fund one of the strongest contributors to results within the Profile series.

On the negative side, our investment in the Great-West Loomis Sayles Small Cap Value Fund struggled against both a stylistic headwind and difficult relative performance. Small-caps and value stocks have been among those most challenged in the current growth-at-any-price era, presenting the fund with macro-related challenges that have recently shown signs of abating. But the fund has also struggled recently with a sizable underweight to names in healthcare, which has ranked among the best sectors in the small-cap value universe in recent periods. We are actively engaged with the fund's managers and have maintained confidence in their approach in spite of the recent setback.

Outlook

Although performance has remained within acceptable parameters for the Great-West Profile Funds, we are constantly looking for ways to improve results. We meet constantly with the managers of the underlying funds in our portfolios with an eye toward understanding exactly how they invest on our behalf and yours. We also continue to conduct research into how your assets are allocated across the various asset classes and sub-asset classes to ensure the broadest possible diversification and the widest possible opportunity set available while taking steps to ensure that the funds are constructed and rebalanced in a way that optimizes our chances for success.

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	3-YEAR	5-YEAR	RANK[1]/ # OF FUNDS 1-YEAR
Great-West Aggressive Profile Instl	MXGTX	5/1/15	U.S. Fund Target-Date 2015	★★★ 169	★★★ 154	★★★ 138	(139/169)
Great-West Moderately Agg Profile Instl	MXHRX	5/1/15	U.S. Fund Target-Date 2020	★★★ 325	★★★ 310	★★★ 279	(211/325)
Great-West Moderate Profile Instl	MXITX	5/1/15	U.S. Fund Target-Date 2025	★★★ 676	★★★ 638	★★★ 581	(458/676)
Great-West Moderately Cnsrv Profile Instl	MXJUX	5/1/15	U.S. Fund Target-Date 2030	★★★ 547	★★★ 514	★★★ 450	(293/547)

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 Aggressive Profile Instl	MXGTX	5/1/15	0.79	0.79	3.22	4.66	8.95	6.53
Great-West Moderately Agg Profile Instl	MXHRX	5/1/15	0.66	0.69	4.72	4.83	7.76	5.82
Great-West Moderate Profile Instl	MXITX	5/1/15	0.57	0.63	5.31	4.83	7.16	5.44
Great-West Moderately Cnsrv Profile Instl	MXJUX	5/1/15	0.48	0.56	4.99	4.44	6.20	4.77

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.

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.

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.

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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.

A benchmark index is not actively managed, does not have a defined investment objective, and does not incur fees or expenses. You cannot invest directly in a benchmark index.

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