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Research sorts index huggers from active

Claims of alpha-driven investment may not be supported, with research suggesting that managers stick more closely to the index than investors realise.

Yale Management School researchers Martijn Cremers and Antti Petajisto have suggested that “closet indexing” characterises nearly one third of the US mutual fund industry. Genuine stock-pickers account for less than 30 per cent of the market.

The two academics have devised a new approach to identifying the degree of alpha held by a fund. The ‘active share’ measure seeks to identify a fund’s degree of overlap with the benchmark. An active share of 100 per cent would mean zero overlap with the index.

By assessing a fund’s active share and tracking error, it is possible to map out different groups of investors. Funds with high active share and low tracking error are diversified stockpickers, whereas those with low active share and low tracking errors are closet indexers.

In their research, Mr Cremers and Mr Petajisto demonstrate that closet indexing has become an increasingly serious problem over the last 10 years, rising from 10 per cent of the total mutual fund market to over 30 per cent. Stock-picking has declined from 60 per cent in the 1980s to less than 30 per cent today.

James Montier, global asset allocation analyst at Dresdner Kleinwort, said: “Stock-picking has declined massively over the last 20 years.” He added: “Given the disastrous nature of the returns achieved by sector bet fund managers on average, it is no wonder that so many funds underperform the index.” In the US, Mr Montier said, of every $100 invested in actively managed funds, $68 goes to funds with negative net alpha.

Justin Modray, investment adviser for London IFA Bestinvest, said he was unsurprised by these figures, and suspected this was mirrored in the UK.

He said: “Sticking to the index is the safe option. Only 30 to 40 per cent of actively managed funds in the UK beat the index. In most cases, this will be because they are tracking the index, but the annual management charge is detracting from performance. In other cases, managers might be taking on risk but getting it wrong."

IFAs reluctant to engage in the detailed statistical analysis conducted by the two Yale economists have other options when it comes to assessing a fund's alpha, Mr Modray said. "The most obvious indicator is a fund's level of correlation to the FTSE indices, but you can also look at the fund's allocation to different market caps. Any funds that diverge significantly from the FTSE All-Share's distribution is likely to be a stock-picker."

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