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Alpha superheroes

If fund managers are the superheroes of the investment universe then adding alpha is their special power. They live and die by the sword of alpha, with reputations staked on the ability to add value to a fund through skilled stock selection. It is this active management, which is supposed to justify the large salaries and the managers' place at the top of the food chain.

However, a recent academic paper by two professors from Yale university in the US, Martijin Cremers and Antti Petajisto, calls into question just how active the majority of managers are. They outline a significant new method that can easily be applied to funds combining the traditional use of tracking error with the new twist of "active share". This demonstrates just how far a manager is diverging from the index in terms of the specific stocks he is selecting and the themes he is implementing within the fund.

Their analysis shows that a significant proportion of managers who claim to be active are, in fact, clinging tightly to their benchmark. They are not demonstrating the courage to choose stocks off of the beaten track and are jeopardising returns as a result. For a long time many commentators have suspected this of being the case and now, armed with active share technique, these managers can finally be exposed.

Mr Cremers and Mr Petajisto have created a formula for looking at the profile of managers and designating an investment style, gauged in terms of how active they are.

They explained: "To quantify active portfolio management, we introduce a new measure we label active share. It describes the share of portfolio holdings that differ from the portfolio's benchmark index. We show that to determine the type of active management for a portfolio, we need to measure it in two dimensions using both active share and tracking error."

The activity of the manager is determined through looking at the level of deviation from a benchmark. This is significant because it has a direct correlation with performance. The research paper continued: "The funds with the highest active share significantly outperform their benchmark indices both before and after expenses, while the non-index funds with the lowest active share underperform. The most active stock-pickers tend to create value for investors while factor bets and closet indexing tend to destroy value."

Mr Cremers and Mr Petajisto use the information generated from this calculation, combined with tracking error, to profile different classes of managers, and in so doing have discovered a high percentage of "closet indexers" - those claiming to be adding alpha through active management while in reality having very low active share and adding very little innovation to the funds.

Hard to distinguish

So what makes this method superior to a straight alpha or information ratio approach? Mr Petajisto explained: "The problem with alphas and information ratios is that it is very hard to distinguish between luck and skill when we look at a manager's past performance, so it is hard to use them when predicting future performance. In contrast, active share is easy to compute for any fund at any point in time, given the mandatory filings to the Securities and Exchange Commission."

Although the report is US-focused and, indeed, US-based, this does not detract from its significance for the UK market and beyond. Its authors have no plans to extend their findings to the UK, but they claim the same concept can easily be transferred to other markets as it simply involves analysing data on the fund holdings and benchmark index holdings. As such, it is already acknowledged by practitioners in the US and in Europe as a significant study with far-reaching implications.

Investment bank Dresdner Kleinwort, for example, has used the findings of the paper as a battle cry to the closet indexers pretending to be active managers, demanding that they "come out" of the closet. James Montier, a research analyst in global equity strategy for Dresdner Kleinwort, claimed that the market is "full of passive funds masquerading as active funds" with the implication being that these findings will help to expose them. Certainly if this formula was applied it would leave the passive "active" managers with no place to hide.

The Dresdner Kleinwort report concluded that the findings were also useful in as much as they provide an extra tool for investors and advisers when choosing which fund to plump for. An active manager, as opposed to a closet indexer, the paper claims, will more often than not remain active in the future and is more likely to continue adding value to the fund. "Mr Cremers and Mr Petajisto provide us with a new measure which seems to make intuitive sense, and also predictive power," Mr Montier said. "Paying for active management is fine, but make sure that is what you are actually getting."

This last point is crucial because it allows investors to form a more accurate idea of the investment style of the manager. It also is very useful for intermediaries as it allows them to provide a better service to clients by painting a picture of each fund in finer details rather than with the broad brush strokes used at the moment.

Poor advice

With IFAs frequently slated for the poor advice they give on specific funds, active share could help by providing information of the exact composition of the fund and a guide to future performance. As fund consultant John Cuthbert said: "Advisers consistently fail to identify the most meaningful characteristics of funds. Time and time again they simply do not understand risk, the investment process or the style of the funds.

"As a result of this they have little capacity to make sense of fund performance indications. The way they approach composition and risk is disgraceful and incompetent. They are giving poor advice to clients."

This criticism is levelled on the basis that the majority of managers analyse funds by looking at the accompanying fact sheets. While this provides a concise oversight of the general performance of the fund to date, a brief comment by the manager on the mandate of the fund and a broad indication of asset allocation it fails to be truly enlightening. When trying to drill down to look in more depth at the construction of the fund, the most that is touched upon is the top 10 holdings rather than analysis of the fund as a whole. Active share offers a straightforward method to dig deep and see what a manager is really doing with a fund.

The downside with the active share method is that it is data intensive and in order to present useable and comparable information on all funds there would need to be a body willing to collate the information, such as fund analysts Morningstar or Standard & Poor's.

What Messieurs Cremers and Petajisto have succeeded to do already though is to turn up the heat on managers and encourage the industry to question performance on a new level.

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