FT REPORT - FT FUND MANAGEMENT: A nugget to please active managers

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No self-respecting fund management group, I trust, neglects to have at least one researcher plough through published academic papers looking for evidence that supports the case for active management. In a field where the concept finds little intellectual support, the rare positive finding, even if improbable or counter-intuitive, is worth its weight in marketing gold.

And these nuggets do exist. To be sure, few academic researchers will buy into the notion that fund managers add value over time. Most would agree with the old adage: "Never has so much been paid to so many for doing so little". Warren Buffett makes the same point even more concisely: "There is precious little value added in fund management".

But even for those of us who subscribe to the implicit superiority of passive management as the most suitable investment solution for the majority of investors, there is something naggingly worrisome about the lack of legitimate evidence in favour of active management. It seems to defy common sense that something so allegedly useless should continue to support one of the most profitable businesses in the world.

One problem is surely that most academic studies into the performance of fund managers are misconceived. There is no easier way to earn a credit as a diligent PhD student than to take a huge mass of aggregate industry data, run it through a computer and post the resulting correlations and t-statistics to some dusty social sciences journal. It is truth of a sort, but not of a sort that has any value.

Better specified tests are a must. Aggregate data about the fund business, however scrupulously analysed, can never tell you much. The data issues alone - fund manager movements, survivorship bias, ownership changes - are legion. More importantly, everybody who works in the business knows that at least 50 per cent of the funds in any given universe are not worth wasting the time of day on.

What really interests the pragmatic investor is what, if anything, defines that tiny minority of funds that does produce consistent market-beating returns, even after allowing for risk, style effects (which appear to be dominant factors in explaining many short-run examples of fund manager "skill") and so on. Few academics attempt to ask questions of the data that have a realistic chance of producing an answer that intelligent, practising investors are likely to find of value.

One new paper that does seek to take a more pragmatic approach is by Martin Crejmers and Antti Petajisto, two academics at Yale. Their paper, *How Active is Your Fund Manager?*, updated this month, takes a distinctive approach to analysing the achievements of actively managed funds. They conclude, contra-conventionally, that fund managers who run the most active portfolios are also those that add the most value.

Where their methodology differs from many earlier attempts to analyse fund management performance is that they don't use tracking error as the primary definition of active management. Instead of looking at how far returns of funds diverge from a benchmark, which they find has no discernible relationship with performance, they look instead at how far the holdings of active fund managers differ from the index they are tracking.

Their argument is that the net long-short holdings of a fund relative to its benchmark, what they call its "active share", is a more genuine proxy for active management than tracking error alone can ever be. Closet index funds, for example, by definition will have a small active share (the analysis in the paper confirms incidentally that the number of closet indexing funds has increased sharply since 1990). Fund managers who are allowed to exercise genuinely unconstrained judgments will have a large active share.

The results of comparing a fund's "active share" with its subsequent returns, they find, are both encouraging for active fund managers and intuitively appealing to the impartial observer. Their data show

that funds with the highest score on this measure outperformed the S&P 500 index by more than 2 per cent a year before expenses, and by a respectable 1.0-1.5 per cent after costs. In contrast funds with the lowest "active share" underperformed by between 1.4 per cent and 1.7 per cent a year after expenses. The best results from active management came from smaller funds, another intuitively appealing result.

Just as intriguingly, the results of the study suggest that the primary rewards in active management go to stock pickers rather than those attempting to exploit style and other market factors. "Funds focusing on factor bets seem to have zero to negative skill" the two academics comment, "which leads to particularly bad performance after fees". Closet indexers, they also find, "unsurprisingly exhibit zero skill, but underperform because of their expenses".

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