FT REPORT - FT FUND MANAGEMENT: A lesson in pursuing alpha and beta

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Fund management has some new orthodoxies. First, active managers underperform. Thanks to the costs they incur, the average active manager will fail to beat their benchmark. Second, "closet indexing" is a bad idea. This became all the rage in the 1990s, even though retail investors took a while to realise it. With so much attention turned to the big benchmark indices such as the S&P 500, and with the growth of indexing in the 1990s, many funds turned to "closet indexing" - hugging the index, but churning stocks a little to justify the higher management fees. Third, "beta" - exposure to the market - and "alpha" - the attempt to generate uncorrelated returns - should be kept separate. Fascinating new research manages to undermine the first contention, while strongly supporting the other two. It also gives some kind of a shot in the arm to a beleaguered group, active long-only equity fund managers. A group of researchers led by Martijn Cremers and Antti Petajisto of Yale School of Management's International Center for Finance, have come up with a new measure for a fund manager's activeness: "active share". This measures the proportion of a fund's portfolio that differs from the index. For example, if a manager started by investing $100m in the 500 stocks of the S&P 500, in the correct proportion, the fund would have a notional active share of zero. If the manager sells half the stocks and puts the $50m generated into stocks that look better, the active share moves to 50 per cent (a 50 per cent overlap with the index). If it has $10m in 50 stocks from the S&P and invests all the rest differently, the active share rises to 90 per cent. This looks at funds from the inside and produces significantly different results from tracking error, the standard measure of activeness, which instead measures how a fund's returns differ from the index.

As an example, a diversified stock-picker who picked one favourite stock from each main sector might have a low tracking error but a high active share. Tactical asset allocators, who make big market timing bets by underweighting one sector and overweighting another, might have a high tracking error but a lower active share. So if tracking error measures the degree of active asset allocation, active share is the best measure of active stock selection. Examining a sample of 2,650 funds from 1980 to 2003, they found that closet indexers (with low active share and tracking error), performed worst. They also found the number of closet indexers was minimal until the early 1990s, when it began to increase sharply. Funds in the highest quintile for active share performed best, by a statistically significant margin, and managed to beat their benchmarks after expenses. Small funds tended to be more active, which accords with intuition. Once funds grew much beyond $2bn, active share reduced considerably. The active share of each marginal dollar put into a fund reduces with the size of the fund. Most intriguingly, high active share is repeated from year to year, and strong performance of highly active funds is persistent over time. If a fund has a high active share and it performs well this year, that is a statistically robust reason to expect it to perform well again next year. Past investment returns are an indicator of the future. Dividing funds by tracking error does not deliver such results, suggesting that the value fund managers deliver for their clients resides in superior stock selection, rather than in market timing (a finding that also casts an interesting light on the current vogue for investors to do their own market timing with exchange-traded funds).

Does this research herald a return to favour for traditional mutual funds, which hold about 100 stocks and involve elements of both stock-picking and asset allocation? Probably not, although truly successful practitioners in this mould who can show they have been truly "active" may stay in favour. The lesson is rather that it is worth paying for the expertise of a manager who makes a few stock-picking bets, providing they have proven their past skills, and providing their fund does not get so big that, like Fidelity Magellan a decade ago, it becomes impossible to find enough good bets. It is better to view this research as reinforcing the notion that alpha and beta are better kept separate. For the former, pay what it takes to get the most talented managers. For the second, get the cheapest you can.

How Active is Your Fund Manager? A New Measure that Predicts Performance, Martijn Cremers and Antti Petajisto. http://ssrn.com/bstract=891719