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Genuine active managers can add value

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Published: January 10 2010 09:02 | Last updated: January 10 2010 09:02

Within the investment management industry there is the eternal question – does **active management add value**? To better inform the debate, I have reviewed the latest academic research in this area from both sides of the Atlantic and come to some interesting conclusions: passive is rational, closet indexing is not and unconstrained active may just be where the skill is.

The investment market rings with the Financial Services Authority's risk warning that past performance is not a guide to the future. Despite this there is a strong perception that in making decisions to hire and fire investment managers many pension schemes are strongly influenced by past performance – good or bad, and that this can lead to manager changes that add little to performance and in fact can be outright detrimental.

Research on decisions by more than 2,000 UK pension schemes over a 20-year period by **Blake, Timmermann, Tonks and Wermers** in 2009 suggests managers were typically fired having significantly underperformed a UK equity benchmark, managers were appointed having recently outperformed the benchmark and that both the fired and hired investment managers produced returns broadly in line with the benchmark index after the change – that is they both performed in line with an index tracker.

A study by **Goyal and Wahal** in 2008 looked into similar hiring and firing decisions by US plan sponsors. It showed US equity managers were typically fired for poor performance and hired after significant outperformance. As in the UK, the outperforming manager, once appointed, typically produced returns broadly in line with the index. The fired manager proceeded to outperform the benchmark in the period after their removal.

This leaves us to conclude that pension schemes have failed to consistently add value when changing investment managers. But can active equity managers add value for pension schemes in the first place?

Research into more than 700 pooled funds available to UK pension schemes over a 25-year period by Clare, Cuthbertson and Nitzsche in 2009 found there was little evidence the managers studied could outperform their benchmark index. They also studied "performance persistence", – whether a manager outperforming in one period tended to outperform in the following period – again they found little evidence of persistence.

A further piece of research comes from the US by Busse, Goyal and Wahal, in 2008 where more than 4,000 US institutional equity funds were analysed over a 16-year period. They found no evidence of manager outperformance on average and also no evidence of performance persistence.

Therefore it seems rational for many UK pension schemes to select a passive manager, as the average equity manager has not exhibited skill and schemes have struggled to identify outperforming managers, despite being strongly influenced by past performance.

However, the academics seemed to bemoan the lack of depth in the data they had available, as they were working off little more than quarterly investment performance data. To dig deeper, we have to look to retail investment funds and in the US, in particular, where these funds must disclose full portfolio holdings on a quarterly basis.

Research into US equity retail funds by **Cremers and Petajisto** in 2009 used data on more than 2,500 funds over a 24-year period. They analysed the concept of "active share", which is the proportion of a manager's portfolio that does not overlap with the benchmark index. They define a closet indexer as a manager with an active share of less than 60 per cent. They found that managers with a high active share, the concentrated stock pickers, significantly outperformed the closet indexers. They also investigated past performance alongside a manager's active share, and found outperforming managers with a high active share showed strong performance persistence.

So have we found the Holy Grail – pick top performing managers with a high active share? As ever, there are lies, damn lies and statistics and one piece of research is not an irrefutable proof. However, for investors committed to active management, the message is clear that closet indexers should be avoided and the focus should be on genuine active managers.

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