

“Closet Index Funds are Doomed to Underperform”



Antti Petajisto

Professor ANTTI PETAJISTO might be a real dread to some fund managers. His “Active Share” measure unmask whether a mutual fund is active or passive, regardless of what the manager claims.

Could you please briefly describe Active Share?

“It tells you what fraction of your portfolio holdings differ from the benchmark index. For example, if your benchmark index has 5 stocks each with 20% weight, and your

portfolio has the same 5 stocks with weights 30%, 10%, 20%, 20%, and 20%, then your Active Share is 10% – relative to the index, you shifted 10% of portfolio weight from stock 2 to stock 1.”

In the Nordic countries, tracking error is probably most commonly used in this context. What does Active Share explain that tracking error doesn’t?

“Tracking error is high if a fund’s active positions have exposure to systematic risk, e.g., if the fund is overweight many stocks in the same industry and all these stocks tend to move together. In contrast, Active Share is high whenever your holdings deviate significantly from the index, regardless of whether those active positions are exposed to systematic risk. Consequently, Active Share is a much better measure of stock picking, whereas tracking error is a better measure of the systematic risk (such as sector bets) you are taking relative to the index.”

What are the key conclusions you have been able to draw from your research?

“Based on prior research, we already knew that a low-cost index fund beats the average actively managed fund after fees and expenses. But my research distinguishes between active managers based on how active they really are. What I find is that the most active managers, specifically the ones who are most active stock pickers, actually beat their benchmarks even net of fees and expenses. So an investor should choose between a cheap index fund and a truly active fund, but not pick anything in the middle, because those funds in the middle just charge relatively high fees for little active management.”

Was this also true during the recent financial crisis and/or are there any situations when Active Share is less useful?

“The most active stock pickers beat their benchmarks also during the financial crisis, from 1/2008 to 12/2009. When we measure active management, there is always the conceptual difficulty of comparing across very different investment universes. For example, if one fund is investing in Finnish stocks and another one is investing in global stocks, and they are benchmarked against the OMX Helsinki 25 and the MSCI World index, the latter fund will basically always look more active relative to its benchmark index simply because it is choosing from a dramatically larger investment universe. But this is a more general problem for any measure of active management, not just Active Share: what would be a fair comparison between funds with such different investment objectives? I don’t think anyone has a good answer for that. I largely sidestep this issue by focusing only on U.S. domestic equity funds, but it’s still an open question. However, Active Share has the virtue of being very simple and transparent, so even in this types of comparisons it may still be more informative than some of the other measures out there.”

Your study is based in the U.S. Do you think you would have got the same results if you were to apply this to other regions?

“I would expect similar results for closet index funds everywhere because they are doomed to underperform: they give you index-like returns but charge high fees for it. As for how well the most active managers perform, that is an empirical question which de-

pends, among other things, on how efficient the stock market is in that region. I have heard evidence from fund managers who have conducted their own studies on Active Share in Europe, and their findings have been similar to what we found in the U.S. market.”

Finally, how can a practitioner use Active Share?

“Well, I could go into great details here and some of it is explained in my research papers, but the short answer is 1) for fund selection, to distinguish potentially outperforming truly active managers from expensive closet indexers, and 2) to understand better how much and what type of active management a manager is engaged in and the risks that you as an investor are exposed to.” ●

ABOUT ANTTI PETAJISTO

Antti Petajisto joined New York University Stern School of Business as a Visiting Assistant Professor of Finance in July 2009. Prior to joining NYU Stern, he was an Assistant Professor of Finance at the Yale School of Management. Professor Petajisto’s research focuses on the interaction of asset pricing and financial institutions. He has studied active and passive portfolio management of mutual funds, performance evaluation of money managers, pricing inefficiencies in exchange-traded funds, the price impact of passive indexing strategies and equilibrium pricing implications of financial intermediaries, from both empirical and theoretical perspectives. His “Active Share” measure for mutual funds has been adopted by a number of practitioners. His research has been published in top academic journals and has also been repeatedly cited in the popular press.