From Yale University: New Research Confirms the Value of Active Management

by Elaine Floyd, CFP®

Advisors who have been in the business 20 years or more remember that nearly all mutual funds used to be actively managed. Professional management was one of the hallmarks of mutual fund investing and investors were happy to pay people who were smarter than they were to manage their money.

Then a raft of studies appeared showing that mutual funds, on average, did no better than the indexes. In fact, once you subtracted out expenses, mutual funds did worse. Why pay a manager, the studies suggested, when you could do better with an index fund? Thus began the movement toward passive investing as evidenced by the explosive inflows into index funds and ETFs and even a growing trend among active mutual fund managers -- consciously or not -- to hug the indexes.

The problem with most of those studies, contend two researchers at Yale University, is that they treat all actively managed funds as one homogeneous group. They do not examine the type or degree of active management in an attempt to separate out the factors that might be responsible for above-average performance. This observation led Martijn Cremers and Antti Petajisto from the International Center for Finance, Yale School of Management, to investigate what they call "active share," a measure that describes the percentage of portfolio holdings that differs from the portfolio's benchmark index.

Active share is expressed as a percentage -- from 0 to 100% -- that corresponds to the portion of the portfolio that is not like the benchmark. An index fund would have an active share of 0, while a concentrated fund of just a few dozen stocks, none of which are contained in the fund's benchmark index, would have an active share of 100%. To calculate active share for funds that hold some of the benchmark stocks, the portion of the portfolio that does not match the index (taking into account weightings as well as individual stocks) is divided by the total. For example, a fund that is benchmarked to the S&P 500 but holds only 50 of the S&P 500 stocks (weighted identically to their weightings in the index) -- meaning 450 are excluded -- would have an active share of 90% (450 ÷ 500 = .90). Unfortunately, there is no commercial source for obtaining active share for funds, so advisors will need to do this calculation on their own.

Of the 2,028 funds examined by the researchers, in 2003 (the latest year for which figures were available) 53.2% had an active share of 80-100%, 26.7% had an active share of 60-80%, 13.3% had an active share of 40-60%, 2.8% had an active share of 20-40%, and 4.1% had an active share of 0-20%. It is interesting to note that in 1980, nearly 80% of funds were in the top quintile (80-100%) for active share, further proof that more managers have become index huggers over the ensuing 23 years.

Active share is used in conjunction with tracking error to identify actively managed funds. Tracking error, which measures how far a fund's return deviates from its benchmark, suggests that there is some form of active management going on, but it does not tell

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what kind or how much. In fact, of two different methods for producing alpha, stock selection and sector rotation or market timing (what the researchers call "factor bets"), stock selection causes less tracking error even when the portfolio bears no resemblance to the benchmark index and where performance is entirely due to manager activity.

This is why it is important to look under the hood to see exactly how much influence the manager is having on a fund's results. If it's not very much -- as in the case of closet indexers -- there's no point in paying management fees. But if a fund is actively working to improve shareholder returns, as evidenced by a portfolio that deviates substantially from its benchmark index, it is more likely, as this study suggests, to beat the benchmark net of fees.

Key Findings

Here are some of the findings from the researchers' examination of U.S. equity funds from 1980 through 2003:

- Funds with highest active share (80-100%) beat their benchmarks by 2.0% to 2.7% before expenses, and by 1.5% to 1.6% after fees and transactions costs. Those with lowest active share (0-20%) matched their benchmarks before expenses and underperformed by -1.4% to -1.8% after expenses were subtracted.

- Size matters: smaller funds with high active share substantially outperformed larger funds with low active share -- to the tune of 5% to 6% per year.

- Where active share was due to stock-picking skill as opposed to factor bets (tactical asset allocation, market timing, sector rotation), performance was higher. A broad universe of individual stocks provides many more opportunities to exploit pricing inefficiencies than may be available in the limited number of sectors or trading opportunities.

- Fees are not an indication of active share. On average, closet indexers charge just as much as the most actively managed funds.

- Turnover is not an indication of active share. Some closet indexers mask their passive strategies with high turnover.

- Beta is not an indication of active share. Funds that excel in stock picking tend to have betas that are similar to their benchmark even though the portfolio is substantially different.

Implications for investors

Studies that draw conclusions from aggregated data must always be viewed in perspective. Throwing all funds into one big pot for statistical purposes cannot possibly

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mimic the investor experience. Indeed, this is the flaw in the studies proclaiming the superiority of index funds; no investor buys the "average" actively managed fund but rather exercises some degree of due diligence to find talented managers with strong track records and good stock-picking skills, thus raising the odds of outperforming the index.

The key message for advisors and clients is that if you're going to buy an actively managed fund, go all the way and find one that is really actively managed. Examine portfolios and look for funds with holdings that are substantially different from the benchmark index. And go with smaller funds. The study showed that among the largest 40% of funds, even the most active do not add value to their investors after fees and transaction costs.

Do your own study

The Yale researchers found that high active share funds outperformed low active share funds by an average of 2.71%. How about narrowing the universe even further and making the results even more relevant to you and your clients: look at the funds you recommend and see how they stack up against their respective benchmarks after expenses. If they fail to beat their benchmarks, consider swapping out those funds for others with higher active share. If they significantly beat their benchmarks, congratulate yourself on your superior fund-picking abilities and keep doing what you're doing.

Read the full study

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