ABSTRACT

Because of the realities of active investment management, passive investing may be preferable in most markets. Active management should only be used when there is a strong likelihood of achieving higher than benchmark returns—and only when skilled active managers can be identified. Unfortunately, finding active managers that can deliver consistent positive returns is challenging.

INTRODUCTION

Attempting to add value through public market active management is difficult because markets are complex, ever-changing, and intensely competitive. If successful, an active manager earns alpha—or return beyond the benchmark (taking market risk into account). Alpha is important because it can help investors meet or exceed their return goal. Alpha can mean the difference between the success and failure of an investment fund.

Alpha results from "outsmarting" someone else, who in turn underperforms relative to a benchmark. This is a very important point: alpha is not available to all, only to the skilled or the lucky (or the skilled and lucky). Said differently, generating alpha is a "zero-sum" game (for every winner there must be a loser). And since active managers charge higher fees than a benchmark index, it follows that the *average* active manager must fail to add value, after fees.

Much of what appears to be alpha is likely random noise. This partly explains why managers appear to go through cycles of over- and underperformance. Yet some managers possess real skill, and their alpha is not random at all. Identifying them in advance, however, is extremely challenging. Past performance is driven by a combination of skill and luck, and the two are not easily separable. Performance track records, therefore, only rarely provide definitive evidence of skill or lack thereof. What is more, what "worked" in one economic and market climate may not work in another. Skill can erode for many reasons. Because of this, strong past performance—even if it was the result of skill—may not persist.

True skill is rare and active management should be used only if (a) the asset class is one in which managers have a good possibility of adding value and (b) plan sponsors have the ability to find managers that can deliver alpha consistently.

BACKGROUND DEFINITIONS

An active manager both (a) provides exposure to and (b) attempts to outperform a market (or benchmark). The term "beta" refers to the market return, such as the stock market or bond market. If successful at outperforming the market, an active manager also earns a positive "alpha," which is the difference between the manager's return and the market's return, adjusted for risk.[1]

[1] This adjustment is made because many managers seek to beat their benchmark by taking on more risk than the market.

Beta is relatively inexpensive, earns an inherent risk premium (the return over cash an investor expects to receive for taking on market risk), is effectively unlimited in capacity, and does not require special investment skill to implement. Alpha, on the other hand, is relatively expensive (but if positive and persistent, well worth the cost) and relatively scarce. Thus, an active manager's return is a combination of beta, from market exposure, and alpha, which can be positive or negative. In contrast, a passive manager's return comes entirely from beta.

THE REALITIES OF ACTIVE MANAGEMENT

When an index fund is available in a needed asset class, passive management should be the default option. However, in some markets, passive investing is not an option (e.g., private equity). In others, investable indices are imperfect or unrepresentative of a target asset class (as in some segments of the bond market), and some form of active management may be advisable. In these cases, plan sponsors must consider active managers. But in those cases when a reasonable passive option exists, for the following reasons plan sponsors should only consider active management if they truly believe that they or their advisor have the ability to identify skilled active managers.

Active management is hard.

Market behavior as a whole is the result of many forces that interact in unexpected and largely unpredictable ways, as price movements are the result of many thousands of investors' decisions. In such complex systems, cause and effect are often not easy to connect. Consequently, the reason a stock (or the market) goes up or down is usually not knowable.

After a manager's winning streak comes to a halt, we tend to look for reasons why. Did the manager lose a key team member? Did success dull the manager's edge? Has their approach been copied and improved? Has their style fallen out of favor? It is often impossible to know.

Active management is a zero-sum game.

Alpha is the result of one active manager trading successfully at another's expense. This means that, unlike beta, alpha is not free for all to share—alpha is available only to the skilled, the lucky, or both. This also means that by definition one half of all active investors will underperform their specific market—before fees and trading costs. After expenses, the majority of active investors will thus underperform.

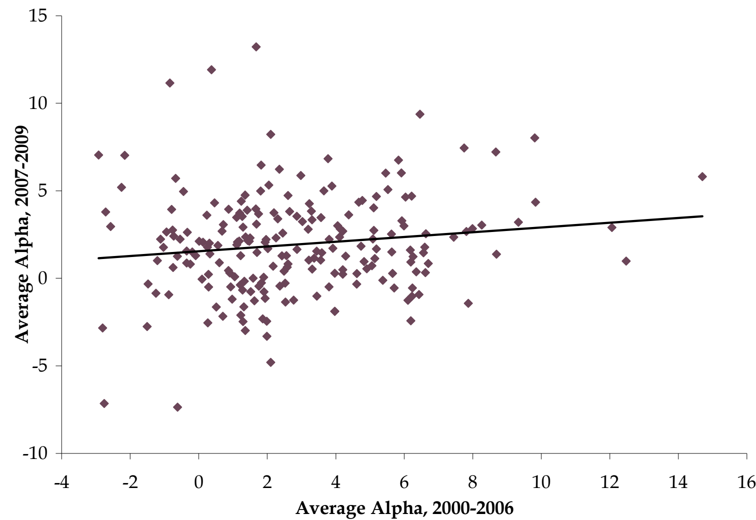
Active manager luck resembles skill.

We know that past performance is only rarely predictive of future performance, and that good performance can result from luck. It would be surprising if—out of the thousands that attempt active management—some did not beat their benchmark consistently. Of course, truly skilled managers are more likely to outperform consistently, so sustained outperformance may provide some evidence of skill—but not nearly enough to confidently identify these managers in advance.

An example makes this point concrete. Assume that you are searching for an active domestic large cap manager. Your first step in your search is to evaluate the performance of all active domestic large cap managers with at least ten years of history. eVestment Alliance, a comprehensive database of current active managers, listed 207 active domestic large cap managers with at least ten years of history at the end of 2009. How predictive of future performance are these "long-term" track records?

Not very. Specifically, as graphically seen in Figure 1, a manager's average yearly alpha from the seven years from 2000 through 2006 is not statistically predictive of their average alpha over the years 2007-2009.[2] Although this is a somewhat arbitrary test (i.e., we could have chosen different time periods), the fact that there is not a statistical relationship between past and future alpha during a reasonable time period indicates that selecting a skillful manager among the population of all domestic large cap managers based on historical performance would be a dubious strategy. While a counter-argument may be that the large cap market is "efficient" and thus harder to consistently outperform, the same result is found among the eighty-seven emerging markets managers with at least ten years of history (see Figure 2).

Figure 1. The predictive ability of historical alpha, domestic large cap managers.



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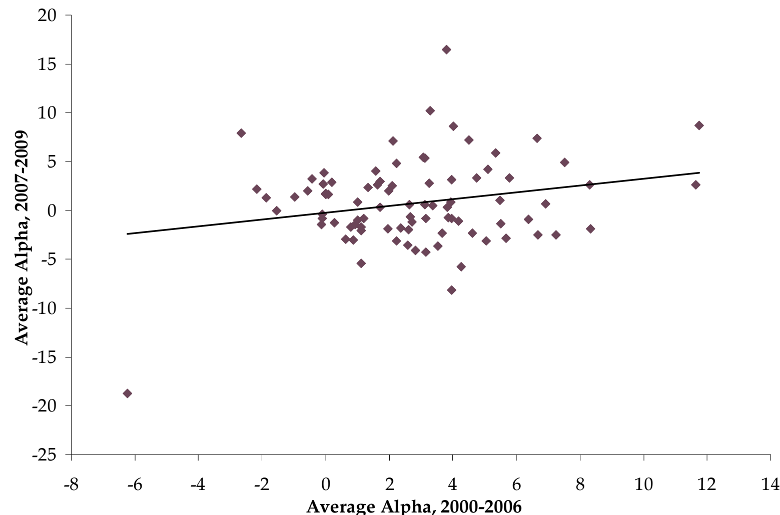
[2] While the best fit line seems to indicate a slight positive relationship, it is not statistically significant. The same is true in the case of the emerging markets managers. In both cases, the average alpha in both time periods is greater than zero because of survivorship bias. The presence of survivorship bias in no way alters the results of this specific analysis.

Figure 2. The predictive ability of historical alpha, emerging markets managers.



When evaluating an active manager, identifying a plausible source of alpha is surely more important than recognizing good past performance. This more comprehensive manager analysis requires a mosaic approach in which different pieces of information are thoughtfully assembled in order to develop a clear picture of a manager's capabilities. As the above analysis suggests, other factors besides past performance are likely to be more important.

Specifically, manager analysis should involve an evaluation of the manager's organization, investment team, investment philosophy, and investment process. Organization broadly refers to the structure of the business: are the assets under management too large? Is the business stable? Are incentive properly aligned? At the same time, the investment team should be stable, properly sized, and structured thoughtfully (e.g., not too large so as to impede effective communication). The investment philosophy—or how the firm believes markets behave—should lead to a clear competitive advantage, and the manager should adhere to a consistent and well-executed process. It is qualitative factors like these that we believe should primarily drive performance.

These general points about active management may irritate some managers (and advisors, too). Most of us believe we are better than average people; this is no less true of investment managers and advisors. Conceding that we have been lucky and that our performance is largely driven by forces outside of our control does not come naturally. Nevertheless, because of the unpredictability of market returns, randomness must play a large part in both success and failure.

IMPLEMENTATION

Some have concluded that active management should be used only in markets where the chance of success is greatest. For example, because it is arguably harder to obtain and correctly use information about smaller European stocks as opposed to larger ones, the

market for such stocks may be relatively "less efficient." In such markets, information is correctly reflected in security prices less quickly than in more efficient markets, such as that for larger U.S. stocks. It stands to reason that skilled active management has a greater chance of achieving a higher alpha in such an area. Unfortunately, as the above example indicates, the challenge of finding these skilled managers remains. Furthermore, even the most "inefficient" market imaginable is complex, and much of a manager's performance may be attributed to luck. Investors should therefore still approach active managers in less efficient markets with skepticism and caution.

Of course, there are no hard-and-fast criteria for deciding in which markets to use active management or what style of management to employ. (If there were, everyone would use the formula and there would not be any reward for taking active manager risk.) Nevertheless, reserving the use of active management for where it is most likely to pay off is a good place to start. One way to identify such markets is by examining the historical return "spread" between the best and worst performers in a given market. Higher spreads *may* suggest exploitable inefficiencies.

As difficult as manager selection decisions are, terminating a manager is equally tough. This is true for many of the same fundamental reasons: it is rarely possible to say with certainty that a manager failed to produce alpha because he or she is unskilled. If performance of one of your current managers falls short of expectations and cannot be explained by an "out-of-favor" style, perhaps your initial assessment was wrong. Because of this uncertainty, judgment is required. Unfortunately, judgment is often biased by personal relationships or the desire to give the benefit of the doubt. Should a retained manager disappoint, perhaps the best question to ask is: Would I hire this manager given what I know now?

CONCLUSION

In most public markets, passive investing may be preferable to active management. True active manager skill is extremely challenging to identify and markets are too complex to warrant the investment of time and money involved in finding and monitoring active public market managers for those who do not have resources dedicated to this task. That said, skilled active managers exist, and they are well worth paying for (indeed, they should pay for themselves). The same is true of the ability to find these talented active managers.

However, if a plan sponsor's required return is such that the plan cannot meet its goals without assuming exceptional above-market returns on the part of public market managers, trustees and their advisors may want to reconsider their assumptions, or consider allocating more to potentially higher-returning asset classes such as private markets.