Financial Planning

White Paper

How Active Is Your Fund Manager?

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October 1, 2006- **Authors:** Professors Antti Petajisto and Martijn Cremers of the Yale School of Management

What It Is: A study that introduces a new way to quantify and compare active portfolio management across equity funds. This method compares the holdings of a fund--as stated in its mandatory SEC filings--against the holdings of its benchmark index. The percentage of a fund portfolio that differs from its benchmark index--either in stock selection or weighting--is its "active share." For example, a fund that overlaps just 10% with its index has a 90% active share.

Major Findings: The number of funds that claim to be active, but are in fact passive, has increased significantly over the last two decades. Funds with a low active share (20% to 60%) held about 30% of all assets in 2003, compared with almost zero in the 1980s. In fact, the average active share of non-index, large-cap funds declined from about 80% to 60% during the study period, from 1980 to 2003.

The study gives advisors a clear way to identify closet indexers, citing Fidelity's Magellan Fund, circa 2002, as an example. That year, its active share languished in the 30% range. When Harry Lange took over from Bob Stansky in October 2005, the fund's active share increased--from 41% in September to 66% at the end of December.

The authors' findings confirm that most actively managed funds do not beat their benchmarks after expenses, but they note a significant exception: Funds in the most active quintile (with active shares above 90%) outperformed their benchmarks by 1.39%, annualized, after fees and expenses, during the study period.

Tracking error is the traditional way to measure active management, yet it doesn't reveal the whole picture, the authors say. Take fund managers who stick to the same sector weighting as the benchmark, but who actively pick stocks within sectors. They would have a lower tracking error than their active stock-picking would suggest, even though the stock-picking can generate alpha. The study looks at both tracking error and active share to determine how actively a fund is managed. The best performers, according to the study, are concentrated stock-pickers characterized by a high active share and high tracking error.

The Authors Say: "If you want active management, make sure you get what you pay for," Petajisto says. "There are many funds in the closet, charging fees for very little active management."

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