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Don’t tar all actives with the same brush

By Peter Elston
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The active versus passive management debate is intensifying. In FTfm the two sides have traded increasingly hostile blows, with the most recent attack (passive on active) by Richard Stott (**Twisting the facts on active management**, May 9 2010).

Aberdeen does not feel particularly threatened by the world of indexing – after all, both camps believe in diversification, just to varying degrees – but we do get concerned when the engagement gets a bit nasty and puts the game itself in jeopardy.

In combat it is important to understand one’s enemy. This, however, requires you first to have identified him correctly. And this is where the active world makes its first, and rather basic, error. As the passive world’s arrows rain down, most wrapped with the message that the average actively-managed fund underperforms, the natural response of the active camp is to assume that the enemy is the side firing the arrows. This, we think, is wrong.

It is not the passive world that is the enemy but those in the active world who make us a target. In other words, the two-thirds of managers who consistently underperform and in the process give the rest of us a bad name. In the medical profession, underperformers get disbarred. Not so in the fund management world.

But while we do not take issue with the concept of index investing – it makes sense for those who have not the time, inclination nor ability to identify a skilful active manager – we do take issue with the arguments used, the main one being that the average actively-managed fund underperforms its benchmark.

This may be true, but lumping us all together in the same pot is absurd. We all have different investment strategies – long term/short term, value/growth, concentrated/ diversified, etc – and different track records.

While the average fund may underperform, about a third of active managers do better than a passive fund.

The question is, can these skilful managers be identified? The indexers, quoting the deeply flawed efficient markets hypothesis, claim not, but research by Martijn Cremers and Antti Petajisto of the Yale School of Management, looking at fund performance from 1990 to 2003, suggests otherwise.

Their research maps fund performance by tracking error (the extent to which fund performance deviates from that of the benchmark) and active share (the extent to which a fund’s holdings differ from benchmark constituents). Their results showed the following.

Funds with low active share underperformed regardless of whether their tracking error was low (benchmark huggers) or high (top-down strategies/factor bets). Funds with high active share but low tracking error (diversified stock pickers) were able to outperform but this out-performance got wiped out by fees. However, funds with high tracking error and high active share (concentrated stock pickers) outperformed by 1.0-2.8 per cent per annum, even after fees.

These results may shock those who think constraining tracking error is a good idea but they are completely logical. Funds that do well are those that take no notice of what is in the benchmark. Those cowards who stick close to the benchmark, or those who try to predict systemic factors, appear destined, like the roulette player who stays at the table, to fail.

Albert Einstein allegedly referred to compounding as the most powerful force in the universe. Once it is appreciated what annual outperformance of 1.0-2.8 per cent does to a fund over 10 years, it becomes clear that high tracking error is a small price to pay and that it might perhaps be worth gambling on there being something to this active management lark, or, rather, certain parts of it.

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