The Case Against Active Management: Is it Luck or Skill?

Many investors spend a lot of time and money trying to predict the future movements of stocks or mutual funds or they hire people to make predictions on their behalf. This is known as "active management." A recent study done by Kenneth R. French, finance professor at Dartmouth College, showed that investors spend about $100 billion a year trying to outperform the returns of the market[1]. Many investors, or their financial intermediaries, actively choose which stocks or mutual funds to invest in based on any number of criteria, most often including a review of past performance. The typical investor looks at the performance record of a fund over 3, 5 and 10 year periods and then buys the fund showing the highest returns. More often than not, those good returns are not sustainable, causing the investor to sell the now underperforming fund and look for another one to buy based on the same criteria - past performance. Not only is this a costly strategy, it does not increase the odds of enjoying a positive experience because:

- Most active managers have underperformed their appropriate passive benchmarks.
- No one knows in advance who the outperformers will be.
- There is no persistence in outperformance; outperforming during one period of time does not increase the odds of outperforming in subsequent periods.

Passive Capital Management's investment philosophy is built on the belief that the capital markets are generally efficient. Security prices reflect all the current publicly available information and, therefore, are a reasonable representation of intrinsic value. Everyday, millions of investors have access to the same information. The decisions to buy or sell a given security by those millions of investors are what set the values of the securities. Of course, there is volatility in prices, driven by random and unforeseeable events and, therefore, cannot be predicted accurately or consistently. And yet, mutual fund managers, stock brokers and even the media still try to convince investors they alone have the skills and knowledge to pick stocks that will increase in value.

Countless studies have been conducted to determine what percentage of mutual fund managers can consistently outperform the broad stock market averages. Because so many investment professionals are trying to outperform the market, randomness and luck would dictate that some will succeed over short periods of time. It is important not to confuse randomness with enduring skill. A new study, "False Discoveries in Mutual Fund Performance: Measuring Luck in Estimating Alphas" shows that the number of managers capable of outperforming over the long term is so small that it is statistically indistinguishable from zero.

The study was conducted by Laurent Barras, a visiting researcher at Imperial College's Tanaka Business School in London, Olivier Scaillet, a professor of financial econometrics at the University of Geneva and the Swiss Finance Institute, and Russ Wemers, a finance professor at the University of Maryland. The statistical test used in the study is designed to simultaneously avoid false positives and false negatives; confusing something as statistically significant when it is entirely random and the reverse, a problem seen in previous studies of mutual funds. The researchers applied the method to a database of 2,100 actively managed domestic equity mutual funds from the beginning of 1975 through 2006. All the funds had at least a 5 year performance history and the database contained both active and defunct funds, ensuring results were not biased by excluding funds that had gone out of business ("survivorship bias").

Two interesting observations were made from the study. First, had the researchers only looked at performance during

[1] Mark Hulbert, *Can You Beat the Market? It's a $100 Billion Question,* New York Times, March 9, 2008

the 1990s they would have found a small percentage, 14.4% of managers, demonstrated stock-picking skills. However, when the time frame was extended to 2006, the number went down dramatically to just 0.6 %. Second, the reasons for the decline, according to the authors, appear to be threefold; high fees and expenses, skilled managers leaving the mutual fund industry and the markets becoming even more efficient, making undervalued and overvalued stocks harder to find.

Further evidence of the lack of consistent outperformance can be found in Standard & Poor's Mutual Fund Performance Persistence Scorecard. This series of studies provides semi-annual results on the performance of actively managed funds within their capitalization peer groups. Some of the findings include:

- Very few funds manage to consistently repeat top half or top quartile performance.
- A majority of top quartile funds in the subsequent period come from prior period second or third quartiles (no persistence in outperformance).
- The low absolute numbers of repeat top performers suggest that past performance cannot be the sole or the most important criteria in fund selection.

Many investment professionals would have you believe they have the ability to predict the future but the facts are indisputable. Luck should not be mistaken for skill. The Standard & Poor scorecard data suggests screening for top quartile funds may be inappropriate because past performance is no guarantee of future results. So, since most active managers underperform and you can't depend on past performance to predict future results, what does an investor do to have a successful investment experience? *Control those things that can be controlled.*

- *Diversification* is critical – it is the only "free lunch" in investing.
- *Asset allocation* drives performance – not manager selection or stock selection.
- Expected returns are a function of *risk* – don't just focus on returns but spend time understanding your tolerance for taking risk and how volatility affects the end value of your portfolio.
- *Re-balancing* is important – it ensures that you maintain an appropriate level of risk throughout all market cycles.
- *Costs* matter – taxes, transaction fees and management expenses all reduce the value of your portfolio.

The S&P 500, an index of domestic large companies, has realized a 10.4% annualized rate of return over the last twenty years through June 2008 and the MSCI EAFE, an index that tracks international developed large companies, has returned 6.7% during that period. The Lehman Brothers Intermediate Treasury Bond Index has had a 6.7% annualized rate of return. Considering active managers' inability to consistently outperform and the high cost of trying to pick a winning manager, one fact is obvious. (Source for all returns data: Dimensional Fund Advisors). Capturing the returns that the stock and bond markets offer you, at the lowest cost possible, will help you enjoy better performance than the average investor. *Remember, most investors can achieve their investment objectives by properly utilizing passive investment vehicles and never spending any time or money trying to outsmart the capital markets.*

"Achieving market returns is a big deal. That's because there is ample data indicating that, over the long term, simply achieving market returns will beat 95 percent of all professionally managed investment portfolios." - Dan Solin, *The Smartest Investment Book You'll Ever Read.*

Mimi H. Boblitz
Principal

Passive Capital Management, LLC
2330 West Joppa Road, Suite 330, Baltimore, MD 21093, 443-279-9980
Two Clinton Square, Suite 215, Syracuse, NY 13202, 315-478-3130
www.passivecapital.com
A registered investment advisor