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Buttonwood's notebook  
**Financial markets**

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## Investing

# Nobody knows anything

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WHENEVER one writes about the [failure of active managers to beat the index](#)



(<http://www.economist.com/blogs/buttonwood/2015/02/mutual-fund-investing>) , someone is bound to pop up online and argue that people don't pick fund managers at random. Select the right fund managers and all will be well. But how? Relying on past performance [does not seem to work](#) (<http://www.economist.com/news/finance-and-economics/21611090-even-experienced-fund-managers-dont-beat-market-practice-makes-imperfect>) . Logic would also suggest that it cannot be easy to identify the best performers in advance; if it were, then why would anyone give money to the underperformers?

Many pension funds and endowments hire investment consultants to help them choose fund managers (one estimate is that 82% of US pension plans use such services, and consultants advise on \$25 trillion of assets). The consultants employ highly-educated workforces, have decades of experience and charge hefty fees. But an award (the 2015 Commonfund prize) has just been granted to an [academic paper](#) ([http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2327042](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2327042)) that concludes

we find no evidence that these (the consultants') recommendations add value, suggesting that the search for winners, encouraged and guided by investment consultants, is fruitless

The paper is not new (the FT [reported on it 18 months ago](http://www.ft.com/cms/s/0/f20eb888-213a-11e3-a92a-00144feab7de.html#axzz3TVwvRL5i) (<http://www.ft.com/cms/s/0/f20eb888-213a-11e3-a92a-00144feab7de.html#axzz3TVwvRL5i>) but the analysis is worth repeating, not least because the lessons take time to sink in. The first point is how important these consultants are: the top 10 have an 82% market share worldwide and are seen by most fund managers as the gateway to clients. Despite this, there is very little data on how good the consultants are at their jobs. For people who demand a lot of numbers from the fund management profession, they release very little information themselves. However, Greenwich Associates have conducted a survey of the consultants' recommendations of American long-only equity funds from 1999 to 2011. The surveys contain an annual list of fund managers showing what proportion of consultants recommend each manager; it also asks the consultants why they do so.

Interestingly, the consultants do not merely chase past returns. This is not too surprising; they are smart people and know the limitations of the data. They look at soft factors such as investment style (is performance consistent with the stated philosophy? can the manager explain trading decisions?) or service provision. Despite all this, they conclude that

the portfolio of all products recommended by investment consultants delivered average returns net of management fees of 6.31% per year (7.13% before fees). These returns are, on average 1.12% *lower* than the returns obtained by other products available to plan sponsors, which are not recommended by consultants.

Worse still, fund managers that experience an increase in consultant recommendations over time perform worse than those that suffer a reduction in recommendations. (NB, the change is not statistically significant, but there is no sign of a statistically significant *improvement* either.)

Why is this? One reason could be that consultants tend to recommend big funds and big funds tend to underperform. (The bigger the fund is, the more likely it is to resemble the market, but with active fees.) It may well be that the consultants are playing safe on the old "No-one gets fired for buying IBM" principle. Of course, one reason that the funds get big is that the consultants recommend them and the clients take note; attracting (or losing) recommendations from a third of consultants boosts (or reduces) assets by around 10% in a year.

So if they can't pick winners, why do the consultants favour active managers at all? After all, fees are higher than on passive products and clients are more likely to switch managers on a regular basis, an activity that tends to reduce returns.

The authors suggest that

Consultants face a conflict of interest, as arguably they have a vested interest in

complexity. Proposing an active US equity strategy, which involves more due diligence, complexity, monitoring, switching and therefore more consultancy work, drives up consulting revenues in comparison to simple cheap solutions.

It is all rather reminiscent of the [recent study of retail investment advisers in the US](http://www.economist.com/blogs/buttonwood/2015/02/financial-planning) (<http://www.economist.com/blogs/buttonwood/2015/02/financial-planning>) who are paid by the product providers and who tend, on average, to recommend poorly performing funds at an estimated \$17 billion annual cost for savers.

So why do the clients still use the consultants? One explanation is the "hand-holding principle"; choosing funds is tricky and clients feel cautious about doing it on their own. They also want someone to blame if things go wrong. Investment consultants act as "money doctors".

But the most likely reason is that clients are unaware of the conclusions of the research and because of the lack of data mentioned earlier. As the authors write

It is unlikely that plan sponsors can reliably judge whether investment consultants add value or not. While fund managers testify to the rigour with which investment consultants scrutinise their performance, investment consultants themselves are shy of disclosing the sort of information which would allow plan sponsors, or any outsider, to measure their own performance.

In short, while one can be willing to accept that there are smart fund managers who can outperform the market, the trick is identifying such managers in advance. This process seems as difficult as identifying hit films in advance; in that business, as William Goldman wrote once "Nobody knows anything".

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#### [Why largecap fund managers usually underperform](http://www.economist.com/blogs/buttonwood/2015/02/mutual-fund-investing)

(<http://www.economist.com/blogs/buttonwood/2015/02/mutual-fund-investing>) (February 2015)

#### [Even experienced fund managers don't beat the market](http://www.economist.com/news/finance-and-economics/21611090-even-experienced-fund-managers-dont-beat-market-practice-makes-imperfect)

(<http://www.economist.com/news/finance-and-economics/21611090-even-experienced-fund-managers-dont-beat-market-practice-makes-imperfect>) (August 2014)

#### [Conflicted financial advice costs Americans \\$17 billion a year](http://www.economist.com/blogs/buttonwood/2015/02/financial-planning)

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