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Investment: Loser's game

John Authers Author alerts

With as few as 10 per cent of US active managers beating their benchmark in 2014, they are having to employ new tactics

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The debate over how our savings should be managed has raged for years. Should our retirement funds be placed, as they have typically been for many decades, with "active" managers, who go out and choose the stocks or bonds that they think have the best chance of beating the market? Or should they be entrusted to "passive" managers who merely try to match a market index — and can therefore charge a much lower fee for their services?

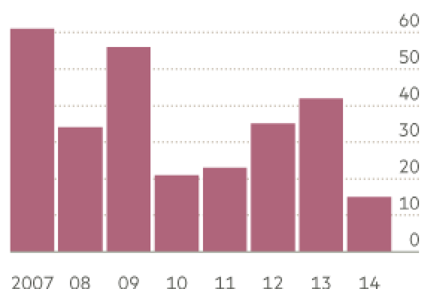
For active managers, 2014 looks uncomfortably as though it marked a tipping point in the debate. They have failed to match their market benchmarks on a scale not seen in decades. Some estimates suggest that as few as 10 per cent of active managers in the US managed to beat their benchmark.

Meanwhile, sales of actively managed funds have collapsed, particularly in the huge market for US funds investing in equities. Over the past 12 months, such funds saw redemptions exceed new sales by $92bn, even as rival passive funds took in a net $156bn.

The money from institutions and retail investors that was already flowing instead to rival passive funds has turned into a flood. Fidelity Investments, once the world's largest fund manager, saw $24.7bn flow out of its active funds this year; Vanguard, its successor as the largest US mutual fund group, took $188.8bn into its passive funds.

Fund groups traded on the success of their fund managers. The Fidelity Magellan fund grew to be the largest in the world, its assets briefly exceeding $100bn in 1999, thanks to the fame of Peter Lynch, its long-time manager, who achieved success investing in smaller stocks throughout the 1980s. Its performance for much of the past two decades has been mediocre, and it now has only $17bn of assets under management.

"These trends are remorseless," says Amin Rajan, head of Create, a UK consultancy that tracks the fund management industry. "Something like 20 per cent of European pension funds' money is tied up in passive funds, and we believe that figure is likely to double by the end of this decade."



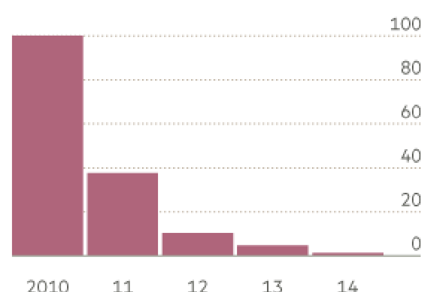
Faith in active management may have been lost. When State Street conducted a survey of investors in 19 countries this year, they found that only 53 per cent of individual investors believed that outperformance was based on skill rather than luck. As for investment professionals themselves, the number was even lower, with only 42 per cent attributing outperformance to superior skill.

The evidence is on their side. A study by S&P Indices last month demonstrated that outperformance almost never persists. As Craig Lazzara of S&P puts it: "Your chances of finding a fund manager who can stay ahead of the index five years in a row are about the same as tossing a coin and calling it correctly five times in a row."

The stakes are high because the sums involved are vast. Strategic Insight, a New York-based consultancy, estimates that the mutual fund industry manages $37tn globally, and brings in an extra $1tn in fresh money from investors each year. Active investing still accounts for more than two-thirds of assets under management in the US, and rather more than that in the rest of the world, so far more money could still be moved — with harsh implications for the many people employed to beat the market.

ETF boom

The flow out of active funds is driven in particular by the phenomenon of exchange traded funds, passive vehicles that can trade directly on a stock exchange. ETFs now have $2.76tn in assets globally. So far this year, about $275bn in new money has flowed into ETFs — a figure almost equivalent to the entire assets that were held by ETFs 10 years ago.



This added to the weight of academic theory, which suggests that active management is a "losers' game". In aggregate, all funds will match the market. Between them, they are the market. But they have to charge fees, which are almost always deducted as a percentage of total assets under management — a percentage that is fixed, regardless of whether the fund has beaten its benchmark. This guarantees that, in aggregate, they will fail to beat the index.

However, the problems of active managers create dangers. Somebody has to do the job of "price discovery", or setting a sensible price for shares, so that capital will be efficiently allocated to where it can be of most use. Index funds, which merely accept whatever prices are on offer, do not do this.

Mr Rajan predicts that the trend towards passive will eventually reverse. "The more money that goes into passives, the more they will become dumb," he says, and prone to massive overshoots. He adds that active managers' problems have been in large part caused by central banks, which have intervened to stop share prices correcting on several occasions. Indexing, he says, has also helped fuel investment bubbles; new money coming into tracker funds is automatically allocated to the companies with the highest market value.

"I can't believe that this amount of money going into passives isn't going to have an impact," he says.

Changing the game

There are signs of a counter-reformation. Now that the failure of the current model for active management seems clear, academics and fund managers are looking for new models. They are finding them in the field of behavioural finance, which applies the lessons of psychology to economics. Understanding how human psychology leads to bad investment decisions opens the chance to correct those decisions.

According to Chuck Widger of investment management firm Brinker Capital, behavioural psychology has revealed some 117 psychological biases that are pervasive in investors. For example, people tend to be overconfident, they will go to greater lengths to avoid losses than to make profits, they tend to extrapolate any current trend far into the future and latch on to the most recent information about a company, even if it is irrelevant in the longer term. All

these biases are good ways to lose money.

That has led to an attempt to improve active managers, and to identify genuine investing skill, using techniques borrowed from psychologists and sports coaches. Investment coaching firms will break down each investment into separate decisions — when to buy, how much to buy, and when to sell — and create prompts to stop managers from making the mistakes to which they are most prone. Rather than analyse price/earnings ratios or market trends, it simply tries to prompt managers out of bad behavioural habits.

Michael Ervolini of Cabot Research in Boston, one of the leaders in the field, provides minute feedback to portfolio managers. For example, some have a tendency to hold on to their "winning" stocks too long — the most pervasive flaw he has found, suffered by one in four managers, and rooted in the tendency to overvalue things that we own ourselves. Cabot will arrange for cues to appear on their screens, prompting them to consider whether they should sell their best performing stocks.

Applied to 100 fund managers around the world, Mr Ervolini claims this approach has turned an average under-performance of one percentage point into an outperformance of 1.5 percentage points over the course of five years. If applied to the $37tn managed by regulated funds, this could make quite a difference.

'Closet indexing'

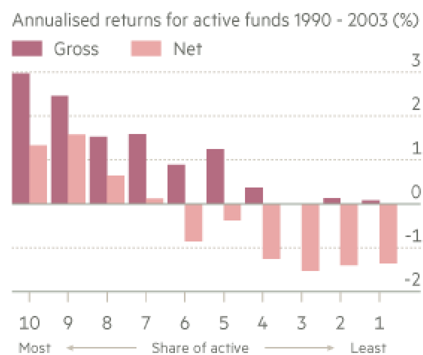
Efforts to remodel active funds have also been driven by research first published in 2006 by Martijn Cremers and Antti Petajisto, when they were at Yale University's School of Management. They showed that many "active" funds were in fact "closet indexing" — holding a big portfolio of stocks that was only slightly different from the index. In effect, they were charging active management fees for a passive product, while contributing to asset bubbles.

When they divided funds according to their "active share" — the proportion by which their portfolio differed from the benchmark — they found that the most active funds did reliably beat the index.

That suggests that active managers have a future, but only if they are prepared to make bold and active bets. Thomas Murray of AthenaInvest, a fund group, is a former academic who has applied these ideas radically, and states that it is easy to beat the index — provided managers have a concentrated portfolio pursued systematically with conviction. This is very different from the current model.

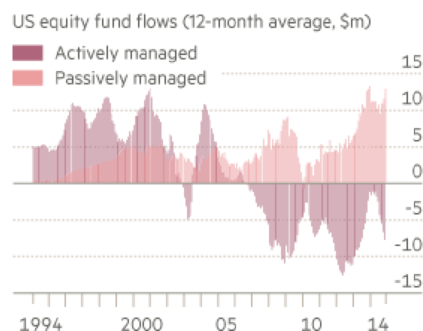
He has taken this approach to extremes. His portfolio only holds 10 stocks — Fidelity Magellan currently holds more than 170. And he causes gasps at investment conferences when he claims not to remember either the names of his stocks or how much he paid for them — a discipline that makes it far easier to avoid behavioural biases. As his annualised return over the past 10 years is 16.2 per cent, against 8.5 per cent for his benchmark index, it looks as though he is doing something right.

... but there are profits for the truly active



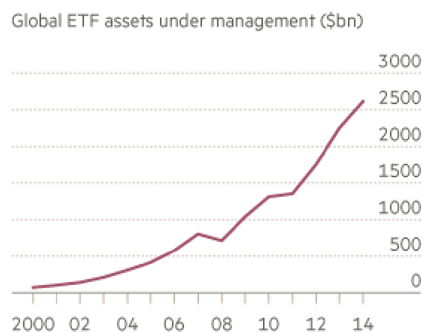
Source: Martijn Cremers & Antti Petajisto 2006

Investors are deserting active funds ...



Source: Morningstar

... and pouring money into the ETF phenomenon ...



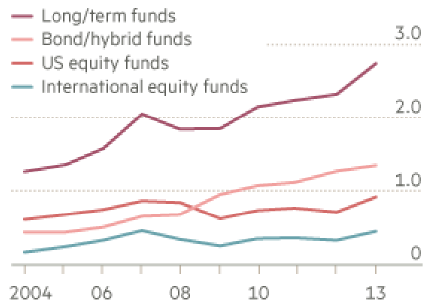
Source: ETFGI

The other way to close the gap with passive managers is by reducing fees. Some fund groups are tentatively introducing new fee structures, forgoing some fees if they fail to outperform.

This could help because in most years the "average" active manager does beat the benchmark before fees. The business of fund management is not a perfect "zero-sum" game because substantial holdings belong to actors who are not making any attempt to beat the market. Stocks belonging to founding families, or allocated to employees as incentive pay, are not being deployed in an attempt to beat the market.

It means there is evidence that in most years, if not 2014, most active managers can beat their index before fees.

So if only active managers would pay themselves less, they might have a far more valid proposition to offer to their clients. That has led to a flurry of attempts to reduce running costs by changing the way funds are structured. Last month, Boston-based Navigate Fund Solutions proposed a new class of "exchange traded managed funds", which could avoid a raft



of fees incurred by mutual funds, such as embedded fund distribution and service fees, the trading costs incurred when shareholders buy or redeem units from the fund.

It claims that this would have reduced the average US mutual fund's costs by 0.65 percentage points per year from 2007 to 2013, enough on its own to ensure that 55 per cent of actively managed funds could have beaten counterpart passive funds over that period.

These ideas are yet to be tested in the marketplace. After the travails of 2014 it is highly likely that they will be.

So the chances for an active renaissance at some point look healthy. But the traditional model of active management is doomed. In future, active managers will find it hard to attract investors' money, unless they can show that their investing is truly "active", and their fees are as low as they can be.

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