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Understand the very real myth of 'active management'

Sobering data continues to pour out of investment performance reports around the country. Again and again, the results tell us active managers are underperforming the market. The term "active" refers to attempts to outperform other investors or "beat the market" through security selection or timing.



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Extensive and readily available research indicates in any given year, about 60 percent of professional managers underperform their benchmarks. Stretch that time period to 10 years and roughly 70 percent underperform. Over 20 years, the number of active managers who fail to deliver market returns reaches a staggering 80 percent. And that's before taxes are considered.

Remarkably, the long-shot odds of active management may be even worse than that. In a recent paper, professors Eugene Fama and Ken French found "only the top 3 percent of managers produce a return that indicates they have sufficient skill to just cover their costs." Fama's conclusion? "An investor doesn't have a prayer of picking a manager that can deliver true alpha (out-performance)."

Of course, above-average results are achieved. Such performance temporarily "validates" managers and raises investor expectations. These hopes, however, are inevitably dashed when performance falters. Charles Ellis, former chair of the investment committees at Harvard and Yale, put it plainly: "The na-

tion's investment managers are not beating the market; the market is beating them."

This shouldn't come as a surprise. As far back as the early 1950s it was discovered that most managed mutual funds earned lower returns than the S&P 500 Index. The logical conclusion, of course, is investors would be better off owning "the market" via an index fund than relying on a manager to pick only winners.

So, why — in the face of such overwhelming evidence — have investors and managers alike continued to pursue active strategies?

There appear to be at least two explanations for this.

- The first can be boiled down to one word: fees. Investors collectively spend around \$100 billion a year attempting to beat the market. Accordingly, Wall Street efforts to promote the latest fund, hot stock and yesterday's winning manager ensure this cornucopia of fees continues.

- A second explanation may lie in our own behavioral biases. As humans, we are overconfident in our own abilities and too optimistic about the future. We've all heard the amusing statistics: 80 percent of us think we're above-average drivers, and most of us think tomorrow will somehow be more pleasant for us than for the average person.

These same biases extend to investing. In spite of the overwhelming evidence to the contrary, active managers continue to believe they can pick better stocks at better times than other investors. And amazingly, there's no shortage of investors who believe them.

It all sounds a bit like Lake Wobegon, a sort of fairy tale world where everyone is strong, good looking and, apparently, an above-average stock picker.

Two recent examples, however, suggest the fairy tale may be nearing its conclusion:

- With nearly \$700 billion in assets, the Norwegian Government Pension Fund employs a staff of 249 to research and hire the best money managers. Norway's Ministry of Finance says the Fund's mission is simple, "to be the best managed fund in the world." Given its ample resources, long time horizon and its unusual level of sophistication, it is hard to think of a fund more likely to succeed.

Norway recently engaged an international team of experts to evaluate whether or not they were accomplishing their mission. The result was a 220-page report produced by three highly regarded academics — Andrew Ang (Columbia Business School), William N. Goetzmann (Yale School of Management) and Stephen M. Schaefer (London Business School).

The report's conclusion? "The three professors found that for all their stock picking and do-gooding, the fund's managers could just as well have thrown darts at a board...The fund's performance was essentially indistinguishable from that of a passively managed index fund."

Despite the immense factors working in the Norwegian Fund's favor — a huge staff of highly-skilled professionals, ultra-low management fees (a mere 0.07 percent!) and the absence of taxes — the Fund has had trouble beating the market.

As one professor pointed out, "The evidence points to the fact that over time, managers do not provide extra profits."

- The California Public Employees' Retirement System, or CalPERS, announced last month it is considering a switch to an

all-passive portfolio. As the largest pension fund in the United States, the moves by CalPERS are closely watched by industry observers.

Already, more than half of CalPERS' \$250 billion in assets is invested in passive index strategies. The investment committee is reviewing whether the time, energy and cost associated with the actively managed portion is worth it.

What's the impetus for the change? According to a consultant to CalPERS, at any given time, only around 25 percent of the fund's active managers outperform their benchmarks. The concern is twofold: first, winning managers are canceled out by managers who underperform; and second, the outperforming managers change from year to year. Winners don't repeat.

A CalPERS board member summed things up clearly: "It doesn't make any sense to continue paying fees for underperformance."

Additional data suggests the sensible trend towards index fund investing is taking hold. Since 2003, investors in the United States have put more than \$1 trillion in passive index funds while pulling nearly \$300 billion from actively managed funds. The CalPERS example may simply be the exclamation point, suggesting the fairy tale of active management may soon be over.

After all, if two of the world's most sophisticated institutions are waking up to the fact active management has failed them, shouldn't you?

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