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Active managers: lucky, skilful, or useless?

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Despite the academic hours put into debating whether active fund managers outperform, no one has definitively won the argument it seems.

The debate has been fuelled recently by papers from Eugene Fama and Kenneth French (Luck versus Skill in the Cross Section of Mutual Fund α Estimates) and Laurent Barrat, O. Scaillet and Russ Wermers (False Discoveries in Mutual Fund Performance: Measuring Luck in Estimated Alphas).

Neither make good reading for active managers.

The first finds “no evidence of fund managers with skill sufficient to cover costs”, and only a hint “of the existence of managers with skill that enhances expected returns”. Even before costs, “formal support for positive true alpha is weak”.

The second shows a big drop in the proportion of skilled fund managers over the past 20 years, and an increase in the proportion of unskilled managers. But it is slightly more encouraging in finding that the underperformance of active fund managers on average is “due to the long-term survival of a minority of truly underperforming funds”, with most actively managed funds providing positive or zero alpha net of expenses. However, only a vanishingly small proportion (0.6 per cent) delivered positive alpha through skill.

A discussion of this paper in August in Advisor Perspectives, a newsletter and data provider for fee based advisers, triggered a debate that is still rumbling on.

Whatever the academic studies say, active fund managers continue to thrive, and investors continue to believe they can find the skilful managers who can reliably outperform. Perhaps they should listen to the likes of Watson Wyatt.

The consultant this month published a report advising that most defined contribution plans should choose passive management, “because of its cost effectiveness and alignment with the governance capability of most plan fiduciaries”.

Watson thinks active management can add value, but says it is difficult and time-consuming. “Spending time searching for active management skill should not be a priority for most plan fiduciaries”, it says.

This is the same advice it hands out to trustees of defined benefit plans, and it notes a “pleasing polarisation” between high governance plans making use of strategies involving active management and lower governance ones going for simpler, often passive, strategies.

Watson Wyatt’s advocacy of passive management for those without the resources to find the best active managers is a practical expression of the academic work. (Watson is, of course, putting itself forward as a selector of good active managers so it is not entirely unbiased in its opinion that there are some active managers worth paying for).

One point worth making, though, is that most of the studies are based on the US mutual fund industry. To the extent that the US stock market is more efficient than others, and harder to beat, is labelling all active managers as useless on this basis a little unfair?

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