



All that's hot in the mutual fund industry

An Information Service of Money-Media

[Print](#) | [Close Window](#)

MoneyVoices: Defending Active Management

Column published on Mar 6, 2008

There are **2 comments**. Most recent comment on 3/6/2008 at 11:10am EST

Guest Columnist: Howard Present is president and CEO of F-Squared Investments of Wellesley, Mass.

Active management has been on the wrong end of a public thrashing lately, but rather than blaming the managers, the critics should instead learn how to get the most from these funds. The moral high ground is being held on false pretenses. Indexers have touted facts bemoaning the failures of active management, and then flaunted the superiority of passive investing. They often use accurate facts, but their conclusions are misguided and they misplace the blame. The correct interpretation shows that fault lies not with the managers, but rather with the means of delivering results to the end client. Let's review the facts:

FACT: Majority of active managers underperform their benchmarks over longer periods. (Research shows less than 20% outperform over 10-year periods.)

FACT: Majority of managers who achieve a strong three-year record cannot repeat their success. (Best research indicates that less than 15% repeat.)

Ergo, active managers should be replaced by low-cost beta products. Case closed, right? Not so fast.

An old debating axiom states that if you let your opponent define the terms of the debate, you have already lost. In this case, the debate is being defined as passive versus active, but — and this is the tricky part — active implies stand-alone active managers on a "buy-and-hold" basis. In other words, once you sign on to a manager you can't jump ship for 10 years. Amazing, considering how many marriages don't even last that long.

Let's revisit the facts. First, defining only 20% of active managers as superior is not an indictment. Portfolio management is a skill and, like other skills, it is distributed on a normal curve in the population. Most managers are average, a subset is lousy, and some are superior. Twenty percent sounds about right. Second, two successive runs of three years of outperformance is tough to pull off. Is this surprising?

The simple truth is that the failure lies with the means of accessing (and delivering) active alpha. Some simple steps to dramatically improve a client's returns:

- 1) Three-year default holding periods for a fund are too long; evidence says 12 months as default is ideal.
- 2) Multi-manager approach within an asset class is optimal; using a stand-alone manager ignores the benefits of process diversification.
- 3) Change the paradigm: Active managers are mini alpha engines and should be "managed" like a portfolio; use multiple managers within an asset class, rotating a subset on an annual basis.

Asking a single manager to consistently outperform over all cycles is like asking a sprinter to run all four legs of a relay race and then acting shocked when they come in last place. Perhaps that public thrashing can be focused just on managers with really high fees.



Howard Present is co-founder, president and CEO of F-Squared Investments, a virtual investment management firm. Previously, Present was managing director at Evergreen Investments where he served on the executive committee and ran global product management and strategy for the firm. He was also a managing director at Putnam Investments, where he

founded the firm's corporate product management department. He also was partner and director of strategy for the Boston Financial Group, a leader in the real estate investment industry, and spent 6 years at Chase Manhattan Private Bank where he ran the firm's offshore fund business. Present earned a BS in Petroleum Engineering from the University of Texas at Austin and an MBA from Emory University. He has also authored or co-authored several strategy white papers and research studies covering the investment industry..

Discussion "Defending Active Management"

3/6/2008, 9:55am by Tom Coakley, Group Manager, Marketing

So, what's the return data look like for a passive approach versus a multi-manager approach within an asset class that uses a 12 month holding period?

3/6/2008, 11:10am by Howard Present

There is actually a real world test of the recommended investment process (professional selection, multi-manager within asset class, default 12 month holding period), with publicly available performance data.

There is a family of 18 indexes constructed exclusively of actively managed mutual funds (brand name ActiFindex). Of the 18 indexes, 12 cover traditional U.S. Equity style/capitalization categories and 6 cover sector categories. On average, each index has 10 mutual funds with the funds selected by third party institutional consultants and reconstituted once a year. Performance values are published daily by the American Stock Exchange, reflecting both net asset value returns as well as gross of fee returns. The latter is constructed by using a daily adjustment to reflect the fund returns assuming zero expense ratios.

In 2007, the 17 ActiFindex indexes with a full year performance return generated an excess return versus appropriate passive benchmarks (i.e. Large Cap Core vs. S&P 500) of 537 basis points (bps) for the gross of fee data, with a beta on average less than 1.0. Even adjusting for the expense ratio, the indexes on a net asset value basis outperformed their passive benchmarks by more than 400 bps. Of the 17 indexes with full year 2007 returns, 16 outperformed on an absolute return basis and all 17 outperformed on a risk-adjusted return basis. Complete information about these indexes is available at www.activeindexsolutions.com¹.

Editor's note: Howard Present is a non-voting advisor to Active Index Solutions' investment committee.

Ignites

Ignites is a copyrighted publication. Ignites has agreed to make available its content for the sole use of the employees of the subscriber company. Accordingly, it is a violation of the copyright law for anyone to duplicate the content of Ignites for the use of any person, other than the employees of the subscriber company.

[Back to Top](#)

Links

1. <http://www.activeindexsolutions.com/>