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The active fund management model is not fit for purpose

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Only 19% of US equity fund managers beat Russell 1000 index of large stocks for the year

When funds brag about their one-year performance, what are they really telling you? They are not excited about a recent hot streak. Rather, a new advertising campaign from a fund company is a sign that 13 months ago they did really badly — so their numbers look good now that month has dropped out of the comparison.

All funds must advertise that past performance is no guarantee of good results in the future. But new research led by academics at Cambridge university shows that it is months of bad performance, and not good ones, that drive both reported results and marketing by fund groups. Unknowingly, investors are chasing "stale returns".

US regulators require funds to publish their one- three- and five-year performance numbers. So companies co-ordinate their advertising campaigns to launch on months when poor performance numbers have just dropped out.

The survey found that mutual funds in the US are most likely to launch an advertising campaign 13, 37 or 61 months after a particularly bad month — and that money was most likely to move into funds at these intervals as well. There is no such immediate effect after a good month's performance.

Worse, the researchers also found that managers were more likely to increase their pay, by withdrawing waivers of fees, at the critical points when bad months dropped out of the main holding periods that they had to quote. Increases in pay, then, are driven not by recent good performance, but by anomalies of poor performance years in the past.

To quote Raghu Rau, of Cambridge university, funds should perhaps advertise that "there is no guarantee of past performance either".

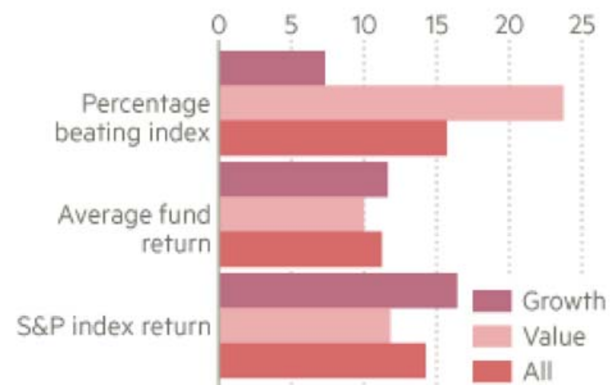
Such behaviour may be technically legal, but it is a nasty cheap practice. It smacks of desperation.

And active fund managers have reason to be desperate. Last year, was terrible for active managers everywhere, as the low dispersion in stock returns made it prohibitively difficult to outperform the market.

According to BofA Merrill Lynch, only 19 per cent of US equity fund managers beat the Russell 1000 index of large stocks for the year. In that context, the success of 43 per cent of active managers in keeping up with the index so far this year, with the average equity manager "only" lagging behind the benchmark by 19 basis points, looks almost encouraging.

Active underperformance is primarily a function of pure mathematics. In aggregate, all funds will match the index, or at best do very slightly better. Then they charge fees. This ensures that the average fund, after fees, underperforms the market.

As this logic has grown more widely understood, so money has started to flow out of actively managed funds, and into "passive" alternatives, which merely track a benchmark, and charge a much lower fee. In the past year, a steady trickle turned into a true flood.



That flow into passive alternatives may have had its own effect on active managers. Their worsening performance compared with the index may be part of a long-term secular trend, and not just part of the mathematics of fees.

There are two reasons for this. First, over the decades, active managers have grown better at spotting mispriced stocks. That makes it harder to make money by finding them. Second, as the more mediocre active managers give up, so only the most talented are left. These talented managers are still playing a zero-sum game which some will lose, so their job grows harder.

All of this puts ever more focus on fees. Asset managers' pay is set to exceed that of investment bankers in 2016, according to research by New Financial, a think-tank. In the UK, the Financial Conduct Authority announced this week that it will investigate asset manager fees.

The focus on fees is good, but there is a serious underlying problem. We need active managers to perform price discovery — making sure that capital is well priced — and to act as stewards over the companies they own. Passive management cannot do this.

The current model of active management, in which funds exploit anomalies from years into the past to sell more and to pay themselves more, is not fit for purpose. There is a pressing need to

find a new and viable model for active managers.

However, it is a fair bet that active management will endure. Charley Ellis, an influential critic, predicted as long ago as 1975 that "gifted, determined, ambitious professionals have come into investment management in such large numbers . . . that it may no longer be feasible for any of them to profit from the errors of all the others sufficiently . . . to beat the market averages".

But despite all that has happened since that great prediction, he doubts that active managers will kick their habits. "Having watched smokers quit and drivers adopt seat belts and folks lose weight, I am unable to imagine large numbers of active investors quitting the Great Game," he says.

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