Letter to the Editor
Compelling Evidence that Active Management Really Works

July 21, 2009

Dear Editor,

In his recent article "Compelling Evidence That Active Management Really Works," Ken Solow concludes that "active management does, in fact, add significant value." The article is primarily based on a 2007 study conducted by Martijn Cremers and Antti Petajisto of the Yale University School of Management. Although the methodology of Cremers and Petajisto's study is sound, readers should be very careful about how to interpret and implement the article's conclusion. It is usually quite misleading to paint the overall performance of either active or passive investments with a broad stroke.

First, readers need to carefully examine the definition of "active management" in Mr. Solow's article. In practice, investors and portfolio managers generally consider all non-index funds as actively managed investments; however, in this article, 70% of actively managed non-index funds are excluded from "active management" because they are considered "Closet Indexers" due to their relatively lower "active share" ratios. In other words, only a small group within the generally accepted "actively managed fund" universe has outperformed passive management.

Second, Cremers and Petajisto's study covers only 1,678 U.S. domestic non-sector focused equity funds, which is only a small portion of the mutual fund industry. The investment landscape in other asset classes and categories (such as Foreign Large Growth, Intermediate-Term Bond, Bank Loans, etc.) can be and is very different.

FundQuest recently conducted a comprehensive research study that analyzed 30,435 U.S.-domiciled non-index mutual funds in 60 categories representing almost $4 trillion of US and non-US assets as of the end of 2008. The study included all live (in operation) and obsolete mutual funds in the Morningstar database in order to minimize the survivorship bias. Mutual funds were analyzed for the 15-year period from January 1, 1994 to December 31, 2008. Every fund's behavior pattern and performance was analyzed for 13 rolling 3-year trailing periods ending December 31, 2008.

The study found that both active and passive investments have their strengths and weakness and, importantly, there is very wide variation in the relative performance of either active or passive management from one style category to another. In some style categories, a high proportion of active managers consistently beat index-based investments while in other style categories, very few active managers justify their additional management expenses. Investors can use these findings to create optimal combinations of active and passive strategies in order to boost the efficiency of their portfolios.

The white paper "What Now--Active or Passive Management? Examining Real Alpha and Exotic Beta" can be downloaded at: http://activepassivefunds.com/research.html

Please feel free to email me if you have any questions.

Sincerely,

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