Letters to the Editor
Fama-French and the Active-Passive Debate

October 20, 2009

The following is in response to Michael Edesess' article, [Luck versus Skill in Mutual Fund Alpha Estimates], which appeared last week:

The Fama and French Farewell Tour

When taking a tour of the western US, one sees wide-open expanses and beautiful vistas. If asked afterwards, the tourists would say they saw little or no evidence of valuable mineral resources along the way. But in fact, the western US is home to many rich deposits of silver, gold, copper, molybdenum, oil, natural gas, and coal, among others. Of course, to detect such deposits it is necessary to sink test wells and/or conduct seismic tests. Such deposits cannot be detected by simply driving above them, since a thick dirt and rock overburden makes detection very difficult.

Think of Fama and French as driving a tour bus through the active equity mutual fund universe. Like many researchers before them, they focus on life-of-fund alphas as a way to detect superior managers. Their thesis is that if managers are skilled stock pickers, then the average long-term performance of all funds will reflect this skill.

This is like asking the tourists to identify mineral deposits along the route by looking out the windows of the bus. Like identifying concealed mineral deposits, the average life-of-fund alpha methodology must detect manager skill through a thick layer of excess portfolio diversification. Exceptional performance resulting from manager skill is obscured by this diversification overburden.

Focusing on manager decisions

Rather than using long-term performance to detect manager skill, a growing line of research focuses on the specific stock-by-stock decisions made by active equity managers. These studies find compelling evidence of manager stock picking skill, with annual alphas exceeding 10% in some cases. In fact, the most recent manager-decision study (Cohen, Randy, Christopher Polk, and Bernhard Silli, 2009. Best Ideas, Harvard Business School working paper), finds that virtually all active managers are superior stock pickers. Thus manager skill is a ubiquitous feature of active equity funds.

So why the polar opposite results between life-of-fund alpha studies and manger-decision studies? The reason is over-diversification. The manager-decision study results, along with the well-known rapid decline in marginal stock risk reduction, argue for a portfolio of no more than10 to 20 stocks. This is consistent with anecdotal evidence that the personal portfolios of professional managers are invested in no more than 15 stocks.

But the typical active equity fund holds 130 stocks. Roughly speaking, bad idea stocks outnumber good idea stocks by 10 to 1. Why do managers so dramatically over-diversify? Investors, advisors, and the industry force them to do so by paying them based on AUM, asking them to be big, asking them to track an index, requiring them to stay in a style box, and requiring them to conform to legal requirements such as the prudent man rule. All of these constraints force funds to over-diversify and thus wipe out the superior performance flowing from manager skill.

Efficient Markets: the last straw

There are many excess return anomalies, so it is a wonder we continue to take seriously the concept of market efficiency. But passive proponents have one final argument: Yes, they say, there are anomalies, but they must not be real since even professional equity managers cannot earn excess returns. However, the manager-decision study results described above demolish this final market efficiency argument.

You can understand why Fama, who first proposed the concept of informationally efficient markets in the 1960s, is a strong proponent of life-of-fund studies, since they uncover little or no manager skill. But of course we now know that it is not the lack of manager skill but the smothering effect of over-diversification that fails to produce excess returns.

Let managers be active

Don't get taken for a ride on the Fama and French efficient markets farewell tour bus. Instead, ask managers to avoid over-diversifying and thus free them to pursue their best ideas. You will be pleasantly surprised by the ensuing performance.

C. Thomas Howard, PhD
Professor, Reiman School of Finance, University of Denver
and
CEO and Director of Research, AthenaInvest, Inc.

Dear Editor:

Michael Edesess' about the latest Fama and French study regarding portfolio manager alpha, calls attention to just another study that misleads financial planners by asking the wrong questions and then presenting the conclusions it draws as "science." Let's review some of the problems with this study, and the many other studies like it, that are used to "prove" that active management can't generate excess returns and that the existence of investment "skill" can't be proved.

First, Fama and French focus on tracking error, or the returns of a universe of equity mutual fund managers versus the returns of a market benchmark. In their important study on Active Share, Yale professors Cremers and Petajisto introduce a second dimension for measuring returns, which is the amount that each fund's holdings deviate from the benchmark's holdings (see my article here). They found that many mutual fund managers are actually closet indexers, and that while small-cap and momentum were important factors in portfolio performance, Active Share, or the deviation of fund holdings from the benchmark, contributed significantly and persistently to fund returns or alpha. Of course the deviation in fund holdings from the benchmark is a direct result of the manager's skill.

Second, Fama and French err in concluding that small-cap and value stocks *on average* outperformed during the time period that was studied. In doing so, they fail to point out that focusing on average returns for a time period is a high-risk methodology for determining portfolio construction. For example, when the economy moves from expansion to contraction, investors in small-cap stocks may be bitterly disappointed with the returns of these stocks. In fact, small-caps are often thought of as a "higher beta" investment than large-caps and, depending on valuations, could dramatically underperform large-caps, not to mention bonds and cash.

In addition, investors who own small-cap stocks when they are favored by investors and have high absolute or relative PE ratios will be similarly disappointed. These observations are the common coin of professional money managers everywhere, and they will be happy to sell their small-cap stocks to undereducated financial planners in both circumstances. The average returns of small-cap stocks should be nothing but an interesting data point to investment managers who are trying to best manage portfolio risk.

Finally, and most importantly, the study offers financial planners the false choice of owning equity mutual funds or an equity benchmark, when in fact financial planners have the ability to own other asset classes such as real estate, commodities, bonds, and cash. Unfortunately there are no studies that I'm aware of that evaluate the universe of managers with the flexibility to own all of these asset classes based on their value characteristics, because to my knowledge such a universe of managers does not exist. The closest might be the universe of global-macro hedge funds, although these databases are so corrupted with 2 and 20 fees, leverage, and problems with survivorship bias that I doubt their analysis would yield any useful insights.

Aside from problems with choosing an appropriate universe of fund managers, a second problem is choosing a proper benchmark for such a study. Unlike the simple equity-manager-to-equity-benchmark comparison, the choice of benchmark in this case is more difficult and subjective. The smallest change in the benchmark will make alpha appear or disappear in the blink of an eye.

Financial planners want to rely on studies of past performance in order to reach conclusions about how to “reverse engineer” portfolios, without understanding why the performance occurs. For those who are desperate for a stochastic, probabilistic approach to portfolio construction that does not consider the cause and effect of economic conditions, I’m afraid that you will find that past performance alone will not tell you what you need to know in order to make a sound and professional forecast about future returns. You would be much better off trying to determine if inflation, interest rates, GDP growth, PE ratios, or other factors affected the returns of the securities in your portfolio. You will find that the best money managers and investment analysts in the world do exactly that.

You may be persuaded by studies like Fama’s and French’s, and if so you will be holding onto your small-cap value stocks with the near-religious belief that if they outperformed on average during the period studied by Fama and French, then science is on your side and they will do so again. The next time the market rolls over I will be thrilled to sell these stocks to you, and – as the market spirals lower, led by the small-caps – the cries of the small-value tilters will fill the air with the venomous accusation of “market timer!” No one will thank you for your persistence, least of all your clients, and the real investment pros will thank you for being the patsy who refuses to follow the most elementary rules of professionally managed money once again. Of course, in the end, it will be your clients who may have to add another five years to their retirement objective because of a misplaced and high-risk methodology that implies that buying and holding asset classes based on their average past performance makes sense.

Yours truly,

Ken Solow
Chief Investment Officer
Pinnacle Advisory Group, Inc.
Columbia, MD

The following is in response to Vitaliy Katsenelson's article last week, Michael Moore – Take This!:

Dear Editor,

Mr. Katsenelson scores a direct hit on why Michael Moore's movies are often labeled "mockumentaries": they are all full of half-truths, opinions stated as facts and (intentional?) omissions that attempt to elicit an emotional response.

Mr. Moore should be inducted into the Cynics' Hall of Shame, as he is profiting handsomely from the very system he finds so distasteful.

Rex L. Wardlaw, CFA
Seattle, WA