



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

October 27, 2009

The following are in response to C. Thomas Howard's [response](#) to Michael Edesess' article, [Luck versus Skill in Mutual Fund Alpha Estimates](#):

To the Editor:

Dr. Howard states that the Fama-French "thesis is that if managers are skilled stock pickers, then the average long-term performance of all funds will reflect this skill." He then concludes, "This is like asking... tourists to identify mineral deposits along the route by looking out the windows of the bus."

Really? The Fama-French methodology of digging for signs of manager skill within average long-term performance data sounds more like intensive excavating to me. Apparently Dr. Howard doesn't feel they've done enough digging. Fair enough. But the research that Dr. Howard cites as more compelling effectively says that it's not fair to look at stock picks that didn't work and that mutual fund managers should instead be evaluated based on their best plays. He specifically sites a recent Harvard Business School working paper that employs this spurious approach to support the contention that "virtually all active managers are superior stock pickers." Dr. Howard then offers various reasons for why manager performance is buried under "the smothering effect of over-diversification that fails to produce excess returns."

What Dr. Howard doesn't say is that this is identical to a losing football team arguing that they really won if you just ignore all of the things that cost them the game. This argument doesn't work in investment management any more than it does in football. A loss is a loss.

If some do not like the structure and limitations of conventional mutual funds they don't have to own them. If one prefers to hold 15-20 individual stocks, as some suggest many professional money managers do with their personal portfolios, fine. If there is alpha to be gained this way then people are free to chase it. However, the question then becomes "alpha compared to what?" What benchmark is being outperformed to justify the claim of alpha? The overwhelming avalanche of academic research indicates that structure, not stock-picking, determines performance. Therefore, regardless of the "best picks" an active manager owns, a passive approach using completely different but structurally similar stocks in terms of market cap and valuation will yield effectively the same results over time – without the hefty fee.



When adjusted for the risk factors that determine performance, all evidence of manager skill completely disappears – and no one has credibly challenged this conclusion. Those who try continue to sound more and more like a losing team arguing that they really won – if only you could see past the fact that they lost.

Very truly yours,

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Dear Editor:

Reading the rebuttals of the Fama and French paper last week makes me pine for C. Everett Koop.

Koop was the renowned Surgeon General whose campaign against smoking – based on the overwhelming statistical evidence that smoking causes cancer – finally overcame the rigged counter-studies of the tobacco companies, and began to break America's smoking habit.

Now, gigantic warnings on cigarette packs proclaim that smoking causes cancer and death. According to T. R. Reid's new book, [*The Healing of America*](#), "More than a hundred nations today require a health warning on every pack of cigarettes and in every tobacco advertisement (in Britain, the warning must be printed in a larger font than any other text in the ad)." These efforts have brought about a drastic reduction in smoking, and in lung cancer and other fatal ailments that it causes.

Alas, there is no Financier General – though there ought to be one. If there were, she would require that all advertisements for professional investment management and advice display prominently a dire warning – in a font that is larger than any other text in the ad.

And what would that warning say? It would say what the overwhelming statistical evidence shows, the evidence that the professional advice and management industry tries to undermine constantly – evidence that is as strong as the statistical evidence that smoking causes cancer.



No, it wouldn't say "ACTIVE MANAGEMENT IS DETRIMENTAL TO YOUR WEALTH." That is not the issue. Active and passive management are about equally good, before all fees.

It would say, "FEES CAUSE MASSIVE DESTRUCTION OF YOUR WEALTH". That's what the statistics show, overwhelmingly. It would also be required that the fees – *all* the fees, boiled down to a single annual number – be displayed in the same large font, with comparisons to median fees and to the lower 10th and 25th percentile fees.

The campaign would drill into everyone's heads the fact that the statistical evidence shows that higher fees for professional investment management and advice bring no expected monetary benefit at all – whether those higher fees are for active management, or passive management, or a combination of the two. This would go a long way toward solving our whole financial industry problem. Fees are a zero-sum (not a positive-sum) game – a veritable torrent of wealth transferred from client to manager and advisor. Of course, some fees are necessary. But the marginal benefit to higher than the minimum needed is zero.

In a somewhat facetious chapter of my book, [The Big Investment Lie](#), I show how the same statistical pitch used to sell, for example, high-cost mutual funds (that is, the vast majority of them) could as easily be used to sell the pitch that smoking *prevents* cancer, not causes it.

All you have to do is get together a group of life-long smokers who never got cancer—a group constructed by design or by accident. If you gather enough groups and launch enough cigarette brands, you'll find one where the smokers got *less* cancer than the average non-smoker. You'll tout that brand mercilessly.

If it weren't for C. Everett Koop – saints preserve him – we'd all be smoking and getting cancer, switching brands constantly to the last one touted by a tobacco company for its cancer-preventing properties, just as we chase the performance of high-cost mutual funds.

So forget the active vs. passive debate. That's not the point. The point is that paying higher fees saps your wealth much, much more than you realize, and gets you no expected benefit. On this point, the statistics are irrefutable.

Active management is often an excuse to charge an enormous extra fee. And I've seen funds labeled "index" funds that are in some sense passively-managed, that charge outrageously too, for example so-called index funds of hedge funds.

We need a major campaign to get people to understand that when they pay high fees to professional managers and advisors in the hopes of *preventing*, or *curing* their financial ills, they'll be doing more to *cause* those ills than anything else they can possibly do.



Probably nobody short of a Financier General will wage that campaign.

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