



Letter to the Editor

November 3, 2009

The following is in response to [letters](#) responding to [The Fama and French Farewell Tour](#), which was a response to [Luck vs. Skill in Mutual Fund Alpha Estimates](#) by Michael Edesess:

Dear Editor

I am responding to three issues raised by the two respondents to my previous article:

- Cohen (2009), the latest installment in the manager-decision line of research, shows that managers overweight, before-the-fact, stocks that subsequently outperform. Furthermore, virtually all managers rank, in the form of relative overweighting, a stock's subsequent performance. This is not Monday morning quarterbacking, but powerful evidence of stock-picking skill.
- Each of the manager-decision studies adjusts for risk using four-or six-factor models. Even after such adjustments, each reports superior stock-picking performance. In fact, stock picking skill shows up regardless of what risk adjusted benchmark is used. Representative of this line of research is this conclusion by Cohen (2009):

“We find that most of the abnormal performance we measure in the four and six-factor regressions comes from stock selection within a characteristic benchmark, not from holding that benchmark passively or tactically.”

That is, the reported positive alphas are not the result of active or passive factor exposures but instead are the result of plain old stock-picking skill.

- It makes no sense to invest in active managers if they are unable to generate returns sufficient to more than offset their higher costs. A variety of recent studies (see [here](#), for example) shows how to identify active equity funds that are able to generate superior after-the-fact returns. Based on these studies, it is fairly straightforward to identify and invest in such funds.

Six years ago I would have sided with the two respondents: hiring an active manager, I thought, was the triumph of hope over reality. But my own research, along with the growing body of manager-decision research, has convinced me otherwise. Before settling for an old, stale notion regarding active management, you owe it to yourself and



to your clients to understand the investment implications of this emerging body of research.

Cohen, Randy, Christopher Polk, and Bernhard Silli, 2009. Best Ideas, Harvard Business School working paper, (March 18).

Yours truly,

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

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