



Letter to the Editor: Coin Flipping and the Active-Passive Debate

May 6, 2008

The following letter is in response to a [letter to the Editor](#) published last week.

Dear Editor,

As I read Mr. Kam's response, in which he cautions against looking at the past performance of *funds* and suggests instead the key to beating the market is to identify truly skillful fund *managers*, I envision him operating in a sort of Lake Wobegon where he and his managers are all above-average. In this Fantasy Land, a few super-skilled investment managers navigate the investment landscape with success, ease and grace. Do they beat the market? Of course they do! They deliver such excess performance, in fact, that they are regularly lured away by offers from competing employers (fund companies, hedge funds, etc.). Their success follows a storybook path: they outperform the market for a few years managing Fund Company A, then go on to record a string of victories at Fund Company B, only to be hired away by Fund Company C where they continue to outperform. Fund Company C sees its performance surge, while the glow of yesterday's performance fades at Companies A and B. And so on and so forth.

The key to living in Fantasy Land, of course, is the ability see through the shallow exterior that is the Fund Company's name. Not fooled by past performance of the fund itself, Fantasy Land residents look instead to the key traits required for a manager to possess market-beating skill. It's hard work (only they can do it), but once identified, they simply entrust their assets to those select managers. Achieving investment success after that is easy: simply follow the star manager from Fund Company A to B to C, since only a fool would remain invested in the same fund for more than 5 or 10 years.

As they move their assets to and fro following the career path of the star manager, residents of Fantasy Land enjoy the carefree ability to brush transaction costs and tax consequences aside, since their darling managers produce "alpha." With so much alpha to be had, there's no need to worry about the costs, taxes, or the risk that the prized manager was in fact--gasp!--lucky.

Back here in reality (with my tongue removed from my cheek), I can agree with neither Mr. Kam's argument nor his interpretation of my original paper. In his most recent response, he asserts "You cannot prove that skilled managers don't exist with an analogy that assumes they don't." Fair enough, but that wasn't my



point. The point of using a fair-coin flipping analogy was to isolate the role chance can play in an outcome. In an investment world where skill (and a lack thereof) are presumed to be evident, it is possible to be lucky long enough to appear skilled. I highly doubt the readers of *Advisor Perspectives* are convinced that skillful managers exist based on Mr. Kam's own coin-flipping experiment, in which he begins with the assumption that skill exists. Sounds like circular reasoning to me.

Furthermore, Mr. Kam--in my opinion--erroneously assumes a cross-section of managers have inherently different abilities. Those managers who beat the market 60% of the time hold "gold coins" while those underperforming the market 60% of the time hold "bronze coins." Where is Mr. Kam's evidence to suggest such inherent skill differences exist? Where is the evidence suggesting these abilities, assuming they do exist, are identifiable in advance?

I can only assume Mr. Kam finds these answers during lunchtime, when he and his star managers drink lemonade and eat rhubarb pie with other above-average residents of Fantasy Land.

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