Letter to the Editor: Active versus Passive Management

We received a number of letters in response to a letter last week, from Henry Schwartzberg, on the issue of active versus passive management. Below is one of these letters:

Dear Editor:

The results (of Mr. Schwarzberg's report) demonstrate that advisors can identify funds that beat their peer groups and deliver positive alpha. And how can you argue with that! Give me a performance report for every active manager for the last 10 years and I will identify, with 100% accuracy, every manager that outperformed his/her benchmark. Of course, this information is useless in identifying which managers will outperform in the next 10 years.

The problem with Mr. Schwarzberg's argument is that, while it is nice that FEDEX outperformed from 3/98 through 2/08, an investor would not have had data that would have prompted him to buy it in '98. According to the Federated website the 10 year return ending 12/31/97 was 15.66%.   The Wilshire 5000 Large Cap index (I like this one better) returned 17.77 for the same period.   So would an investor in 1998 rush out and buy the Federated Capital Appreciation fund based on its under-performance for the preceding 10 years? Would Mr. Schwarzberg?

Roughly 20% of active managers outperform their benchmarks each year. The problem is identifying that 20% before they do it. It can only be done "ex post". There is no research anywhere that has been able to identify any characteristic of an active manager that will give a clue as to who will outperform in the future.

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Henry Schwartzberg responds:

This is not about crystal balls, genies, or our proprietary process. This is about exhorting our industry colleagues to not benignly roll over and accept the norm of “use index funds because you can’t predict in advance the managers who will outperform their appropriate measuring yardsticks”.

A short while ago there was the bulk of humanity that swore the earth was flat and that to head for the horizon was to risk falling off the edge. There was a much smaller sub-set that sailed for the horizon and found the opposite to be true. Just a hundred years ago flight was deemed impossible by most. In the fifties there was a debate about the ability of an aircraft to "break" the sound barrier. In all those cases risks were taken by a few to prove the collective wisdom wrong.

This is about a forward looking position based upon robust analytics that decipher the value and nature of a manager's investment process. This is about the assertion that the continuation of prior successful behaviors is more likely than not to lead to continued success.

One thing is for certain: one cannot correctly judge the value of a manager's process if a sub-optimal index and an inappropriate peer group are used for measurement. Ron Surz, of PPCA, Inc., says "peer groups are a tough cipher to crack." If optimal index selection is part of the historical measurement process, and if either Surz' PODS or carefully parsed peers are, in a disciplined and consistent manner, selected for comparison, then the researcher will have a sounder basis on which to judge the prior success – or lack thereof – of a manager. At any point in time one would not begin with a manager that has not evidenced prior success. However, if a manager's success is correctly measured, other metrics can be added to the process which can improve the chances that a given manager will continue to beat its peers and the index going forward.

Ron graciously and professionally points out: "I personally disagree with the premise that it's easy to find yesterday's winners. The fact is that we just think we know yesterday's winners, but we don't. The performance evaluation industry has suffered through 35 years of not knowing what it doesn't know, and there's little sign that this will change. Winners are declared losers and losers are adjudged to be winners all of the time. How can we pick tomorrow's winners if we don't even know who's winning today? Tiger Woods the bowler never gets hired."

But the fact that such exercises are difficult does not mean that they are impossible. There are skillful active managers who will deliver alpha and, with proper analytical tools, advisors can identify them.

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