



Letter to the Editor

August 19, 2008

The following is in response to [four letters](#) that were received in response to Professor Tom Howard's [article](#) last week, which was in response to our article the prior week, [Luck versus Skill in Active Mutual Funds](#).

Response to: **Luck versus Skill Letters**

C. Thomas Howard, PhD
Professor, Reiman School of Finance
University of Denver
and
CEO and Director of Research
AthenaInvest, Inc.
August 19, 2008

Bob Huebscher's August 5 article about the Barras, Scaillet, and Wermers (BSW) paper and the ensuing responses by Ron Surz, Russ Wermers, myself and others is generating a good discussion around luck versus skill among active equity mutual fund managers. In last week's response, I presented evidence that manager skill increased over the 1980 to 2008 time period rather than decreased, as BSW conclude. Below I comment on the four new letters generated as a result of my response.

Investing in Active Managers Makes Sense

My data shows that average alpha is increasing over time and is now positive. This puts a serious crimp in the argument that an advisor can rationally index client portfolios and still be operating in their best interests. I estimate that the current average active U.S. equity fund outperforms the S&P 500 by about 100bp. Indexing is now a second best alternative.

Emphasis on Portfolio Characteristics rather than on Fund Strategy

Several respondents claim my results are due to managers simply riding trends. My response is "so what." Isn't that what we pay managers to do - identify market trends and ride them as long as it makes sense? Unless the advisor or investor is



good at identifying such trends ahead of time, and the evidence is not supportive of this proposition, a manager should be allowed to do their job.

What many advisors do instead is Monday morning quarterbacking. They say, for example, a manager did well because the fund is invested in small-cap stocks and these stocks did well. Then they turn around and force the manager, who just happened to be invested in small-cap stocks because of the strategy being pursued, to be a small-cap manager going forward. Then they are upset that the manager performs poorly as a small-cap manager. We create our own problems! The focus should be on manager strategy and not on portfolio characteristics. The relentless pursuit of a well crafted strategy is the key to superior performance, while portfolio characteristics are a byproduct that should be ignored.

Finding Skilled Managers

There are a number of ways, including those proposed by Wermers and Surz, for identifying successful active managers who are pursuing successful strategies. At AthenaInvest, we focus on the strategy being pursued by the fund and we have developed a portfolio building methodology we call Strategy Based InvestingSM. Using this methodology, it is possible to construct better active equity mutual fund portfolios.

My results reveal that it is easier to find skill among short history managers. Several respondents had trouble with this counterintuitive result, so let me explain why I believe this is the case. Performance declines over time because the manager, once successful, comes face to face with the performance killing forces of the industry. These include growth in AUM, marketing pressures such as having to stay in a box (e.g. small-cap value), having to meet short term budget numbers, reporting to an investment committee, responding to requests for lower volatility, good upside capture, and low downside capture, and so forth. The latter is the unreasonable expectation among advisors and investors alike that somehow a manager can generate superior performance while also producing consistent short term returns. The evidence, both at the market and individual security level, shows that long term superior performance is accompanied by highly unpredictable short term returns and thus eliminating short term volatility has the undesirable consequence of hurting long term performance.

This is not to say skill cannot be found among long history managers. On the contrary, one would expect skill to increase with experience, but the performance killing forces of the industry grow ever stronger the longer the fund is around. It takes a tremendous force of manager will to push back and stay focused on strategy. This is particularly the case as fund organizations increase in size with



the attendant growth in staff and the pressure to meet short term budget numbers. And unfortunately, advisors contribute to this pressure. Often I hear advisors say they are more interested in short term consistency than in long term performance. How sad for their clients.

Manager search methodologies, such as those offered by Surz, can help get beyond the standard performance numbers. Many advisors have their own method for identifying skilled managers that can help in building better portfolios. Often these correctly focus on the strategy being pursued by the manager and how successful the manager has been in executing the strategy. Excluding managers with shorter than a five year performance record is a mistake and focusing solely on a long term track record is fraught with problems, as the empirical relationship of declining returns with longer history reveals. The search process is more complicated than simply looking for a long term track record.

Methodology Questions

There were several comments regarding the use of correct benchmarks. If one is talking about individual fund performance, then the S&P500 is not the appropriate benchmark and a carefully selected benchmark is needed. But since I present aggregate data over thousands of US equity active mutual funds, hundreds of thousands of fund/month observations, and a nearly 30 year time period, using the S&P500 benchmark is appropriate. There is no reason to believe that over time mutual funds as a whole change, relative to the market, along such dimensions as sectors, market cap and P/E, and so it is unnecessary to make additional adjustments.

Risk models, such as the Carhart four factor model used by BSW, adjust for relative risk among funds but not aggregate risk. This means they adjust for risk differences from one fund to another, but do not adjust for increases or decreases in collective fund risk relative to the market. Since I report aggregate fund results, such risk adjustment models provide no insight into the overall risk being taken on by funds that might help explain the observed increase in average alpha. Add to this the large data cost (consuming as much as 50% of the sample) of such models, and I conclude the costs outweigh the benefits. In this sense, the average standard deviation I report is an adequate measure of changes in aggregate fund risk. And since the average fund standard deviation declines over this nearly 30 year time period, changes in aggregate risk cannot explain rising alphas during the 1980-2008 time period.



Building Better Client Portfolios

The current market environment favors active management over indexing and there are tools available to help find skilled managers. My hope is that advisors take advantage of the current opportunity to build better client portfolios.

www.advisorperspectives.com

For a free subscription to the Advisor Perspectives newsletter, visit:
<http://www.advisorperspectives.com/subscribers/subscribe.php>