



Letter to the Editor

June 24, 2008

The following letter is in response to our [interview](#) with Ken French, published on June 3, regarding his study, *The Cost of Active Management*.

Dear Editor:

I enjoyed our interview with Ken French. As the publisher of a [newsletter](#) geared to institutional investors, we have written about French's study as well. I thought your readers would be interested in our views on the results of the study and Ken's comments in your interview.

Immediate benefits of active management

Institutions have increased their allocation to passive investing significantly over the past 20 years, so the question becomes whether institutions are wising up to high active management fees. Interestingly, French points to increasing institutional hedge fund allocations as evidence that they are not, in fact, becoming more passive after all:

Advisor Perspectives: Institutions hold a significantly higher percentage of their assets in passive funds, as compared to individuals. As of 2006, DB plans held 31.2%, non-profits held 28.7%, and public funds held 52.7% of their assets in passive funds. Are institutions wiser as to the negative sum consequences of active investing?

French: My initial reaction to the public equity data was that institutions were getting the message. After looking further, however, I am not sure this is the correct inference. For example, much of the explosive growth in hedge funds is driven by institutions. Thus, instead of paying fees of 100 basis points per year for actively managed mutual funds, institutions are paying 425 basis points in hedge fund fees. It looks like many institutions have not really embraced the passive story.

French is right, institutions have not "embraced the passive story." They have embraced the separate management of active and passive portfolios - of *alpha/beta bifurcation*. Indeed, French himself acknowledges that markets are only semi-efficient - opening the door for all kinds of active management opportunities.



Aggregate benefits of active management

French doesn't mince words with his central argument in the paper:

On average, active investors spend 0.67% of the total market cap each year on what, in aggregate, is a futile search for superior returns. If we assume that society will continue to spend the current real dollar cost of active investing forever and that the expected real return on the U.S. stock market is a constant 6.7%, the capitalized cost is 10% of the current value of the market.

But his conclusion makes you wonder...If we *all* invested passively, markets wouldn't function. If every dollar flowed through, say, Barclays Global Investors (BGI) into the stock market on a cap-weighted basis - relative market caps of different companies would never change. The whole purpose of markets - to allocate capital to the most constructive business opportunities - would remain unfulfilled (unless a non-market-cap weighted index such as fundamental indexation was used). There would be a sort of self-fulfilling inertia to market values.

There seems to be little question that in aggregate active management has a net cost. But then again, so does sales and marketing. I am always amazed at the amount of resources that are spent on sales and marketing activities (conventions, advertising, direct sales, commissions etc.). In fact, according to the US [Bureau of Labor Statistics](#), well over 10% of the American workforce can be categorized as being in "Sales and Related Occupations." Their salary alone is nearly 5% of US GDP.

Now imagine a world without such waste. No salespeople or marketing budgets. No one to undertake wasteful and time consuming competition. No costly "getting the message out" about a certain product. Imagine how much we'd all save by simply having a central authority plan the economy - say, in 5-year increments. We could call this central authority the Bureau of Global Investing or "BGI" for short.

Of course, that's been tried by some countries under different names, and as counterintuitive as it seems, it never really panned out as expected. Functions that initially seemed wasteful and inefficient actually had the indirect effect of channeling resources toward the better, more efficient products and services.

. I'm not suggesting French is an advocate of central planning or anything. (He's actually in the AllAboutAlpha.com Hall of Fame). But passive management only really works if active management also exists. In a sense, passive management is a free ride on the "wasted" resources of active management.



In fairness, French explicitly recognizes the value of “price discovery” resulting from active management, but he appears to side-step the issue a little in the interview.

Advisor Perspectives: ...Without active management, there would be no marketplace for companies to raise capital. The whole economics of the stock market would stop working if there was no active management. Doesn't the benefit of active management (to society) go beyond price discovery?

French: I don't include the cost of marketing securities; I only include the cost of trading them. Since I do not include the cost of road shows to convince people to invest in initial public offerings, it does not make sense to include the benefit of this process in my analysis either.

IPOs aside, active management benefits go “beyond price discovery” by keeping the marketplace alive. That benefit can't possibly be excluded from such an analysis. So while we agree with French's straightforward and elegant analysis, we might not be so quick to dismiss the aggregate benefits of active management.

Others, notably active managers, may want to change the name of the french-fries in their cafeteria back to “freedom fries” in protest.

Yours truly,

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