Letters to the Editor – Luck versus Skill: Round Three

August 19, 2008

The following four letters 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. Professor Howard's response is shown here.

Dear Editor,

Unfortunately, Dr. Howard's study features as much bias as Dr. Wermers', if not more so. The thing that makes this problem so interesting is that they can both be right, and both provide so little guidance for investors.

Dr. Howard's largest bias is that he owns a company based solely on the concept that he can identify superior fund managers in terms of performance. If no such superiority exists, his company has been selling a worthless service. Like the pig and the chicken at breakfast-time, Dr. Wermers may be involved, but Dr. Howard is committed!

Some specific points of view from an investor's standpoint:

1. Newer funds often show superior performance as they are forced to contain less of the investment universe than larger funds who eventually they bloat up. I could buy Dr. Howard's argument if he recommended only newer, pin-point style funds, especially when they are usually formed jumping on a trend. I could make the argument that his study is totally dependent on new fund bias, yet the average investor shares in none of this as advisor's may not even be aware of the new fund until it has achieved a critical mass from in-house money.
2. As funds get larger, you would expect that they would show smaller standard deviations reducing risk for investors. This is caused by both the larger universe of stocks getting closer to a market index and the inherent conservatism we see among fund managers as they grow larger.
3. The most compelling point is that the increasing universe of mutual funds combined with the much larger fund pools they control have arbitraged away any opportunity for superior long-term active management performance. There are a limited number of equities, and with all funds using similar screening tools, as soon as one fund sees an opportunity, they all see it, and any superior returns are quickly arbitraged away.
4. Lastly, even if Dr. Howard is right and there is a long-term improvement in active managers performance (which I don't buy, but there certainly has

> been an improvement in investment tools), why are fund alpha returns declining overall? It is because large funds are becoming a larger share of the industry. We all know that a very small group of funds attract the vast proportion of new assets.

I love these debates. I figure the professors can support any side of the argument. I have to stand there when a large client has seen-below market returns from a fund my firm has recommended. As such, it is index ETFs for us with extensive allocation of separately managed, tax-advantaged accounts.

Cheers, and keep up the good work.

Bob Ellis
Senior Vice President, Wealth Management
Celent
New York, NY

Dear Editor,

While I have seen Dr. Howard and his business partner, Dr. Craig Callahan of ICON Funds, present their studies and have great respect for their work, I see one critical error in the methodology presented in this letter. By measuring the alpha of a fund versus the S&P 500, he is using extremely biased benchmarking. Could it be that midcap funds, emerging market funds, small value funds and international funds mostly have higher alphas than the S&P 500 simply due to the fact that these asset classes have outperformed the S&P 500 from 1980 - 6/2008?

In other words, there may be some managers in the small value space that have severely underperformed the small value index, but by their nature of being small value funds, have still beaten the S&P 500. This is alpha generated by asset class, not manager skill. As another example, even the lower quartile emerging markets managers have likely beaten the S&P 500 since 2002, but they are certainly not adding alpha versus an emerging markets benchmark. The "alpha" that Dr. Howard seems to be measuring largely depends on the field in which the manager is playing, not the skill with which he is playing the game.

Regards,

Kane S. Cotton
Sr. Portfolio Strategist
Capital Allocation & Management, Inc.
Greenwood Village, CO

Dear Editor,

I have three observations to Dr. Howard's letter "Letter to the Editor – Luck versus Skill in Active Mutual Funds":

1. He observes that it is the newer or shorter term manager's results that increase the alpha in recent years. Longer time periods cause performance to deteriorate. If "newer" managers are more "skillful", what causes them to lose their skill when they gain more experience? This logic definitely trends to the idea that any added alpha is indeed luck rather than skill. How many trades or professions can you think of where more experience equals less skill? This logic is faulty on its face.
2. If I am going to attempt to pick these "skillful" managers with short histories, how am I to distinguish between the "skillful" and the "lucky"? With essentially no history, I have no way of determining a manager's skill in advance of his longer history and consequent reduced performance that comes with more time on the job.
3. Since time on the job equals reduced performance, I am forced to choose an optimal time to fire this "skillful" manager before his "skill" diminishes and find another "skillful" newbie to replace this worn out old manager who has more than five years experience.

The observations in Dr. Howard's letter do me absolutely no good in assisting me to select "skillful" outperforming alpha adding managers over what I can achieve with passive asset class investing.

Charles Stanley
Capital Financial Advisors, LLC
La Jolla, CA

Dear Editor,

I want to offer some feedback to the Editor and to Dr. Howard regarding Dr. Howard's letter to the Editor on the "Luck vs. Skill" research by Dr. Wermers, et. al.

Wermers' research and discussion may well not have been complete. But the review submitted to the Editor was also far from comprehensive and failed to address a few important matters (implied assumptions) associated with the assertions it made.

I'm not sure that the matter of the dropping funds having a history shorter than 60 months was given sufficient attention in the letter. Howard asserts that "superior" manager performance is more pronounced in the basket of managers having less than 60 months of run time than for those having 60+ months in operation. But is that performance really superior? If so, superior to what? Generic benchmarks that bear little or no resemblance to the strategies at play?

Speaking entirely anecdotally but, I think, quite correctly, don't new fund launches tend to be made covering those parts of the economy (i.e., sectors and sub-sectors) that have already experienced at least a short period of favorable performance and which, generally or on average, have a bit of sector-specific mileage left in them? Is that *really* alpha? Or, rather, is that sector or sub-sector-specific beta?

The assumption that the benchmarks are appropriate ought to be nailed down head-on in any research significantly impacted by it (including Wermers' as well as Howard's response). I have serious doubts about manager performance relative to appropriate benchmarks. Based on the totality of research that I've reviewed, I could reasonably and (I believe) convincingly argue that the Three Stooges could have done as well as most managers against broad, generic (and irrelevant) benchmarks. The onus is and should be on the manager side of the table - and "benchmarking" assumptions need to be fully raked over.

Clearly, I don't trust the "benchmarking" gig that the mutual fund industry uses and that most researchers fail to properly address --- in which case resulting analysis is fundamentally flawed from the start. Lack of clarity on the part of the mutual fund industry in this area is irresponsible. Lack of clarity on the matter in the research domain is simply bad science.

Wouldn't it be extremely, extremely naïve to expect newer funds, on average, to do anything other than to perform "better" relative to *broad, generic index "benchmarks"* than those that are still hanging around after their area-specific (not necessarily benchmark) cyclical performance pendulum has swung away and the manager's Midas touch (surprise, surprise) just doesn't seem to work like it once did (maybe 60 months earlier)? Come on.

And to a substantial portion of the apparently vast pool of "skilled" fund managers, of which nearly any manager can claim to be a part (depending on what liberties are taken with the modeling and interpretive brush): a spade is a spade is a spade.

Advisor Perspectives has had some great (i.e., truly useful) reports over the last couple of months.

Best Regards,

The author of this letter asked to remain anonymous.