

Our Interview with Ken French

June 3, 2008



Kenneth R. French is the Carl E. and Catherine M. Heidt Professor of Finance at the Tuck School of Business, Dartmouth College. He is the author of numerous articles on investing, finance, and economics. He is perhaps best known for his work on the Fama and French Three Factor Model, which in 1992 demonstrated that small capitalization and value stocks offered higher historical returns, and the difference is attributable to additional risk. He is a consultant to Dimensional Fund Advisors (DFA), a money management firm with close ties to the academic community. He is also on DFA's board of directors and their Head of Investment Policy. His most recent [study](#), *The Cost of Active Investing*, quantifies the cost of active investing, relative to passive/index investing, in the US equity markets.

We spoke with Ken French on May 29, 2008.

What is the main point of your study?

Basically, all I am trying to do is quantify an argument made by Burton Malkiel, William Sharpe, John Bogle, and many others. As they point out, if one investor chooses to hold a passive market portfolio, the aggregate of all other investors' portfolios must be the market portfolio. Thus, before fees, expenses, trading costs, etc., both the passive individual's portfolio and the aggregate of everyone else's portfolios must deliver the market return. And as long as some investors in that aggregate portfolio pay the high fees and transaction costs of active investing (and we assume our passive investor does not suffer trading losses to the other investors), we can be sure the passive investor's net return is always higher than the value-weight average of all other investors. I measure how much higher. How much does the average investor give up when he or she tries to beat the market?

You found that between 1980 and 2006, the average investor gives up 67 basis points a year by not investing passively and that this percentage was relatively stable through time. In dollar terms, the total cost of active management was \$101.6 billion in 2006. Did you find either of the stability of the 67 basis points or the total cost in 2006 surprising?

The stability of the percentage is a surprising and interesting result. But it is also sensitive to a key assumption I made: the turnover in the passive portfolio is 10% a year. I think the 10% assumption is reasonable, but if I had



assumed a turnover of 5%, the percentage cost of active management would have increased over time.

The estimate of \$100 billion as the cost of active management is probably low, but I am trying to be conservative. I don't want someone to say I overestimated some small cost, and use that as a reason to throw out my overall conclusion. So I tried to include only the most defensible costs. I have received four emails challenging my results and all were from people in the investment industry who complained that my estimates were too low. I am happy with that outcome.

In the study, you ascribe the cost of active management to what society must pay for price discovery. In other words, the benefit society obtains from active management is that it allows the prices of public securities to be accurately determined by the market. But doesn't society also benefit in another way? 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?

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.

Your study shows that passive funds, as a percentage of open end mutual fund assets, grows from 1.0% in 1984 to (only) 12.4% in 2002 and remains at about 12.5% through 2007. Why do you believe individuals have not embraced passive investing?

With individuals, I think there are two dominant forces. First, people are unaware of the negative sum nature of the process. Many think if they work hard they should earn superior returns. In fact, there are lots of people working hard, competing for a bigger slice of the same pie. Obviously, they can't all win. In fact, on average they must lose, but lots of people do not recognize this.

Wall Street spends a lot of money promoting this misconception. Their basic message to investors seems to be that everyone can get rich through active investing. And the financial press reinforces that message. I understand that the press is just responding to market forces; who wants to read a column that reiterates the wisdom of passive investing when, for \$1.25, you can



discover the next Microsoft or the next Peter Lynch? But that does not mean the column about passive investing is wrong.

The second reason is overconfidence, which is one of the dominant biases identified by researchers who study individual behavior. In a noisy environment such as the equity markets, where feedback is poor, it is easy for investors to be overconfident about their own skills. If their decisions work out, they happily take the credit. If their decisions fail, they conclude they were unlucky.

When I talk with individuals about the negative sum nature of active investing, it is easy to identify who is confused and who is overconfident. Once they understand the argument, people who were simply confused say, "Oh, now I get it. How do I switch to passive?" Overconfident people react differently. Their response is, "Boy, aren't those other people dumb."

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 are wiser as to the negative sum consequences of active investing?

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.

DFA, the firm with which you are associated, follows an approach that is guided by (among other things) low transaction costs and low management fees. Have you encountered anything significant in the "real world," through your experience at DFA, which has conflicted with your academic views?

I have learned a lot while working with DFA, but have not found anything that is significantly inconsistent with what I learned from my academic work. I was not involved with DFA when they first started trading small stocks, in 1982. At the time, however, there was a general perception both at DFA and among leading academics who were involved with the firm that it would be expensive to trade small capitalization stocks. But David Booth, Rex Sinquefeld, and the other folks who were trading for DFA back then discovered that if they



were patient they could buy and sell small stocks effectively and efficiently. And they continue to do that today.

Do skillful active managers exist, and is it possible to identify them in advance?

This is an interesting question. Even though some of my academic colleagues might disagree, I am confident skillful active managers exist. But that raises two even more interesting questions. Can I identify them and can I earn a superior return by investing with them? Despite what Morningstar, much of the financial press, lots of folks on Wall Street, and many others in the financial industry would like investors to believe, it is very difficult to identify managers who are able to deliver superior returns with any consistency. There are two problems. First, security returns are so noisy it is hard to distinguish skill from luck. Second, as Berk and Green (Journal of Political Economy, 2004) point out, investors chase any evidence of managerial skill, investing more assets in funds that have had good returns. As the assets under management grow, the manager's expertise is diluted. In Berk and Green's model this dilution stops when the value added from the manager's expertise is just offset by the fees and expenses investors pay to own the fund. And that is basically what we see in the data. I can identify funds with reliably inferior returns, but I don't know how to identify funds with consistently superior returns.

Can you say how much of your own money is invested actively versus passively?

This is easy to answer – all of it is invested passively.

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