



*The following is in response to the debate on the role of luck versus skill among active managers. This debate was **summarized** last week.*

## **The Manager Skill Enigma**

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A large number of studies address the question of whether US equity mutual fund manager skill is sufficient to produce superior returns. At the gross return level the answer to this question is a convincing yes. A range of studies show that the average US equity mutual fund manager produces a positive risk adjusted alpha. But when management fees are taken into account, the answer is not so clear. Some studies conclude managers cannot cover their fees, reporting average fund alphas (risk adjusted and net of management and other automatically deducted fees) in the range of -50bp to -150bp. On the contrary, other studies use screens that identify funds which generate positive after the fact alphas. What is more, this superior performance persists over time. So why do some studies show superior performance and others do not? In order to unravel this enigma, it is important to understand the underlying assumptions as well as the institutional and economic realities affecting the link between manager skill and fund returns.

### **Life of Fund Studies**

The assumption underlying many large sample academic studies is that manager skill should reveal itself as a positive life of fund (LoF) alpha. These studies assume the skill-return relationship is constant over time and is not affected by changing institutional structure or the business cycle. The general conclusion of LoF studies is that there are very few managers who generate positive LoF alphas. This is discouraging for those looking for managers who can produce alpha over very long time periods.

The LoF assumption rules out the possibility that the relationship between skill and return is affected by a changing institutional structure or the business cycle. In many cases, the LoF approach is driven by the need for a large number of observations in order to demonstrate statistical significance. But if there is a



dynamic relationship between manager skill and fund returns, the LoF approach will not capture it.

### **Manager Skill, Institutional Structure, and Fund Returns**

The finding that not many managers are able to produce LoF alphas does not address the possibility that the relationship between skill and returns is a function of the institutional structure within which the manager operates. Thus while skill might be constant or even increasing over time (a plausible possibility as the manager gains experience), fund returns may actually decline over time due to ever more restrictive institutional constraints.

This might transpire something like this. The fund launches with a small staff and considerable investment freedom and is able to produce superior returns. As the fund attracts additional assets, employees are added and overhead expenses increase. Sales, marketing, and distribution become increasingly important. The asset manager is evolving from a small, innovative company to a large company focused on distribution, as happens in many industries. Investment performance, while still important, must share the stage with the increasingly important fund distribution efforts. Thus, as the asset manager grows in size, fund performance declines as business needs and their attendant constraints restrict the manager's ability to place active portfolio bets.

Is there evidence consistent with this story? Various studies reach the following conclusions:

- Funds that hug an index or stay in a style box underperform
- Funds that place active portfolio bets perform better
- Performance declines with the size of the fund
- Performance declines with the age of the fund
- Team managed funds underperform sole managed funds

As the asset manager grows, distribution becomes increasingly important and, since the Style Grid is widely used in the fund distribution system, the manager is asked to track an index or stay in a style box in order to increase acceptance in the marketplace. Staying in a style box restricts the manager's ability to place preferred portfolio bets since such bets may not be consistent with the new tracking error requirement. Both the size and age of the fund increase as the asset manager succeeds over time. Large funds often switch to team fund management from solo management because it is less expensive or they are unable to retain successful solo managers. All of these happen as the fund grows and, as a consequence, performance deteriorates.



Since these changes occur early in the life of the fund, the LoF alphas underweight the superior performance that exists prior to institutional structure changes. Thus LoF studies fail to capture these fund growth dynamics. They overweight the time period over which a manager is so constrained that he or she cannot pursue the strategy that made them successful in the first place. This does not mean that every fund fully experiences these changes, but it does say that an asset manager has to work very hard to not have these forces hurt long term performance.

### **Manager Skill, the Business Cycle, and Fund Returns**

It has been suggested that the relationship between skill and returns depends on the phase of the business cycle. The table below confirms this relationship:

<b>Returns vs. the Business Cycle</b>	
<b>(0 = Recession Year)</b>	
<b>Recession Year</b>	<b>Average Annual S&amp;P 500 Alpha</b>
-2	-9.32
-1	1.27
0	3.65
1	1.54
2	-0.67
3	-0.57
4	-2.54
5	0.05
6	-4.05
7	-5.72

Based on all US equity active open end mutual funds that existed in any month from Jan 1980 through December 2007, resulting in 482,443 fund/month observations. Fund returns are net of automatically deducted fees and are the average of the returns on all share classes that existed that month. Excludes index, allocation, mixed asset, and 529 funds. Actual alpha reported below is the average monthly return over all funds existing that month minus the S&P 500 return for that month, summed over the 12 months (Jan, Feb,..., Dec) to obtain the annual alpha.

Source: July 2008 Thompson data base



The highest alpha is recorded in recession years (1980, 1981, 1982, 1991, and 2000), with the years on either side (-1 year and +1 year) having the next highest alphas. It is interesting to note that the year before a recession has a positive alpha as compared to the negative alpha for two years prior, which means that an average alpha switch from one year to the next may foreshadow a recession. For example, in 1998 the average fund alpha was -13.1% but swung dramatically upward to 4.7% in 1999. The US experienced a recession in 2000. In the second and third years after a recession the average alpha is slightly negative and becomes more so as the recession recedes further into the past.

Manager skill produces the best returns around and during a recession or, said differently, manager skill is most beneficial during difficult economic times. This is because during such times there is a wide range of possible stock returns, some good and some poor, and so it pays to carefully analyze these possibilities before making an investment decision. During good economic times, on the other hand, the range of possible returns narrows and thus there is less reward for careful analysis. This means that if the economy is healthy, the argument for indexing is more convincing. On the other hand, if economic problems are expected, then active funds represent a superior investment. Since WWII the average business cycle has lasted roughly five years, with one year in recession and four years in expansion. If this is the pattern going forward, then active managers are the better choice. If, however, the business cycle lengthens, the argument in favor of indexing is strengthened. Based on the alphas reported in the table above, the business cycle would have to lengthen to an average of 8 years or longer, with a recession of no longer than 12 months, for indexing to become the superior choice.

### **The Manager Skill Enigma**

I have discussed how the relationship between manager skill and returns is impacted by changing institutional structure and the business cycle. As an asset manager succeeds and grows, it adds institutional constraints that hurt fund performance. These changes include staying in style box, reducing strong portfolio bets, growing larger and older, and switching from sole fund managers to team management. Manager skill produces the best returns during the difficult economic times experienced before, during and after a recession, and produces ever poorer returns as the recession fades into the past. These relationships are not visible in the results of LoF long term studies. Knowledge of these relationships, however, can help investors and advisors make better decisions with regard to investing in active equity funds and help unravel the manager skill enigma.

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