The New Ptolemains

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The following is in response to our article last week, When Will Objectivity Enter the Active v. Passive Debate?, by Dave Loeper.

In the early 16th century, the world of astronomy was on the verge of dramatic change. The Ptolemaic theory of a geocentric world was in constant need of repair. The path of the Sun, moon, and stars through the sky behaved as predicted, but those seven closer stars (we now know them as planets) did not (think of them as the anomalies of their day). As telescopes grew more powerful and the paths of the planets were measured with greater precision, Ptolemains responded by adding ever more epicycles in order to produce acceptable predictions. When Copernicus introduced his heliocentric theory in 1543, it was the beginning of the end for the geocentric theory and its many epicycle patches.

In today's world of investing, the accepted theory is that markets are informationally efficient and as a result managers are unable to add value. The earliest version of this theory was that a manager could not beat the stock market as a whole. But when evidence began showing up that those who bought small stocks with low PE's consistently beat the market, the new Ptolemains began adding their version of epicycles. Now a manager had to not only beat the market, but beat a subset of the market defined by the anomaly. When more anomalies were uncovered, more subsets were created. As does Loeper, many of the new Ptolemains have taken this to the extreme, adding dozens of US equity manager subsets (Loeper has 31!). The epicycles did not disappear, they mutated into equity subsets!

Equity Market Subsets

Breaking the market into fund subsets, based on portfolio characteristics, makes little sense for creating performance benchmarks. To explain why, let's focus on the widely accepted manager characteristic based subsets of large-cap value, large-cap growth, small-cap value, and small-cap growth. The first question one might ask is why these particular subsets? The reason is that research beginning in the 70's revealed that small capitalization stocks outperformed large stocks and low PE stocks outperformed high PE stocks even after adjusting for risk. This meant that a manager who bought small, low PE stocks could beat the market, or so it seemed at the time. In 1984 the first 2 x 2 manager "style grid" was introduced and the subset-ing of the manager market began. To understand what this means for performance evaluation, consider the 1982 – 2007 average annual returns for the S&P 500 and the four style indices shown below (Source: December 2007 Zephyr data base).

	VALUE	GROWTH	
LARGE-CAP	14.93	13.18	**14.05**
SMALL-CAP	15.33	10.25	**12.79**
	15.01	**12.59**	
	S&P 500	**14.19**	

A manager's performance is compared to one of the four style benchmarks, depending on how categorized, rather than to the market. Let's say a manager is categorized as a large-cap value manager (more about the problems associated with this process later). Then to be considered successful, a manager would have to earn a return greater than 14.93% rather than 14.19%. What happens to the 74bp difference between the style and market benchmarks? The manager does not get credit for it because the performance benchmark has been increased by this amount. From an investor standpoint, this only makes sense if the additional 74bp is a reward for risk or if the investor can easily capture the additional return on their own. Neither of these hold up in light of the evidence

First, there is no agreement on whether the extra returns to size and PE are rewards for risk or simply a mispricing opportunity. So we really cannot say the 74bp is compensation for risk. Second, there are a number of problems with the investor picking up this return on their own. You will note in the table above that over this 26 year period large-cap outperformed small-cap stocks, just the opposite of what the initial research showed. So, is there a small firm or large firm effect? We need to know this to tilt the portfolio in order to earn this additional return. In terms of the so called value premium, a January 2007 study by Phalippou found that it disappears for those stocks largely held by institutions (93% of market capitalization). This means that the PE related value premium is unavailable to fund managers. So if there is no consistent size effect and no value premium, how can an investor or advisor go about picking up the 74bp through long term portfolio tilting? The answer is they can't.

How about placing short term style bets rather than executing a long term portfolio tilt? Here the evidence is not very encouraging. The general conclusion is that managers have stock picking skill but no style timing skill. If the fund managers cannot style time, then how likely is it that investors or their advisors can? Instead, why not allow managers an opportunity to capture, indirectly, this premium through their stock picking rather than taking it away by changing benchmarks. This is quite different from the current practice of saying, after the fact, the manager did well, not because the strategy was successfully pursued, but because the portfolio was tilted towards large-cap value stocks and they happen to do well. The moral is don't "Monday morning quarterback" the manager if you are unable to pick up the additional return yourself.

Problems with Categorizing Managers based on Portfolio Characteristics

So if the 74bp is not a reward for risk and the investor or the advisor cannot easily earn this additional return by tilting the portfolio or placing short term style bets, then why change the manager's benchmark from the S&P 500 to large-cap value? There is no good reason for such a decision. In fact, there are a number of residual problems that are created by categorizing managers based on portfolio characteristics.

Managers are categorized using portfolio holdings or style index returns. But what does this tell you about the strategy being pursued by a manager? The answer is little to nothing. Shouldn't a categorization system help you better understand the management process? But it is worse than this. Since many investment organizations use style designations for organizing and selling investment products, there is a strong motivation for the manager, once classified, to avoid drifting into another category. Thus is created the conflict between staying in a style box and consistently pursuing a strategy. Unfortunately, many managers choose the former to the detriment of performance. I and others, including Wermers, have documented the decline in performance resulting from a manager hugging an index or staying in a style box. This is the categorization system getting in the way of what a manager should be doing, relentlessly pursuing a well defined investment strategy.

Considering all of this, it begs the question why market cap and PE? There are hundreds of characteristics that could be used to categorize funds. For example, why not categorize funds based on their holdings' average ROE and earnings yield? The answer is there is no logic. It used to be argued that market cap and PE be used because they had a long term return advantage. But the recent evidence mentioned above throws this argument in doubt. But any portfolio characteristic will run into the same categorization problems as do market cap and PE. So it is time to look elsewhere for a way to think about managers.

Focus on Strategy Instead

Based on research conducted over the last five years, a better way to think about managers is the strategy they are pursuing. Once each manager has been strategy identified, it is possible to form meaningful peer groups. The advantage to this approach is that the manager self-declares a strategy and thus is free to pursue it without having to worry about fitting into a style box. Focusing on strategy avoids the conflict between doing what is right for your investors and doing what is right for selling your products. The manager can then be compared to a homogeneous peer group rather than to an arbitrary style box which always contains managers pursuing a variety of strategies and thus is a questionable basis for creating a benchmark. Focusing on strategy also provides insight into what the manager is doing, unlike the opaque style boxes.

Finding Successful Active Managers

I was a firm believer in indexing for the first 25 years of my academic and investment career based on the evidence that was available at the time. But my research over the last five years and the growing literature regarding the existence of manager skill and persistence has convinced me that indexing is now a second best alternative. It was only after the research began portraying a changing picture that Craig Callahan and I formed our company AthenaInvest in 2005. I am sure that Loeper feels just as strongly about the research underlying his firm.

One of the defenses put up by the new Ptolemains when evidence of manager skill pops up is to create additional subsets on which to build portfolio characteristic performance benchmarks. I have already described the problems with the best known of these benchmarks, those based on market cap and PE. So it makes you wonder if these subsets are introduced as way to counter the manager skill evidence rather than as a way to better understand the investment process. It is possible to introduce enough subsets to wipe out evidence of manager skill even as little is added to our understanding of how to pick managers. Is this what Loeper has done?

So how do you find successful active managers? We believe that the starting point is first to identify the strategy being pursued by the fund. Then within that strategy peer group, identify the successful active managers using objective measures. Our resulting carefully researched, patent pending system is called Strategy Based Investing. Based on our research and the research of others, we believe that it is possible to build better performing portfolios of successful active managers who are pursuing successful strategies.

Finally, past returns are a noisy signal for identifying skilled managers. A manager who has produced good returns could just be lucky rather than skillful. That is why it is important to consider aspects other than long term performance when building a portfolio of active managers. Those who bring other aspects beyond returns into the equation, such as Surz and Loeper, are moving in the right direction. We also go beyond returns when identifying successful active managers.

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