Passive Versus Active Management

Based on the differences between passive and active investing styles, it might appear that active management should easily beat passive results.

But, based on comparative research, the reality is much less clear.

Today, we will look at a few studies and see what they recommend.

First, a quick caveat. I tend to to be a little cautious with individual studies as often data can be massaged to reflect the outcome desired by the researchers.

For example, if I looked at U.S. equity returns, as represented by the S&P 500, for a 3 year period, I might find that their performance is fantastic, mediocre, or terrible. It all depends on the 3 year blocks that I choose.

The 3 year period of 2003 (28.7%), 2004 (10.9%), and 2005 (4.9%) makes it appear that equities provide excellent returns. However, the 3 year period from 2007 (5.5%), 2008 (-37.0%), and 2009 (26.46%) is less promising. And the 3 year period from from 2000 (-9.1%), 2001 (-11.9%), and 2002 (-22.1%) suggest that U.S. equities should be avoided.

So when looking at data always consider who is preparing the study, whether they may have a hidden agenda, and maintain a healthy degree of skepticism.

In this blog, I prefer not to review technical research. It can be quite dry and a little too complex for easy explanations. But in this post, I want to look at some third party studies before I give you my own views on passive versus

active management.

The Case For Active Management

“Can Mutual Fund “Stars” Really Pick Stocks? New Evidence from a Bootstrap Analysis”

Kosowksi, Timmerman, Wermers, and White authored “Can Mutual Fund “Stars” Really Pick Stocks? New Evidence from a Bootstrap Analysis” in the *Journal of Finance* vol. 61, no. 6 (Dec 2006).

I like this study as it covers a decent sample size and a long time period. The authors examined 1788 open-end U.S. domestic equity mutual funds that operated for 5 or more years between the period of 1975 to 2002.

They found that there were more top-performing managers than would have been expected simply from the inherent variation of the fund’s returns. Further, the better results of these top managers continued in future periods.

This indicated to the authors that there were certain managers with superior skills and that their results were not simply the result of luck.

A positive in the debate as to whether active management is better than passive.

“When Active Management Shines vs. Passive”

Jane Li of Fundquest issued “When Active Management Shines vs. Passive: Examining Real Alpha in 5 full market cycles over the past 30 years” in June 2010.

Fundquest’s sample was extremely impressive, both in number of funds reviewed and time period. They “analyzed 31,991 U.S. domiciled non-index mutual funds in 73 categories representing over $7 trillion of assets as of February 28, 2010.”

“Mutual funds were analyzed for the period of January 1, 1980

to February 28, 2010. Every fund's behavior pattern and performance was analyzed for 5 full market cycles…"

Fundquest found that there are advantages and disadvantages to both passive and active management, depending on the particular market segment and phase of the economy.

"We found that, after adjusting for risk, active managers in general generated higher risk-adjusted returns than their passive benchmarks in bull markets, and lower risk-adjusted returns than their passive benchmarks in bear markets."

"We also found that, on average, equity and allocation categories tended to add value in bull markets and detract value in bear markets. Conversely, fixed income categories tended to add some value in bear markets. Municipal bond and alternative categories in general were not found to add much value in either market environment."

"Of the 73 categories in our study, we recommended a bias to active management in 23 categories, a bias to passive management in 22 categories, and deemed 28 categories to be neutral (no bias)."

A bit of a mixed bag as to when active outperforms a passive strategy. In some areas, and at some times, active management may outperform passive. At other times, and in other market segments, passive was the preferable strategy.

Also of note in their findings was four things of interest with respect to active management.

One, the longer a management team was in place, the higher the probability of outperforming the benchmark. This should make some intuitive sense. If a manager or team does not perform well, changes are made.

Two, the lower the expenses, the greater the probability of outperformance. The greater the costs, the harder it is to

achieve superior performance on a net basis. Not surprisingly, this is a major argument for passive strategies.

Three, the lower the volatility of the portfolio as measured by the standard deviation, the greater the probability of outperformance.

Four, the higher the outperformance in the previous market cycle, the greater the probability of outperformance in the next cycle. This meshes nicely with the Koswoski etal. findings above. Namely that top performance should continue in future periods.

Based on their findings, Fundquest believes that a combination of active and passive approaches should be utilized. In those categories and economic conditions that favour active management, active should be used. In the other circumstances, passive management should be followed.

Again, a positive for active management in certain situations.

The Case Against Active Management

“Reflections on the Efficient Market Hypothesis: 30 Years Later”

Burton G. Malkiel authored “Reflections on the Efficient Market Hypothesis: 30 Years Later” in the *Financial Review* vol. 40, no. 1 (February 2005).

The author assesses the returns of actively managed mutual funds versus benchmarks and index funds. A relatively small sample is examined, although the time frame is long.

Over short periods, the author found that some actively managed funds performed well but that there was no consistency of fund performance over the long run.

In one year results for 2003, “73% of the actively managed large-cap equity funds obtained from Lipper Analytical

Services had after-expense returns lower than the S&P 500 Index. For periods longer than 10 years, more than 80 percent of the funds failed to meet this benchmark. Returns from all equity mutual funds indicated that actively managed funds underperformed index funds by more than 200 bps over 10- and 20-year periods. The weaker performance of active funds was a result of higher expenses and trading costs."

No surprise as to his reasons for the underperformance of actively managed funds.

The author differs as well from the other studies as to whether good performance persists in future periods.

"Good performance by a fund in one period does not indicate good performance in the following period. The 20 top-performing funds during 1996–1999 beat the market by more than 50 percent. During the following four years of 2000–2003, these funds earned a return of –15.1 percent compared with –5.41 percent for the Vanguard 500 Index Fund and –5.34 percent for the S&P 500. Even the Morning- star four- and five-star funds did not perform as well as the Wilshire 500 Index over time."

The author found "similar results for international and global markets. More than 80 percent of the European equity funds and European global equity managers performed less well than MSCI benchmarks over the 10-year period ending in 2002. Even in relatively inefficient small-cap and emerging markets, active funds did not outperform their benchmarks."

Based on this study, it does not appear that an active management style is useful in outperforming the markets. A plus for passive management.

"False Discoveries in Mutual Fund Performance: Measuring Luck in Estimated Alphas"

In 2005, Barras, Scaillet, and Wermers authored a paper

entitled, “False Discoveries in Mutual Fund Performance: Measuring Luck in Estimated Alphas”.

They looked at “1,456 U.S. open-end equity funds between 1975 and 2002” and assessed whether any fund outperformance versus the market (an investor’s or manager’s “alpha” in investing terminology) was based on skill or simply luck.

And yes, they managed to quantify luck as a component of performance. And no, I cannot explain it in a sentence or two.

“Using a large cross-section of U.S. domestic-equity funds, we find that 76.6% of them have zero alphas. 21.3% yield negative performance and are dispersed in the left tail of the alpha distribution. The remaining 2.1% with positive alphas are located at the extreme right tail.”

That is, only 2.1% of the funds reviewed were able to demonstrate that their managers outperformed the markets based on skill.

Based on this study, the ability to use active management, as opposed to pure luck, to outperform the market is quite poor. Another argument for passive investing.

Conclusion

You can look up these papers and read all the supporting evidence and conclusions. There are a multitude of other studies out there to peruse as well.

They might be of interest, but typically they bog down in very complex formulas and theory.

I think that if you do read a lot, you will come to one conclusion.

While there are many studies that claim active management can outperform passive, I would say that more find passive the better approach, on average, statistically.

What do I think is the better approach?

I will share my own thoughts next.