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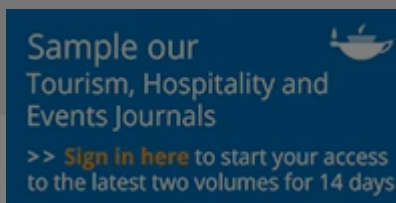
PORTFOLIO MANAGEMENT

# Portfolio Constraints and the Fundamental Law of Active Management

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Pages 48-66 | Published online: 02 Jan 2019

 Cite this article  <https://doi.org/10.2469/faj.v58.n5.2468>



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## Abstract

Active portfolio management is typically conducted within constraints that do not allow managers to fully exploit their ability to forecast returns. Constraints on short positions and turnover, for example, are fairly common and materially restrictive. Other

constraints on portfolio management include constraints on the benchmark, the composition of the portfolio, and the performance of the portfolio. These constraints are often generalized and can be thought of as "management to the constraints of the benchmark." Examples of constraints include constraints on the composition of the portfolio, constraints on the performance of the portfolio, and constraints on the management of the portfolio. These constraints are often generalized and can be thought of as "management to the constraints of the benchmark." Examples of constraints include constraints on the composition of the portfolio, constraints on the performance of the portfolio, and constraints on the management of the portfolio.

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The expected value added in an actively managed portfolio depends on both the manager's forecasting skill and the manager's freedom to take appropriate positions in securities that reflect those forecasts. The “fundamental law of active management” gives the maximum expected value added for an actively managed portfolio based on the forecasting ability of the manager and the breadth of application. The fundamental law does not, however, address the impact of portfolio constraints on potential value added. Constraints such as no short sales and limits on security concentration impede the transfer of information into optimal portfolio positions and decrease the expected value added.

We generalize the fundamental law of active management to include a transfer coefficient as well as an information coefficient. The information coefficient measures the strength of the return-forecasting process, or signal, and the transfer coefficient measures the degree to which the signal is transferred into active portfolio weights. The transfer coefficient turns out to be a simple scaling factor in the generalized fundamental law and is an intuitive way to measure the extent to which constraints reduce the expected value of forecasting ability. In an ideal world without any constraints, a well-constructed portfolio has a transfer coefficient of 1.0 and the original form of the fundamental law applies. In practice, managers often work under constraints that produce transfer coefficients ranging from 0.3 to 0.8. The transfer coefficient suggests why performance in practice is only a fraction (0.3 to 0.8) of what is predicted by the original form of the fundamental law.

Measuring the impact of portfolio constraints on active weights through use of the transfer coefficient. The transfer coefficient is a measure of the extent to which constraints reduce the expected value of forecasting ability. In an ideal world without any constraints, a well-constructed portfolio has a transfer coefficient of 1.0 and the original form of the fundamental law applies. In practice, managers often work under constraints that produce transfer coefficients ranging from 0.3 to 0.8. The transfer coefficient suggests why performance in practice is only a fraction (0.3 to 0.8) of what is predicted by the original form of the fundamental law.





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