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Active Management in Mostly Efficient Markets

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Abstract

This survey of the literature on the value of active management shows that the average active manager does not outperform but that a significant minority of active managers do add value. Further, studies suggest that investors may be able to identify superior active managers (SAMs) in advance by using public information. Investors who can identify SAMs should be able to improve their overall Sharpe ratio by including a meaningful exposure to active strategies.

Our review of academic studies of active management has produced the following findings and recommendations:

- Active returns across managers and time probably average close to zero, net of fees and other expenses. This finding is what we should expect in a mostly efficient

market, in which fierce competition among active managers drives average (net) active returns toward zero in equilibrium. By keeping markets efficient, however, active management provides a critical function in modern capitalist economies: Efficient, rational capital allocation improves economic growth and leads to increased wealth for society as a whole.

- Thus, to keep the competition fierce, the rewards to superior (as opposed to average) active management must be rich indeed, as in fact they are—for both the manager and the ultimate investor. Superior managers earn high fees and often share in their added value, whereas inferior managers are soon bereft of both clients and fees. Investors who engage active managers can earn positive alphas with modest additional risk on a total portfolio basis (i.e., an attractive incremental return–risk ratio). But this benefit comes at a cost—the risk that active returns may prove negative and lead to lower terminal wealth.
- Investors can lessen this risk by using some of the research we discuss in the article. In particular, studies suggest that investors may be able to identify superior active managers (SAMs) ex ante by considering (1) past performance (properly adjusted), (2) macroeconomic correlations, (3) fund/manager characteristics, and (4) analyses of fund holdings. We suspect that using a combination of these approaches will produce better results than following any one approach exclusively.
- Active management will always have a place in “mostly efficient” markets. Hence, investors who can identify SAMs should always expect to earn a relative return advantage. Further, this alpha can have a substantial impact on returns with only a modest impact on total portfolio risk. Finding such managers is not easy or simple—it requires going well beyond assessing past returns—but academic studies indicate that it can be done.


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