Financial Analysts Journal ›
Volume 67, 2011 - Issue 6

728 Views | 51 CrossRef citations to date | 8 Altmetric

Portfolio Management

Active Management in Mostly Efficient Markets

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Pages 29-45 | Published online: 30 Dec 2018

Cite this article https://doi.org/10.2469/faj.v67.n6.5

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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,
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