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Active Share and Mutual Fund Performance

Equity Investments

Active Share and Mutual Fund Performance

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Abstract

Using Active Share and tracking error, the author sorted all-equity mutual funds into various categories of active management. The most active stock pickers outperformed their benchmark indices even after fees, whereas closet indexers underperformed. These patterns held during the 2008–09 financial crisis and within market-cap styles. Closet indexing has increased in both volatile and bear markets since 2007. Cross-sectional dispersion in stock returns positively predicts performance by stock pickers.

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exposure to systematic risk. Active stock pickers take large but diversified positions

away from the index. Funds that focus on factor bets generate large volatility with respect to the index even with relatively small active positions. Concentrated funds combine very active stock selection with exposure to systematic risk. Closet indexers do not engage much in any type of active management. A large number of funds in the middle are moderately active without a clearly distinctive style.

Focusing on closet indexing, I started by looking at examples of different types of funds and then examined two famous funds in detail. I also investigated general trends in closet indexing over time and the reasons behind them. I then turned to fund performance, testing the performance of each category of funds through December 2009. I separately explored fund performance in the financial crisis of January 2008–December 2009 to see whether historical patterns held up during this highly unusual period. Finally, I tried to identify when market conditions are generally most favorable to active stock pickers.

I found that closet indexing has been increasing in popularity since 2007, currently accounting for about one-third of all mutual fund assets. Over time, the average level of active management is low when volatility is high, particularly in the cross-section of stocks, and also when recent market returns have been low, which also explains the previous peak in closet indexing in 1999–2002.

The average actively managed fund has had weak performance, losing to its benchmark by –0.41%. The performance of closet indexers is predictably poor. They largely just match their benchmark index returns before fees, and so after fees, they lag behind their benchmarks by approximately the amount of their fees. Funds that focus on factor bets have also lost money for their investors. However, one group has added value for investors: the most active stock pickers, who have beaten their benchmarks by 1.26% a year after fees and expenses. Before fees, their stock picks

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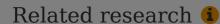
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Cross-sectional dispersion in stock returns positively predicts benchmark-adjusted returns on the most active stock pickers, suggesting that stock-level dispersion can be used to identify market conditions favorable to stock pickers. Other related measures, such as the average correlation with the market index, do not predict returns equally well.

Author's Note: This article was written when the author was a finance professor at the NYU Stern School of Business.



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