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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 c tperformed
their ber formed.
These pa ap styles.
Closet in . Cross-
sectiona k pickers.

Should a the answer
is no. A naged fund
loses e managers
are not
manage ent types of
active m formance.

I divided e Share,
which m mostly
exposur 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 j ees, they
lag behi nds that
focus on group has
added v their
benchm ock picks
have ev t of skill.
High Ac p funds, but
its p atistically
significa

The fina
underpe erns were
similar t er the crisis
period b n.

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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