Active Management: What Are You Paying For?

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If you want market returns, buy the market. There's no shortage of exchange-traded funds (ETFs) that provide you with low-cost exposure to a wide variety of market indices. Known as passive products, these are great for investors who want to do no worse, and no better, than the market.

If you want to beat the market, look to active management. There are plenty of opponents of active management who point to statistics and studies which show that the majority of managers underperform the market(s) in which they invest. While there are some flaws with these studies, my purpose here is not to ignite a debate over whether active or passive management is the way to go (there's more than enough dialogue on the topic out there already).

The fact is, if you want to beat the market, active management is your only option. So, if you fall into the active camp, make sure that you're giving yourself a fighting chance of beating the market. How? By owning funds that don't look like the market.

It seems intuitive that active managers would seek to beat the market by building portfolios that look different than the market. However, with investors' obsession on short-term performance, managers are becoming more reluctant to deviate their portfolios too much from the index. If their 1, 2 or 3-year numbers look bad relative to the market, investors head for the exits.

This has led to "closet indexing", i.e. actively managed funds that closely resemble the index they're trying to beat. For example, if Royal Bank's weight in the S&P/TSX Composite Index is 6%, managers who don't want to be caught offside if the stock has a good run will add the bank to their fund in roughly the same proportion. If the stock goes up, they'll reap the same rewards. If the stock goes down, they won't look so bad because the market will fall as well. It's the safe way out.

When you add the oftentimes high fees of active management to a closet indexing approach, the manager has little or no chance of beating the market.

How prevalent is this (closet indexing) phenomenon? A study last year published by two professors from the Yale School of Management suggests that it is becoming all too common. In their paper titled, *How Active is your Fund Manager? A New Measure that Predicts Performance*, the researchers conclude that a good portion of actively managed mutual funds (in the U.S., at least) closely mirror an index. They point to a ratio known as Active Share, which (along with tracking error) they use to measure how actively managed a fund really is. Active Share is simply the fraction of a portfolio that is different from the benchmark index.

The Yale researchers also found that Active Share significantly predicts fund performance. They concluded that funds with the highest Active Share more often outperform their benchmarks both before and after expenses, while shares with the lowest Active Share underperform.

The good folks at Yale aren't alone in suggesting that there is a marked trend in convergence toward the index among active managers. Bob Krembil, the co-founder of Trimark (now retired) and a prominent figure in the industry, echoes this sentiment. In a February interview with *National Post* columnist Jonathan Chevreau, Mr. Krembil noted, "Managers have all become closet indexers and not just in Canada. The whole industry has become about how far you are from the benchmark, under or overweight [certain sectors]. It's a stupid way to run money." And he knows a thing or two about beating the market. When he was at the helm, his Trimark Fund was a consistent outperformer.

This closet indexing trend goes a long way in explaining why active managers seemingly have a poor record of beating the index.

Back to my original point. If you want to beat the market, you have to own funds that don't look like the market. How do you know if you're paying for legitimate active management? There are a number of simple measures you can take to determine if you're getting what you're paying for, or if your fund is really just a closet indexer.

First off, by their very nature, funds that concentrate their assets in a limited number of stocks (e.g., 30-40) are bound to look different than the market. They don't own a lot of the companies that are in the index, and they likely

have meaningful positions in the ones they do own. Funds that own a vast number of stocks are far more likely to look like an index.

Second, look at the sector breakdown of a fund. If it closely matches that of the index, it may very well be replicating that index. Comparing a fund's market capitalization breakdown to that of the index can also be a useful indicator.

Third, look into any constraints that may be placed on the manager. This can be difficult to determine, but if you speak to a representative from the fund company, they should be able to provide you with this information. Some fund mandates are surprisingly inflexible. It is not uncommon to find that a manager may be required to invest a fund's assets in the same sectors that comprise the index, plus or minus a few percentage points. For example, if the energy sector makes up 30% of the S&P/TSX Composite Index, the manager may be required to invest no less than 25% and no more than 35% of her fund's assets in energy stocks (i.e., plus or minus 5%). Or, if Manulife makes up 5% of the index, she may be required to hold a position in the stock of at least 3%, but no more than 7% (plus or minus 2%). To steal a line from Mr. Krembil, this is a stupid way to run money. If the manager doesn't like energy stocks, she shouldn't be required to invest a large portion of her fund in them. If she doesn't like Manulife, she shouldn't be required to own it at all. These types of constraints only serve to bring a manager more closely in line with the index.

Finally, look at the manager's track record. Annualized returns can be misleading, but if a manager produces annual returns that consistently look like those of the index, chances are pretty good that they don't want to stray too far from the index.

Since funds that don't look like the market don't perform like the market, investors should be prepared for periods of divergent returns (which can be extreme). Again, this is what scares managers. Short-term underperformance often leads to money leaving the door, which leads to fewer assets under management, which leads to lower bonuses…you get the picture. Managers who stick to their guns will go through periods when they underperform the market, but if they're proven, astute stock pickers, they'll more than make up for it in periods of outperformance. Bob Krembil, Sir John Templeton, and Warren Buffett come to mind, although there are many others who fit this bill.

I'm a steak fan. If I go to Hy's or Ruth's Chris and order a medium-rare fillet, I want a medium-rare fillet. If it comes to me under or over-cooked, I'll send it back. It's not what I'm paying for. If you're paying for active management and you're being sold a closet index fund, you should do the same. Send it back. It's not what you're paying for.

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