Active Management

Active management[1] exposes investors both to beta risk (that is, market risk) and to alpha risk (that is, deviations from the market that the active manager takes.) Beta return (or market return) is what we see in the newspapers every day. For instance, the S&P 500 is thoroughly tracked by the Wall Street Journal and many other publications. Beta risk is easily assumed and beta return is easily obtained for very low fees. Vanguard, Fidelity and others have S&P index funds (among other indices) available, no load, for a total cost in the range of 0.15% to 0.3% annually. Information on alpha return (or manager contribution) is not generally available, and is difficult to obtain, except in certain instances. Alpha return is what you are paying extra for when you hire active management. Reliable information on alpha return is generally available only from those active managers that have their results audited to AIMR standards (or after 2005, to GIPS standards.) Beyond professional consultants, these are the only sources that might have both the requisite procedures and the reliable data necessary to make good statistical estimates segregating alpha risk and return from beta risk and return in an actively managed portfolio.

Investors employing active managers would expect that those managers would do better than the market, or that they would take less risk than the market or that they would do some combination of the two. Why would investors pay those managers anything otherwise? These investors would also expect that those managers would produce alpha return in sufficient quantity to pay the extra fees involved, and investors would expect some leftover alpha return for themselves. The conundrum that underlies this logic is that the weighted average alpha return of all market participants is zero – before fees are paid. Skillful investors will take alpha return away from other, less skillful, investors. This makes sense because the markets are capital allocation mechanisms. The economy runs off of price signals created by the markets, and skillful investors are skillful because they have a knack for anticipating what is next. Investors, using active managers that cannot demonstrate positive active alpha return in excess of their fees, face a foggy future.

There are many skillful managers. However, even they can only elude luck with time. These skillful managers have to contend with luck because they are anticipating and interpreting events, not controlling them. In the short run, it is very difficult to distinguish between luck and skill, good or bad. Time averages luck out of the equation, and skill will tend to dominate. For this reason, less than five years of data has almost no significance. Beyond ten years, data assumes significance with time if the important operating factors (modus operandi, personnel, etc.) remain constant enough[2]. Style, while popular in recent decades, is not significant to all active managers and need not be significant to investors[1]. Active alpha return is born of skill, not of style. There are many academic studies extolling the benefits of style and allocation. Many of these studies, however, deal with the entire market – a zero active alpha proposition and are associated with achieving beta return, before fees. Skillful managers will want to emphasize their skill by distinguishing their own contribution from the beta risks and returns invariably present in their client's portfolios.

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Investors should avoid focusing on the rate of return histories of skillful managers – or of any manager for that matter. Although when good, those histories are what we all want for ourselves. There are simply too many exogenous variable factors that we can't know while attempting to anticipate the future. Past performance really does not guarantee future results, good or bad, even with skillful management. Statistical risk characteristics, including active alpha, are more likely to be a better 'fingerprint' of the skillful active manager. Investors should focus there, attempting to understand where that manager's value lies, attempting to match their own risk tolerances with that manager's methods, as well as attempting to gain some confidence that active alpha returns will flow their way regardless of what environment awaits them. Investors also need to keep cost in mind in order to give active management a chance on their behalf. Investors with total costs (the total of fees, fund expense ratios and commissions) exceeding 1.0% annually need to reconsider what they are doing, because skillful active management is easily available in the 0.5% to 0.9% total cost range – varying inversely with account size. Taking these steps will significantly improve your chances of having a desirable long term record to reflect upon.

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1. The logic here follows the framework of M. Barton Waring in "The Dimensions of Active Management" AIMR Conference Proceedings Improving the Investment Process through Risk Management, 2003, No. 4.
2. This assumes the absence of long tail risks – short option strategies, and the like, come to mind.

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