Spotlight on Active Management:

Finding Superior Active Managers

Superior managers do exist. We know how they behave and what they look like.

Research in behavioral finance over the last two decades suggests that superior managers do exist. We see how superior managers behave, we know what they look like, and we believe we know how to find them.

In 2002, University of Maryland professor Russ Wermers found that constraining managers to boxes defined by price/earnings ratio and market capitalization costs about 300 basis points a year in performance. In other words, a manager pursuing a rigid investment strategy should not refrain from purchasing his or her best ideas when those best ideas do not fit in one style box.[1] Cremers & Petajisto reported that higher Active Share is associated with higher returns, with Active Share being the percent of the portfolio that is different from the portfolio's benchmark index.[2] Yakov Amihud and Ruslan Goyenko at NYU found the same results but came at it from a different direction by measuring a fund's correlation with an index.[3] Low correlation proved to be associated with superior performance. Finally, R.B. Cohen, at Harvard, reported that the typical fund manager had superior stock selection abilities and could even rank their best ideas, but held too many stocks. 'Productive' best ideas dropped off at about 40 stocks.[4] Worded differently, Cohen's findings suggest you don't want a manager's 65th or 75th "best" idea.

ICON has been involved in additional research that has categorized managers into ten very different investment strategies, where a strategy is defined by how a manager goes about selecting stocks. Before categorizing a manager by strategy, we first determine what elements a manager uses to select stocks. Some managers may use P/E, economic forecasting, profitability ratios, etc. Our research supports the conclusion that the fewer elements used by the manager, the better his or her performance.[5] This finding suggests superior managers are focused. In the course of our research, we learned what stocks each manager was holding in pursuit of his or her strategy. A manager holding stocks typical of other managers pursuing his or her same strategy is also associated with superior performance.[6]

Putting all of this research together, we believe we know how superior managers behave. They are not constrained to boxes. They are willing to have a portfolio that looks different from an index, resulting in low correlation. They are focused, evaluating and considering only a few elements. They hold concentrated portfolios of just their best ideas, usually 40 stocks

At the opposite end of the spectrum, there are active managers who aren't focused, who hold too many stocks, are constrained by some limitation like a style box and who, perhaps inadvertently, hug an index. These managers and their funds are included in studies of average mutual fund performance and usually drag down overall performance of the mutual fund industry, much to the delight and benefit of those promoting passive investing.[7]

So much has been written about passive investing these days that advisers and their clients may overlook the body of research that champions active management. Superior managers do exist. We believe we know how they behave and what they look like. Therefore, we believe we can identify them.

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Price/Earnings Ratio (P/E) is the price of a stock divided by its earnings per share.

[1]Wermers, Russ. 2002. .A Matter of Style: The Causes and Consequences of Style Drift in Institutional Portfolios. Working Paper, University of Maryland, July.

[2]Cremers, Martijn and Antti Petajisto, 2009. How Active is Your Fund Manager? A new Measure that Predicts Performance. Review of Financial Studies, September.

[3]Amihud, Yakov and Ruslan Goyenko, 2008. Mutual Fund's R2 as Predictor of Performance. Working paper, NYU, December.

[4]Cohen, R. B., C. Polk, and B. Silli, 2009. Best ideas. Harvard Working paper. March.

[5]Howard, C. Thomas, 2010. The Importance of Investment Strategy, University of Denver. March.

[6]Id.

[7]Id.

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