Column

According to Vetter

Are active managers really active?

The influx of index funds and European Return Funds (ERFs) are breaking record after record, so it's time for active fund managers to demonstrate their added value. But how do you measure objectively – i.e. not simply on a cost and return basis – whether an active manager really is active?

Investors are increasingly asking active managers to demonstrate their active share. Active share has emerged as a criterion for measuring the level of activity of a fund manager and managers who are in charge of an active mandate. This is an improvement on traditional criteria, such as the tracking error. But does active share have a predictive value too?

Active share provides insight into the extent to which managers diverge from their benchmark. The index has an active share of 0. Therefore, an active share of 80 means that 80% of the holdings in a fund diverge from the index. The higher the active share, the greater the divergence is. Because it looks at the individual positions in the fund, active share provides a better indication for measuring the effect of a fund manager's active management than can be obtained from the tracking error alone. The two criteria are complementary.

In 2009 researchers Martijn Creemers and Antti Petajisto (Yale University) categorised active managers on the basis of active share and tracking error, varying from diversified stock picks (with the highest active share), concentrated stock picks, and factor bets to closet indexing (lowest active share).

This categorisation gives an indication of the extent to which managers are truly active but it says nothing about performance. In particular, 'closet indexers' – popularly known as index huggers – have been under pressure recently. These are funds that purport to follow an active investment policy but, in practice, more or less follow the index while charging the higher fees for active management. In Sweden this recently led investors to bring a class action against one of the country's largest fund providers because it had been selling a fund 'under false pretences' for years. The Netherlands Authority for the Financial Markets (AFM) recently announced an investigation to interrogate closet indexers amongst others.

Reliable indicator?

The research by Creemers and Petajisto showed that funds with a consistently high active share over a long period outperformed their index. Their conclusion was that "A high active share adds value." This was a reason for some active fund managers to publish their active share, so that they could demonstrate their added value vis-à-vis index funds and tempt investors.

The research caused considerable controversy. Proponents of active investment finally had an argument to defend themselves against the fierce criticism from passive funds. However, recent investigations present a more balanced picture.
Yes, a high active share can outperform the index but there is no guarantee that it will. Some studies have in fact shown that the managers with the highest active share were completely unable to outperform the index over a given period and even performed worst of all the aforementioned categories. There were various reasons for this.

For example, the market (index) a manager tried to outperform made quite a difference. The stock exchanges in London and Latin America are dominated by banks, oil companies and mining companies. When these sectors underperform, managers with a high active share do well in these markets.

In an index with a wide spread, such as the S&P 500, in which no single company or sector is dominant, even managers with the highest active share appear to have difficulty outperforming the index. In small and concentrated markets, managers with a high active share appear to do significantly better than closet indexers. Information about the active share is therefore useful but has no predictive value.

Transparency is key

Active share is an important criterion but certainly not the only one that should be used for the selection and ongoing evaluation of an active fund manager. It provides no indication of the extra return that can be expected and isn't a constant over time and across markets. You have to see it as an extension of cost transparency and investment management and risk management reports. The added value of active share is that besides providing insight into costs it also creates insight about what is being paid for (i.e. the level of activity) and what it yields (i.e. the level of outperformance). Above all, it provides you with valuable information to assess active investment against passive investment on the basis of facts. Measurement leads to understanding.