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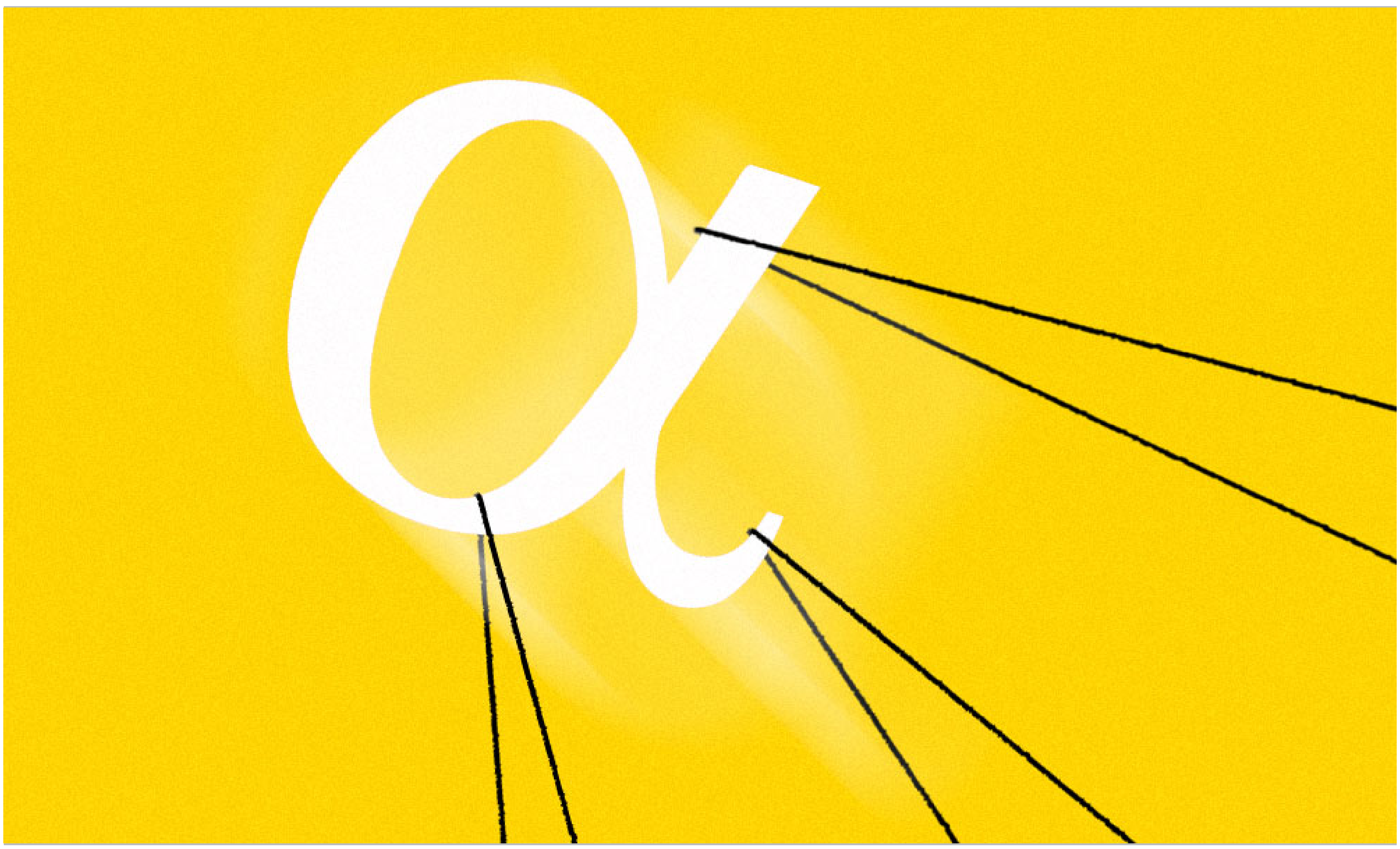
The ‘Genetic Defect’ in Active Management

Active managers produce a surprising amount of alpha. Most end up squandering it.

By Julie Segal October 18, 2019



(Illustration by II)

Active managers can produce persistent excess returns when it comes to their best ideas — but they only devote half of their capital to these investments. The result has been a shredding of the industry as investors have moved to passive index funds, according to new CFA Institute research.

research.

“We have discovered a genetic defect in active management as an industry,” said Alexey Panchekha, founder of Turing Technology Associates, who oversaw the study. “That has caused 10 years of underperformance and, if it’s left untouched, the next 10 years will be the same.”

The research evaluated manager conviction, or the level of a managers’s commitment to to a subgroup of stock picks in the portfolio. The CFA Institute will be hosting an industry discussion of the results later this year.

Panchekha found that so-called high-conviction overweight positions, if treated as a stand-alone fund, outperform their benchmarks 83.7 percent of the time during rolling one-year periods, before fees. After accounting for a theoretical 85 basis point fee, the high conviction ideas had a 74.2 percent success rate. The research relied on a daily analysis of stock holdings in more than 100 actively managed U.S. equity mutual funds representing about $2 trillion in assets.

Active managers’ other stock picks generated negligible alpha, according to the study. “Active fund managers do, in fact, have stock selection skill – although it is limited to their high conviction overweight positions,” the report stated.

The average active manager diluted this alpha with other investments by about half. According to the study, the best ideas averaged about 55 percent of the overall portfolio weight. The rest of the portfolio acted as anchor that diluted excess returns.

[*II* Deep Dive: Where Active Managers Should Dominate, They’re Flopping]

“To use a sports analogy, this is the equivalent of an NFL football team voluntarily taking their superstar quarterback out of the game after the first half,” the study concluded. “It is safe to say, that is not a winning strategy.”

In an interview with *II*, Panchekha noted that active manages under-allocate to “the only source of value they have.”

“They produce a huge amount of value but only in one place,” he said. “That is what makes this finding so important.”

The findings “defies at least some long-held views that managers can improve performance throughout the entire stock selection and portfolio construction process,” the report stated. Active managers have historically created highly diversified portfolios as a risk management tactic. But the approach is putting active managers permanently in the penalty box.

The solution, according to Panchekha, is to diversify across managers, rather than add positions that won’t add value. If a retirement plan or asset manager merged the best ideas of six to 12 portfolio managers, the end investor would get the necessary diversification without the drag of positions that no one has faith in, he said.

Still, Panchekha cautioned that he deliberately focused only on active managers’ best ideas, not risk management. Maybe that’s the theme of a future paper.

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