Rekenthaler Report

The Argument That Fund Managers Are Improving

By John Rekenthaler | 03-07-14 | 08:00 AM | Email Article

The Bad Old Days

After an intermission sponsored by PIMCO, back to unpacking a recent academic claim that younger fund managers are better than veteran managers.

The logic chain begins with the assumption that mutual fund investors are rational. They recognize and invest in skillful managers. Unfortunately, their sound decisions do not lead to above-benchmark results. The many fund investors who have similar, rational ideas overwhelm mutual funds with their incoming assets, thereby chasing away fund managers' profit opportunities.

The original argument, discussed in the first column of this series, was that funds struggle to incorporate new assets because they become bloated. They can't purchase some securities that they once were able to own; their trading costs rise as their buy/sell orders become large enough to begin to move the market's price; and they can't trade as frequently as they would like.

The revised version, covered in the second column, is that the effect occurs mostly at the industry level, not the fund level. The issue lies less with fund bloat and more with the sheer mass of smart money, as represented by skillful fund managers, chasing the same investment ideas. By this notion, the flood of money into actively managed mutual funds has made the stock market depressingly efficient.

Let's explore that idea further.

The paper, "Scale and Skill in Active Management," measures what percentage of the U.S. stock market is controlled by actively managed U.S. stock funds. Thus, the paper does not directly address all types of mutual funds, but rather only those that invest mainly in U.S. stocks. (Presumably, though, the authors believe that their findings also tend to hold for other fund categories.) That seems a wise decision, as domestic-stock funds may be only a single segment, but they are a very large, homogenous segment.

Implicitly, the approach takes the growth in U.S. stock mutual fund management as a proxy for all the growth in all professional management. Surely U.S. stock mutual fund managers do not behave differently from the managers of balanced and world mutual funds (who also purchase domestic equities), or from collective investment trust managers, separate-account managers, hedge fund managers, variable-annuity managers, and so on. Wherever fund types they run, these managers pursue similar investment ideas. Following the theory advanced by the paper, they should be equally effective at squeezing the excess returns out of profitable trades.

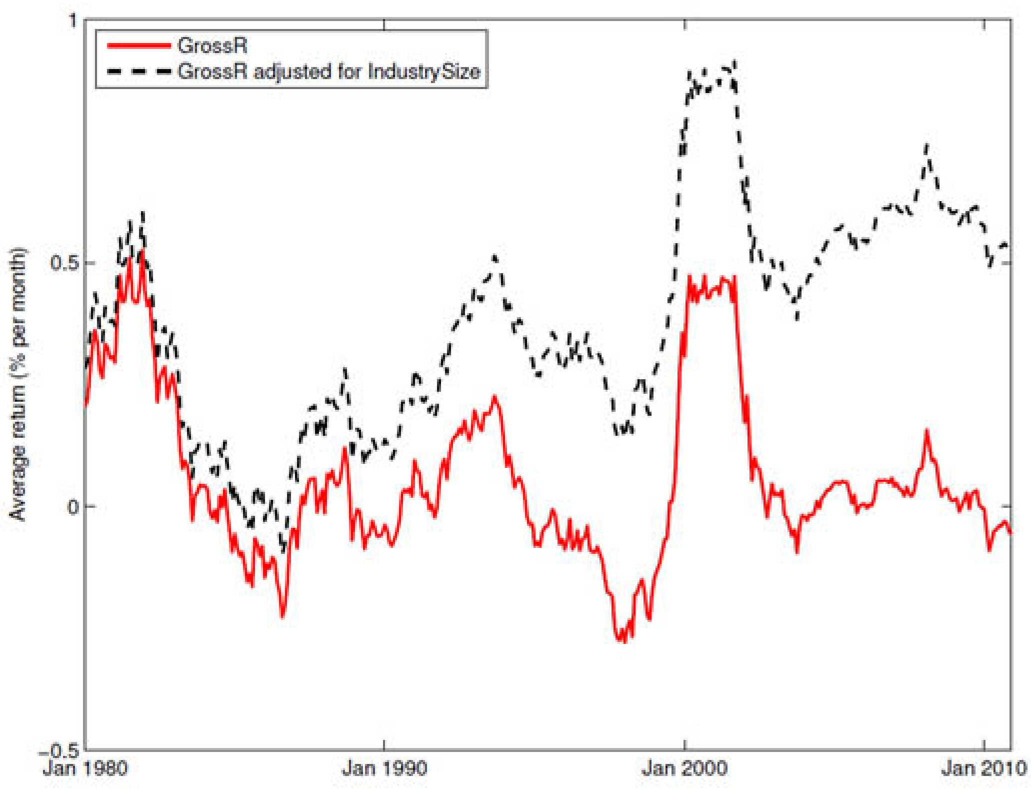
Is the growth of active U.S. stock mutual fund management an accurate proxy? I can't find a figure for the total change in active management, across all fund types, but I suspect that the answer is yes for the past two decades. Since the early 1990s, the growth in actively managed U.S. equity mutual fund assets has been modestly above the growth of the overall stock market. That likely mirrors what has occurred with other fund types.

The 1980s and early 1990s, however, are another matter. Assets in U.S. stock mutual funds grew twentyfold from 1981 through 1994. At that time, mutual funds were gobbling market share from other forms of professional management--particularly as institutions were beginning to embrace indexing. Thus, mutual funds clearly grew faster than did overall professional active management. How this affects the authors' results is not clear, but it is worth noting.

Let's turn to the findings. The paper looks at the universe of actively managed U.S. stock mutual funds, adjusted for survivorship and excluding very small funds with asset bases of less than $15 million, from 1979 through 2011. For each fund, the authors calculate its gross return by adding its expense ratio back to its performance. (Investors, of course, receive net return rather than gross return, but as the authors wish to measure manager skill, gross return is appropriate.) The fund's gross return is then compared against that of the relevant index assigned to its category by Morningstar, over a rolling two-year period. A positive figure means that the fund's manager showed "alpha" in that the fund's gross returns were higher than that of the index. A negative number, of course, indicates the opposite.

The results are shown below. The red line indicates the industry average.

Average Fund Returns Over Time



- source: "Scale and Skill in Active Management"

Two items to note.

First, little has changed over the past 30 years. At the very beginning of the chart, when the fund industry was tiny, the average fund manager showed alpha according to the paper's calculations. Since the early 1980s, though, the results have been a wash. Sometimes the average has been below, sometimes above, but overall it has hovered near zero. Managers in aggregate show neither positive nor negative alpha. This fits with the theory that investors squeeze the profitability out of active managers' trades by giving mutual funds more money than the trades can handle.

Second, there is substantial fluctuation in the red line. While it's possible that portfolio managers got smarter and then dumber and then smarter again, it's more likely that the fluctuation captures imperfections in the measurement process. Category indexes are not perfect matches for the funds that they benchmark. The indexes may contain somewhat larger companies, or smaller firms, or more technology stocks, or a variety of other differences. These systematic differences can be captured as indicators of manager "alpha."

The issue is not unique to this paper; it occurs wherever manager alpha is estimated, including in Morningstar's research. In such an exercise, humility is warranted; our tools can at times be clumsy.

You probably are wondering about that black line. That is the authors' estimate of what alpha active managers would have delivered had the industry remained at its 1979 size. The thesis is that the professional investment management has become harder because of increased competition. Thus, if the swimmers are recording the same time that they were 30 years ago but are now doing so while swimming against a much faster current, they must be stronger swimmers than in the past. Their recorded speed as measured by performance versus a benchmark is the same, but, adjusted for the current, they are flying. The black line represents the adjustment.

On Monday, I'll talk more about how the authors arrived at that black line, about their estimates of the differences between the top and bottom managers, and--finally!--about this series' starting point, whether younger managers are superior. The message for today, though, is that perhaps the good old days never were. Perhaps today's fund managers are better than ever before--but are underappreciated because their degree of difficulty is not apparent.

John Rekenthaler has been researching the fund industry since 1988. He is now a columnist for Morningstar.com and a member of Morningstar's investment research department. John is quick to point out that while Morningstar typically agrees with the views of the Rekenthaler Report, his views are his own.

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