Why Do Active Investment Managers Struggle So Much To Beat The Index?

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This is a question making headlines around the world. Recent reports indicate that, in the United States, eight out of ten large cap fund managers failed to bet the index in 2014. Closer to home, only 15% of South African unit trust managers, benchmarking the All Share index, were able to outperform this index, over the past 6 and 12 months.

Whilst there is much debate on this issue, conclusive answers are hard to come by. However, most analysis tends to focus on the following:

- **Markets are becoming more efficient** – if this is the case, the search for undervalued or mispriced stocks becomes more difficult. The index provides the average return of the market and in efficient, well traded liquid markets, the index is hard to beat with any consistency.

- **Indices are becoming more representative** – more and more indices are being calculated. Not only simple market capitalisation indices, but also indices designed to mirror investment strategies, valuation techniques and composite investment models. Accordingly, the active manager is finding it hard to justify using entirely inappropriate benchmarks to measure their performance.

- **The investment industry is consolidating**- institutional investors dominate the large economies and the major markets. Because of their size, such investors typically stick to large capitalisation, highly liquid stocks, but these counters are equally represented in the indices. The bigger you get, the harder it is to outperform the index.

- **Short-term Volatility** - markets move up and down regularly, often reacting to exogenous events from the other side of the world. Forecasts, assumptions and models can be made obsolete overnight. The active asset manager should react to these changing circumstances if they are true to their interventionist management philosophy and policies. But, just as soon, markets can revert back to the mean. The passive manager, with their index tracking products, like ETFs, sit out this short-term volatility and reap the benefits of saving on portfolio churn and other costs.

This volatility also affects the performance of individual active fund managers. An S&P Dow Jones Study in mid-2014, found that of the 697 US funds that were in the top quartile of the various categories in March 2012, only 3,78% were still there two years later. This massively backs the case for sticking to the market average return of the index tracking manager.

- **Costs** - any number of studies in the USA and elsewhere indicate that low cost funds typically beat the performance of high cost funds, particularly over time. Active management, of course, costs more than passive management. Expensive asset managers, researchers, risk managers and other specialists are required by the active manager in their quest to find the elusive value in the markets.

  By contrast, the passive manager can replicate the index with the right software and a few people and "commoditise" the average return of efficient markets.

  Can the active managers bring down their costs? To some extent this seems possible, but high costs seem sticky in many developed markets. Most active managers prefer to spend more on marketing, promotions, moving to new or less specialised markets, sponsorships, etc. Often the aim is to persuade the investment community that the large institutional manager offers more than just performance and that investment management has some qualitative elements, like intellectual superiority, honesty, integrity and other "soft" factors.

Have active managers given up on pretending they can beat the average return of the market, or the index trackers, many of them seem to have done so.