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Is Active Management Getting Harder?

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In a word, yes.

The data are clear. Our year-end 2016 SPIVA® U.S. Scorecard, e.g., showed that 66% of large-cap mutual funds underperformed the S&P 500 in 2016.[1] Results were even worse for mid- and small-cap managers. Nor were 2016 results unusual—in the 15 years we've produced SPIVA, active managers beat the S&P 500 only three times. Moreover, when active success has occurred, it has tended not to persist. Our Persistence Scorecards demonstrate that an investor has a better chance of flipping a coin and getting four heads in a row than he does of identifying a fund manager who will be above average four years in a row.[2]

Successful active management is obviously difficult, and there are two reasons to suspect that it may become even harder.

First, **there is no natural source of outperformance (or, in technical jargon, "alpha").** One investor can earn a positive alpha only if some other investor earns a negative alpha. Successful (or lucky) active managers, in aggregate, can only produce positive alpha if less successful (or unlucky) managers endure negative alpha, and the aggregate value of the winners' gains is exactly offset by the losers' underperformance. Since trying to earn alpha costs more than passive management, whether the quest is successful or not, it's not surprising that most active equity managers typically underperform a passive benchmark; nor is it surprising that passive management has consistently gained market share relative to active management.

But what happens when passive management gains share? Where do the passive assets come from? If some active managers are more skillful than others, and their skill is manifested in outperformance, then presumably it is the least skillful

[1] Soe, Aye M., and Ryan Poirier. "SPIVA U.S. Year-End 2016 Scorecard," April 2017. http://spindices.com/documents/spiva/spiva-us-year-end-2016.pdf.

[2] Soe, Aye M., and Ryan Poirier. "Does Past Performance Matter? The Persistence Scorecard." June 2017, http://spindices.com/documents/spiva/persistence-scorecard-june-2017.pdf. Poirier, Ryan, and Aye M. Soe. "Fleeting Alpha: Evidence From the SPIVA and Persistence Scorecards." February 2017, http://spindices.com/documents/research/research-fleeting-alpha-evidence-from-the-spiva-and-persistence-scorecards.pdf.

active managers who lose the most assets. In that case, the existence of a passive alternative raises the quality of the surviving active managers, thus contributing to market efficiency.[3] By reducing the number of potentially underperforming active managers, indexing makes it harder for those who remain.

Second, a new generation of index-linked products makes it possible to **indicize strategies that were formerly the exclusive preserve of active managers**. Smart beta or factor indices provide exposure to a wide range of attributes which investors may find attractive. Consider, e.g., an active manager who historically has tilted away from his or her cap-weighted benchmark in a systematic way (perhaps by emphasizing value, or small size, or low volatility). The manager's clients have had no way of disentangling how much performance is attributable to factor tilts and how much is attributable to stock selection beyond the factor. Now, factor indices make it possible for the client to access the factor, without paying for a manager's stock selection, and to do so transparently and at low cost. Thus smart beta may also make life more challenging for active managers.

SPIVA tells us that most active managers underperform most of the time; the growth of both cap-weighted and factor-based passive investing suggests that the future of active management is likely to be just as grim as its recent past. Of course, what is true across the population of active managers does not mean that individual managers cannot be exceptions. Indeed, managers like Warren Buffett and Peter Lynch are famous because their performance was exceptional. If most active managers could outperform consistently, we wouldn't celebrate the few who do.

[3] Note, though, that increasing the ability of the average manager doesn't translate to outperformance for the average manager's clients – a conundrum first noticed by Charles Ellis (in "The Loser's Game," https://www.cfapubs.org/doi/pdf/10.2469/faj.v51.n1.1865) more than 40 years ago.