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True Active Management Works

By Robert C. Lawton, AIF, CRPS, President, **Lawton Retirement Plan Consultants, LLC**

Many experts believe that it doesn't make sense to invest in actively managed mutual funds. They say there is not a substantial enough difference between the returns that index and actively managed funds generate to justify active managements higher fees. I believe that true active management still works. It is just a matter of screening out those actively managed funds masquerading as index funds -- the closet indexers.

Recently, Antti Petajisto, former NYU assistant professor and now vice president for BlackRock's multi-asset strategies group and Yale Professor Martijn Cremers authored a paper which introduced the mutual fund management concept of "active share". Active share can best be described as the extent to which managers deviate from the allocations within a funds benchmark. For example, if a fund manager decides that Apple has become overvalued and underweights the stock and decides to overweight Google, this will create a deviation from the funds benchmark. Greater deviation results in a higher active share value.

Active share is different from a similar benchmark deviation measure called "tracking error". Tracking error is meant to represent deviation from a benchmark that is undesirable (e.g. a manager who strays into another asset class to grab returns, resulting in style drift). Active share intends to report benchmark deviation that is a result of management actions to create additional alpha. This is just the sort of fund management activity that investors feel they are paying for with an actively managed fund.

As reported by Michael Finke in his article "Why Hyperactively Managed Funds Outperform", the percentage of passively managed fund assets has risen from about 10% in the mid 1990s to about 50% now. The article goes on to explain that only about 20% of these fund assets are held in pure index funds -- the other 30% are held in actively managed funds that essentially hug the benchmark. These are the so-called closet indexers. Historically, closet indexers have not performed well enough to justify their active management fees.

Finke adds that the other half of mutual fund assets are invested in funds whose asset holdings deviate substantively from their benchmark. Finke says that these are the fund managers who identify stocks or sectors they believe are undervalued. In other words, they try to do something. Mutual funds with active share values of 80% or greater have been shown to consistently beat their benchmarks by more than 1.50% (net of fees).

Although active share is not currently a measure being widely reported by data services, the concept can be roughly approximated by using R-squared and upside/downside capture. Actively managed mutual funds having an R-squared value close to 100% and upside/downside capture rates close to 100% are also closet index candidates.

Active management works, provided you screen out those active managers who are really index huggers. You may have developed your own method of screening out closet indexers. If so, I would enjoy hearing what has worked best for you.

About the Author

Robert C. Lawton, AIF, CRPS is the founder and President of Lawton Retirement Plan Consultants, LLC. Mr. Lawton is an award-winning 401(k) investment adviser with over 30 years of experience. He has consulted with many Fortune 500 companies, including: Aon Hewitt, Apple, AT&T, First Interstate Bank, Florida Power & Light, General Dynamics, Houghton Mifflin Harcourt, IBM, John Deere, Mazda Motor Corporation, Northwestern Mutual, Northern Trust Company, Trek Bikes, Tribune Company, Underwriters Labs and many others. Mr. Lawton may be contacted at ***(414) 828-4015*** *or* ***bob@lawtonrpc.com****.*

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