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Resolving the Dichotomy between Investors and Managers about Whether Active Management Beats the Index

Jeffry Haber
(Accounting Department, Iona College, USA)

Abstract: In looking at the question of whether US Equity managers can outperform a relevant benchmark, a previous paper discussed the dichotomy of views between investors and managers. This paper tries to reconcile the divergent views and understand why each group believes what they do. The previous paper provided evidence for both views (managers could not outperform an index on an annual basis, but did provide a cumulative return that exceeded the cumulative index return). Now I take the cumulative return and consider the entry date into the fund in order to see if it matters to an investor whether then they became an investor in the fund. 84% of the Large Cap Core funds outperformed their index over the entire 11 history. At the other end of the time spectrum, only 41% of the funds outperformed the index on a cumulative basis over the last 3 years of the span (entry date of 2009). This might help explain the divergent views—investors would enter a fund based on the recent success of the fund; however, the possibility of their obtaining a cumulative return that was greater than then index declines substantially. This explains how managers can point to their cumulative return over their 11 history as superior to the cumulative index return, but this is not experienced by investors late to the party.

Key words: investing; active investing; passive investing; benchmarks
JEL code: G11

1. Introduction

In a previous paper[1] I looked at whether US Equity managers were able to beat their benchmark (which was usually a broad, appropriate index, so the terms "benchmark" and "index" are used interchangeably in this paper). I used a data set[2] that covered 11 years (2001 through 2011, inclusive). The data set provided the appropriate benchmark for each manager, and across a given strategy there was usually a prevalent benchmark. The prevalent benchmark was applied against all managers within a given strategy.

Some funds were in existence for all 11 years; others entered after 2001 and therefore had a shorter history. A snapshot of the data set is provided in Table 1.

I then compared the annual return for each fund against the index return for each year. Below (Table 2) is the number of funds beating the index by year (those funds with at least 6 years of history).

Jeffry Haber, Ph.D., CPA, Professor of Accounting, Hagan School of Business, Iona College; research areas: accounting. E-mail: JHaber@iona.edu.

[1] "The failure of equity managers to beat their benchmark: Lord, is it I or is it the benchmark?", *Journal of International Business Management and Research*, Volume 4, Issue 11, pp. 122-129.

[2] PNS Monitor, which included 1,551 funds that had at least $1 billion under management across 9 strategies.

Table 1 Snapshot of Data Set

	Large Cap			Medium Cap			Small Cap		
	Core	Growth	Value	Core	Growth	Value	Core	Growth	Value
Total sample size	258	235	285	67	129	128	118	148	183
	S&P 500	Russell	Russell	Russell	Russell	Russell	Russell	Russell	Russell
Benchmarks		1000	1000	Midcap	2000	2000	2000	2000	2000
		Growth	Value		Growth	Value		Growth	Value
Number of funds with a history of:									
11 years	152	155	182	34	78	74	65	101	123
10 years	20	8	12	3	4	3	9	3	5
9 years	13	10	15	4	6	11	7	4	12
8 years	8	10	22	0	10	6	4	2	10
7 years	13	11	11	6	5	4	7	8	4
6 years	16	12	12	6	15	8	8	12	7

Table 2 Number of Funds Beating Their Index

	Large Cap			Medium Cap			Small Cap		
	Core	Growth	Value	Core	Growth	Value	Core	Growth	Value
11 Years	2	0	0	0	0	0	0	0	0
10 Years	0	0	0	0	0	0	0	0	0
9 Years	0	0	0	0	0	0	0	0	0
8 Years	0	0	0	0	1	0	0	0	0
7 Years	0	1	0	0	0	0	1	0	0
6 Years	0	0	0	0	0	1	0	0	0

By looking at Table 2 it is not difficult to understand why investors say that US Equity managers cannot consistently beat their benchmark. The results seem indisputable. But why do the managers say that they do beat their benchmark? As I worked with the data and considered the divergent views (which was not the focus of the original paper), I realized that having an annual return exceed a benchmark is not the ultimate goal of the manager. For instance, I imagined a scenario where I presented this data to a manager and he or she responded:

> "So, if my fund beat the index by 80% each year for 10 out of 11 years, and in the one year it did not beat the benchmark it fell short by .01%, your paper would view that as a failure and not include it above. Do you think the investor would be happy or not?"

This imagined conversation was compelling—I do believe the investor cares a lot about cumulative returns, and in answer to the question of the fictional manager, the investor would be happy, extremely so. So I went back to the data and calculated the cumulative returns for the funds against the cumulative returns of the respective indices. I looked at the funds with 11 years of history. The results are shown in Table 3.

Now the narrative took an interesting turn. The funds with 11 years of history overwhelmingly provided a cumulative return that exceeded the cumulative return of the index. This is the point at which my last paper left off, and where this paper now picks up.

Table 3 Managers that Provided a Compounded Return Greater than the Index

	Large Cap			Medium Cap			Small Cap		
	Core	Growth	Value	Core	Growth	Value	Core	Growth	Value
Total number of managers	152	155	182	34	78	74	65	101	123
Number of managers exceeding the index	128	121	145	27	54	57	61	80	111
Percentage	84%	78%	80%	79%	69%	77%	94%	79%	90%
Number of managers not exceeding the index	24	34	37	7	24	17	4	21	12
Percentage	16%	22%	20%	21%	31%	23%	6%	21%	10%

2. Theory

Based on the comparison of the annual returns of a fund versus an index on a year-by-year basis, investors feel that managers do not beat their benchmark. Based on cumulative returns, the managers feel that they do. Hence the dichotomy in opinion between managers and investors that this paper is trying to resolve. But a question, which leads to the approach this paper will take, is that the investors have the same return information as the managers, meaning that they possess the annual return information contained in Figure 2 as well as the cumulative information contained in Figure 3. As reasonable people, why don’t they weigh the cumulative returns above the annual comparisons as managers do? In answer to the imagined conversation I posed before, I believe that the average investor would agree with the manager. Yet the investors I know would acknowledge the data and still feel that managers fail to beat their benchmark.

If the investor did not have access to the cumulative returns, or if there was reason to believe that the investor would not attribute the same weight to the cumulative returns, we could dismiss the dichotomy as resolved—it results from the investors and managers having different world views. But I contend that this isn’t the case—the managers and investors have similar world views. So it was back to the drawing board.

After considerable thought, I realized that the difference might stem from different longevities—the manager cares about the fund for its entire existence, whereas the investor cares about the fund only for as long as they are an investor. Perhaps the dichotomy arises because not all investors were clients of the fund for its duration, and therefore the cumulative return over the duration does not apply to them. Stated another way, if I was a client of a fund for the 11 years it has history, then the cumulative return over the 11 years versus the benchmark is relevant to me. But if I joined the fund at some point during the 11 year history, then the cumulative return over the 11 years is not relevant to me, only the cumulative return over the period of time I was an investor. So, if there happened to be a terrific first year, so great in magnitude that it masked the failings of the other 10 years, the only investor who would be satisfied on a cumulative basis would be the investor that was in the fund for the entire 11 years. Everyone else would be disappointed, and hence the dichotomy is again on the table for discussion.

3. Methodology

I decided to deal with one strategy (large cap core), and only those funds with the complete 11 years of history. This provided a sample size of 152 funds. We know that the cumulative return for 128 of the 152 funds exceeded the 11 years cumulative return of the index, providing a success rate of 84%. Conversely, 24 funds failed to provide a cumulative return that exceeded the cumulative return of the index, providing a failure rate of 16%.

I then calculated the cumulative returns over shorter periods. I calculated the cumulative return an investor would have received had they entered the fund at the beginning of 2002, and calculated the index over the same period. I found that an investor that entered the fund in 2002 would have had a success rate of 84% (based on the cumulative return of 127 out of 152 funds exceeding the cumulative index). This provided the same success rate as the 11 year history. I then repeated this exercise, each time assuming an entry date of one year later. The results are shown in Table 4.

Table 4 Success Rate with Varying Entry Fund Entry Dates

	Year of entry into the fund:								
	2009	2008	2007	2006	2005	2004	2003	2002	2001
Number of funds beating index	63	95	107	102	114	120	116	127	128
Number of funds not beating index	89	57	45	50	38	32	36	25	24
Success rate	41%	63%	70%	67%	75%	79%	76%	84%	84%
Failure rate	59%	38%	30%	33%	25%	21%	24%	16%	16%

Based on Table 4, it looks as though entry date does matter. If an investor entered in the fund in 2001, then 84% of the funds would have provided an 11 year cumulative return that exceeded the cumulative index return. An investor that entered in 2009 would have a 41% chance of selecting a fund that produced a cumulative return that exceeded the cumulative return of the index over the same period. This is less than half of the funds that have the 11 year track record.

A graph of the success rate is shown in Figure 1.

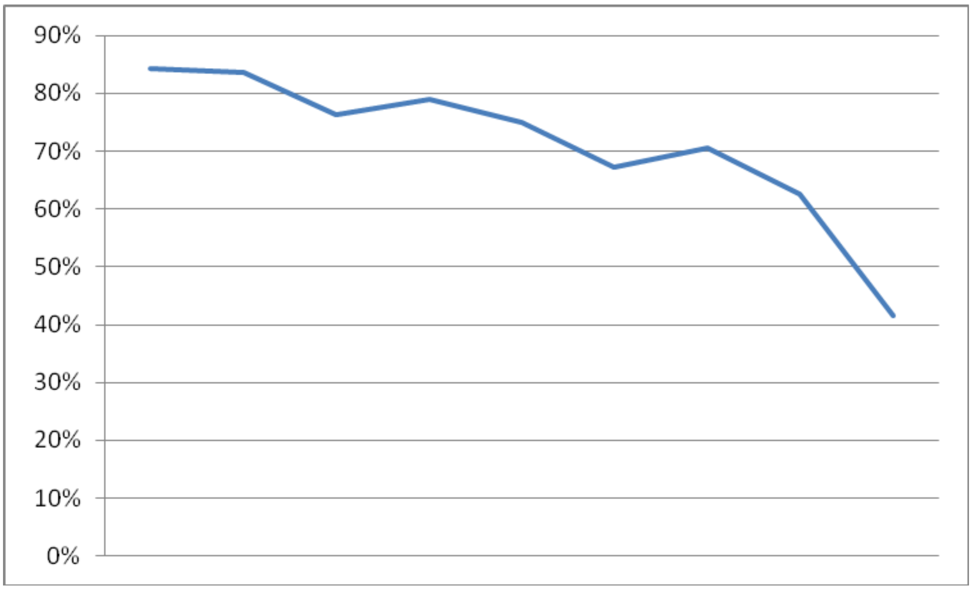

Figure 1 Graph of Success Rate Entry Date 2001 to 2009

Less than half the funds provided a cumulative return from 2009 through 2011 that exceeded the cumulative index return calculated over the same period. This is quite different than the experience of those that were in the fund in 2001 or 2002, when 84% of the funds would provide a cumulative return that exceeded the cumulative return of the index. Without knowing the number of clients each fund had in each of the years (as well as the number of new investors in each year), there is no way to know for sure whether the number of clients were evenly spread over the years. It is not a stretch to think that the number of new clients was increasing, based on the success of the fund, but that is speculation. In any case it does appear that clients who were early into funds would have a different opinion compared to those that entered later.

4. Conclusion

This paper tried to reconcile the divergent views of investors and fund managers about whether active managers can outperform a relevant index. A previous paper provided evidence that supported both sides (managers failed on an annual basis to outperform an index, but succeeded by providing a cumulative return over the history of the fund that exceeded the cumulative index return). This paper looked at whether the year you entered the fund would alter your opinion. Using the funds in the Large Cap Core strategy that had 11 years of history, it was calculated that 84% of the funds produced a cumulative return that exceeded the cumulative index return, but this steadily decreases to 41% for those that would have invested starting in 2009.

Future research could apply the methodology from this paper to the other strategies to see if similar results appear. Depending on whether there is enough of a sample size, future research might also use a population of funds that had less than 11 years of history.

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