

When active investment management and costs collide...



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Active investment management is appealing, at least in theory – appointing financial experts that will be managing your hard-earned monies and who will make the tough decisions allocating it according to their best views to maximise returns through time, given your pre-determined risk profile (tolerance and capacity). For that service money managers charge you management and transactional fees, and often “outperformance” fees - sometimes masqueraded in different forms and shapes, but at the end it all boils down to the same thing – it will detract from your portfolio returns over time. That nett return may still be good, like above-average, but chances are that “heavy” investment cost burdens will dump you in the below-average spectrum over time.

Investment managers typically measure themselves against some sort of pre-determined benchmark – which is often calculated assuming no costs (management and transactional) – thus, managers’ performance must overcome their cost hurdle first, before comparing themselves with a selected benchmark. Alternatively, they may compare themselves with their peers operating in the same investment categories. But some managers are structurally more expensive than others – either by choice/design or perhaps they are managing smaller pools of monies, hence higher operational costs. Thus, there are “expensive” managers and “simple fee” managers. We know in the real world we mostly pay up to acquire top-quality goods and services, but it is much less sure whether the same “rule” applies or should apply in the investment world!

The bottom line is while many managers would like us to focus on their expertise and investment processes as a proxy for their skill and the definite reason why you should make use of their services, costs do matter in the final analysis. It’s not the same as buying a sports car and then complaining about the high insurance costs or fuel consumption of the car afterwards – you should have known about those things beforehand, but the utility (thrill of the car’s performance) you derived from driving this vehicle may overrule its running cost concerns, therefore you keep it. Thus, in the driver’s mind the joy of driving exceeds the costs thereof. In the rational investment world, however, the only thing that matters to investors is simple: what returns accrued nett of all fees to their investment accounts – in fact, there are not a positive and negative side that can be weighed up against each other, but only one side to it and one outcome.

Theory...

Let's examine the underlying theory of active investment management a bit (not too much, otherwise it will frighten the casual reader into a state of bewilderment!) to understand how active investment management can derive value from the investment market.

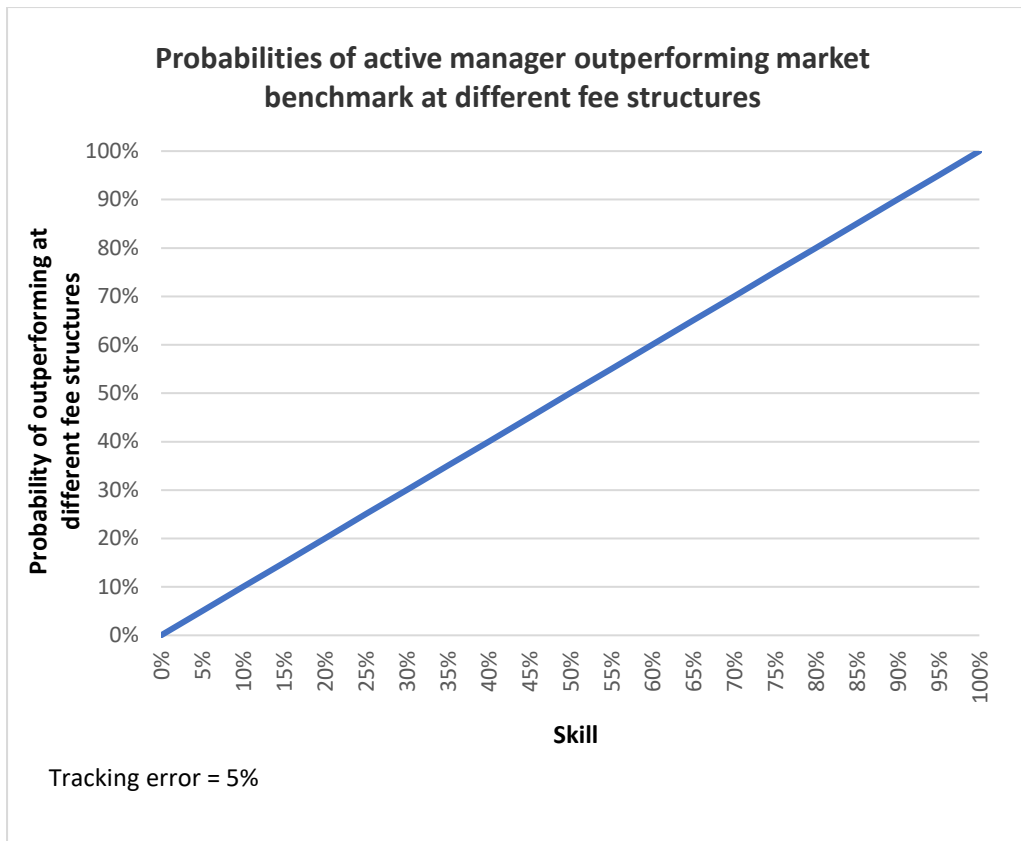
The premise or *raison d'être* of active management is simply to derive more net value from the management of investments than the market average, like using low-cost, passive alternatives. But also understand the environment in which the industry operates. First, it is a hugely competitive environment where there are usually no easy pickings from low-hanging fruit. Most of the shareholding of securities are owned by institutions, like pension funds who are typically well advised in their dealings. Second, market information and updates are available in milli-seconds these days, unlike a couple of decades ago. Insider information dealings are illegal, and thus not a legitimate source of information. Thirdly, with the advent of low-cost, online dealing systems transactional costs have been reduced dramatically over the past decades. All these developments contributed to the notion that markets are perceived quite efficient and relatively little scope for outperformance is available (there are certainly pockets of opportunities available at any point in time.)

How do active managers create additional value over and above the market index? By doing things differently, to have different weightings of securities in their portfolios than its respective weightings in the market-cap index portfolio. Thus, they're relying on the good performance of securities that they've over-weighted relatively to their market-cap weighting in an index, and/or, because of the bad performance of securities they underweighted in their portfolio relatively to their index weighting. This cause their portfolio to perform differently than the index benchmark over time, and this deviation is called the active risk or tracking error of the portfolio. Obviously, if an active manager attained outperformance after fees (active return or alpha) with the tracking error, she would feel vindicated with her active management efforts and it will form a strong basis for future marketing campaigns. Yet, this is not where it stops – active managers generally find it difficult to repeat outperformance consistently over time, for various reasons. One of them may be that some active managers often tend to charge outperformance fees after a period of outperformance, and ironically, that lessen the probability of repeating the same feat in a next period!

Moreover, investment skill, especially relatively, is somewhat of an opaque concept. If a manager's outperformance records are explained purely by skills, what then explains the same manager's subsequent period of under-performance? Skill can't appear and disappear like mist in the morning and certainly luck, good or bad, which is random, should explain performances too. Sometimes, it is hard to distinguish between luck and skill on an absolute basis, especially when that skill does not lead to repetitive successes over time. For the purpose of this discussion I refer to investment skill as the ability to "read" market and economic situations, security selection (stock-picking), portfolio construction and risk management. Thus, those managers with the best chances of attaining outperformance due to their investment processes being followed. I don't consider qualifications, or the university attended as reliable indicators, but it is often used as an indicator of skills available in the absence of hard, statistical evidence.

A model...

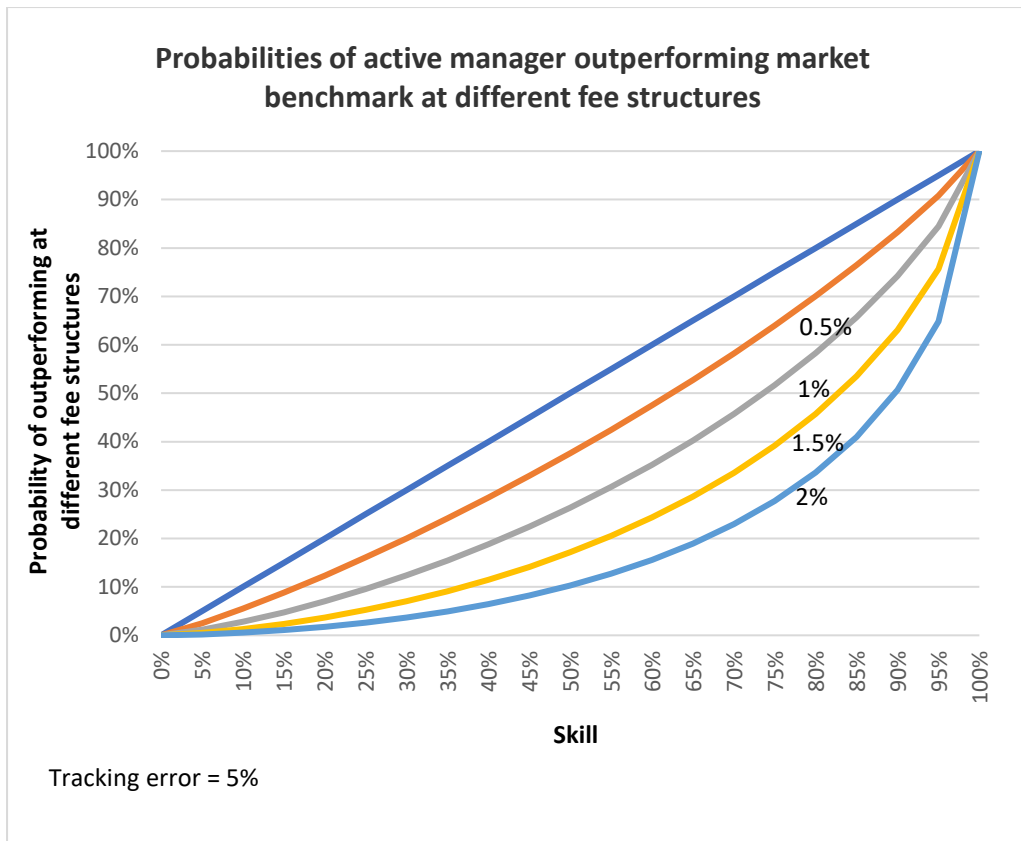
Richard Ennis and co-workers developed some years ago a theoretical "fee plausibility model" that evaluated the probabilities that an active manager will outperform the market or benchmark, given a set of perceived skill and fee structures.ⁱ In the following discussion I'll make use of this model, re-worked in a spreadsheet format, to illustrate some basic concepts.



The graph depicts a linear relationship between skill and the probability of outperforming the market benchmark in the absence of any investment fees. A manager with average skill (50%) will have a 50% probability of beating the market index, while the best-skilled manager (100%) will beat the market 100% of the time.

Investment fees...

Next, we add fees, tracking error and time (investment period) to the equation. A different picture emerges if we consider an investment portfolio with a tracking error of 5%, an investment period of ten years, and we show the probabilities of outperforming at 0.5%, 1%, 1.5% and 2% fees, respectively.

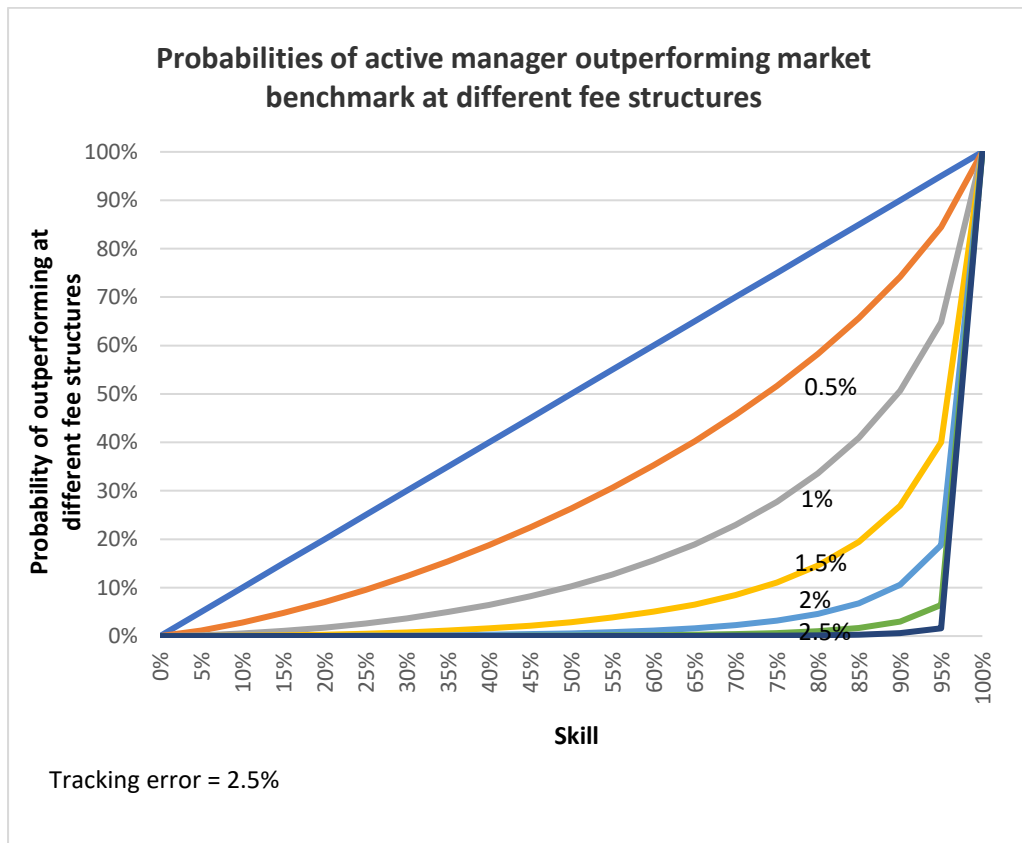


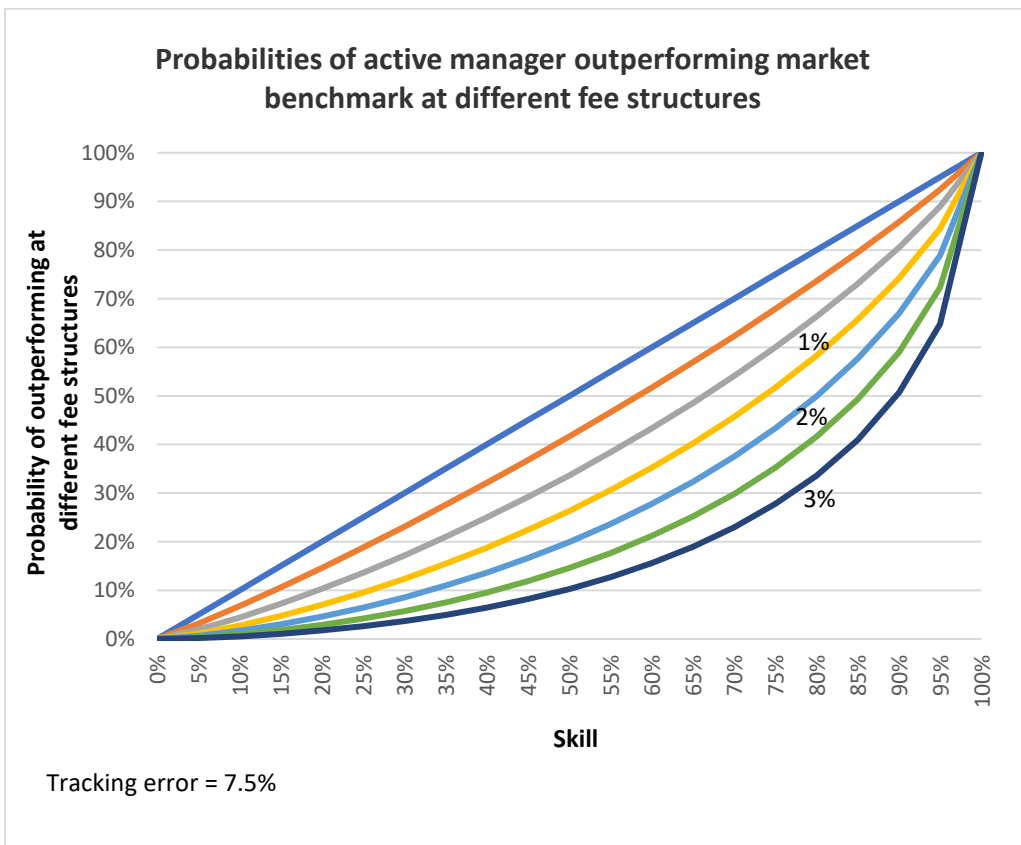
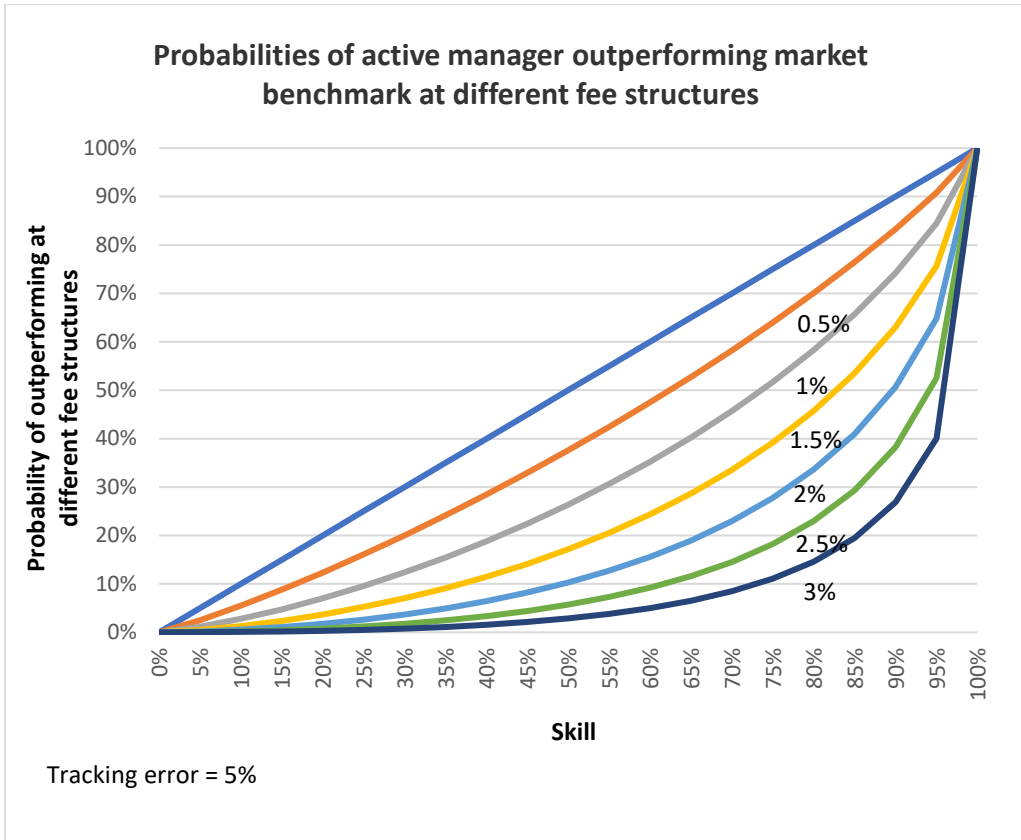
Let's consider a management fee of 1.5% per annum: We notice that the probability of an average manager (50% skill) outperforming the benchmark over a ten-year period will drop to 17% only. Even a top-quartile (75%) skilled manager will have a probability of only 39% beating the benchmark over a ten-year period. The odds are only very favourable for the top-skilled (>95%) managers, which, by definition, would only be a handful of managers. Ironically, very much the same number of managers who you would expect by pure chance (throw of the dice) to have risen to the top over that time period!

What is obvious from the above, is the detrimental impact fees will have on the probabilities of a manager outperforming the benchmark. The top quartile skilled manager has a decent chance (64% probability) at 0.5% fees, but slim chances (28% probability) at 2% fees. Thus, you have a situation where a good-skilled manager who is otherwise doing a good job with the management of her portfolio, yet she will unlikely be able to show her real worth in the presence of high management fees!

Tracking errors...

Another management variable is the tracking error of the portfolio. Consider the changes in probabilities for a 10-year investment period when a manager is deviating less and more from the portfolio benchmark.



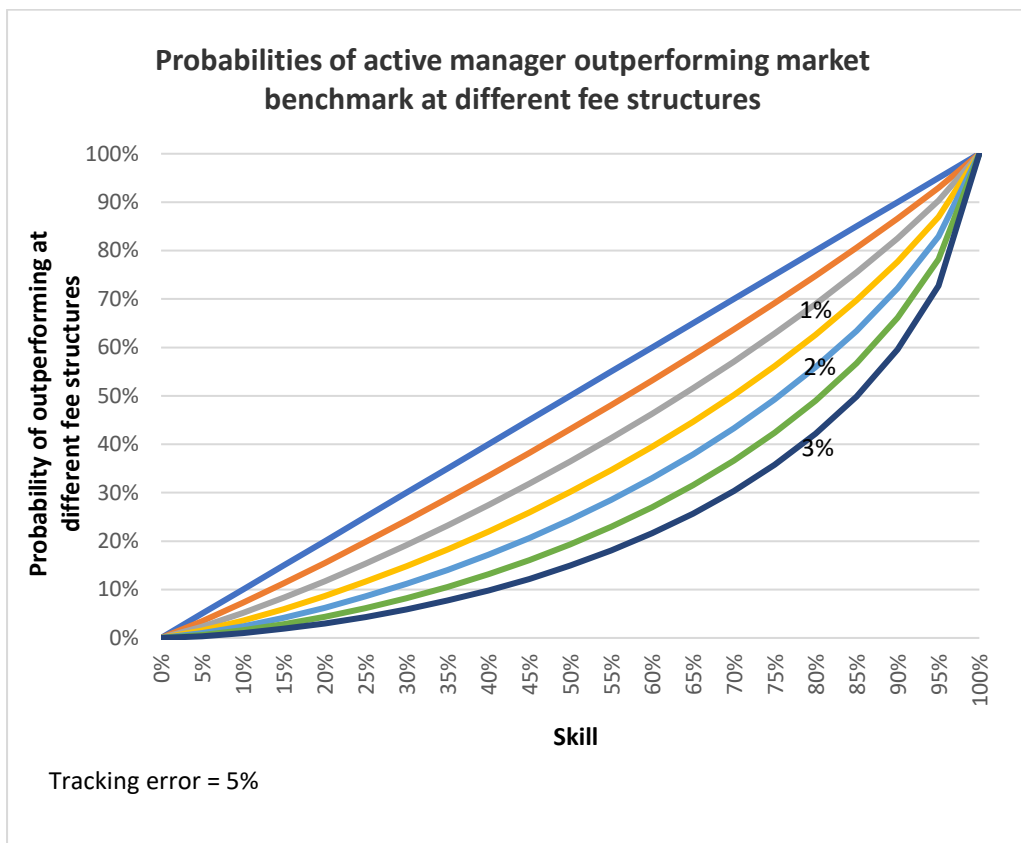


All else being equal, the probabilities of an active manager outperforming will increase the further the portfolio deviates from the benchmark, i.e. running higher tracking errors and not following the market index too closely.

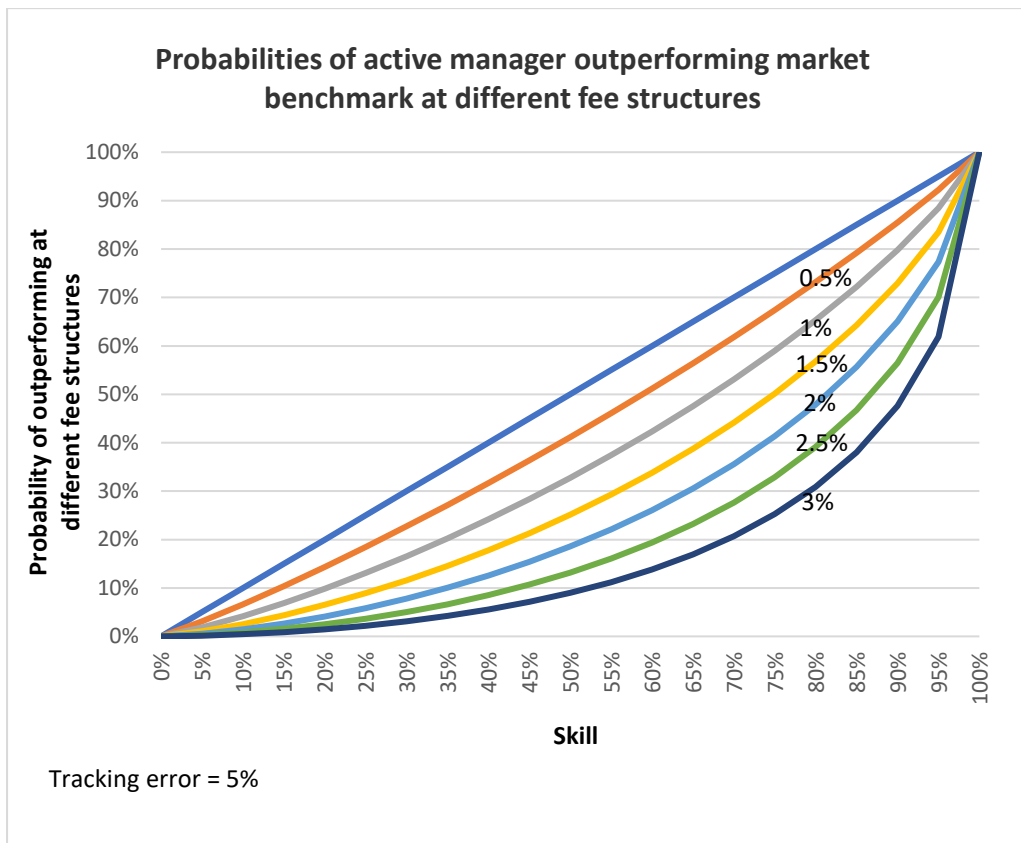
Investment period...

Also, the curves and probabilities above will change according to the investment period evaluated. Let's consider the following examples:

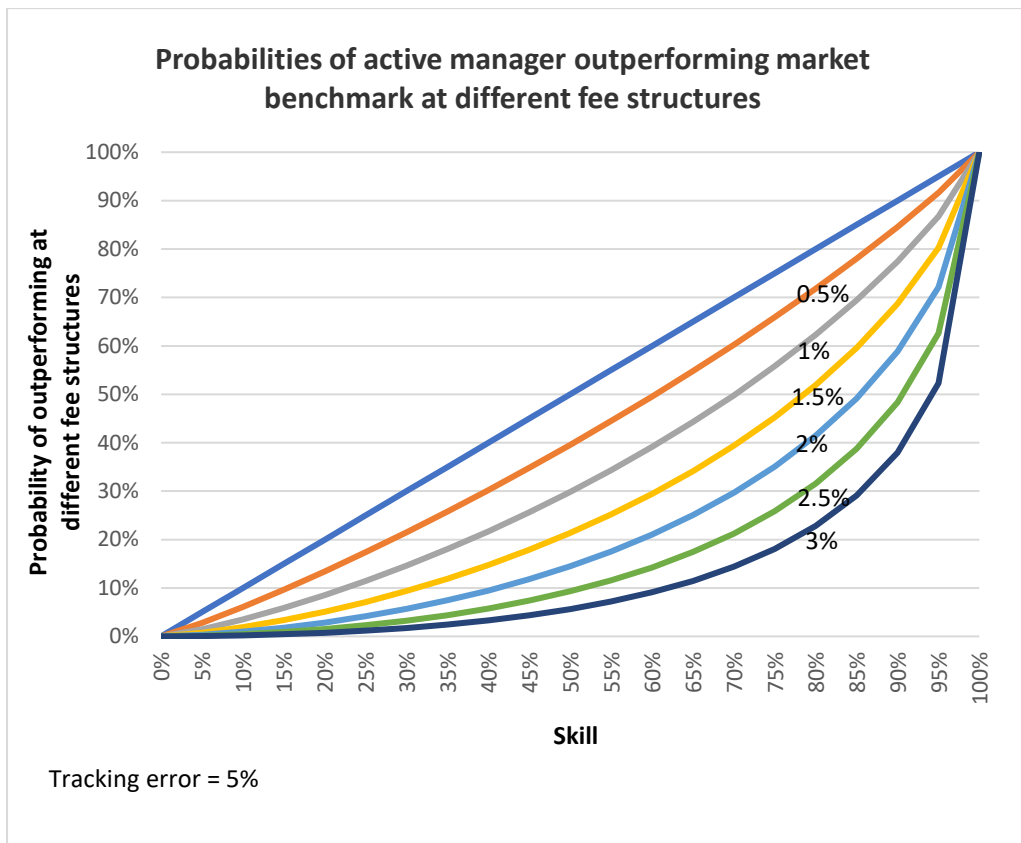
3-year period



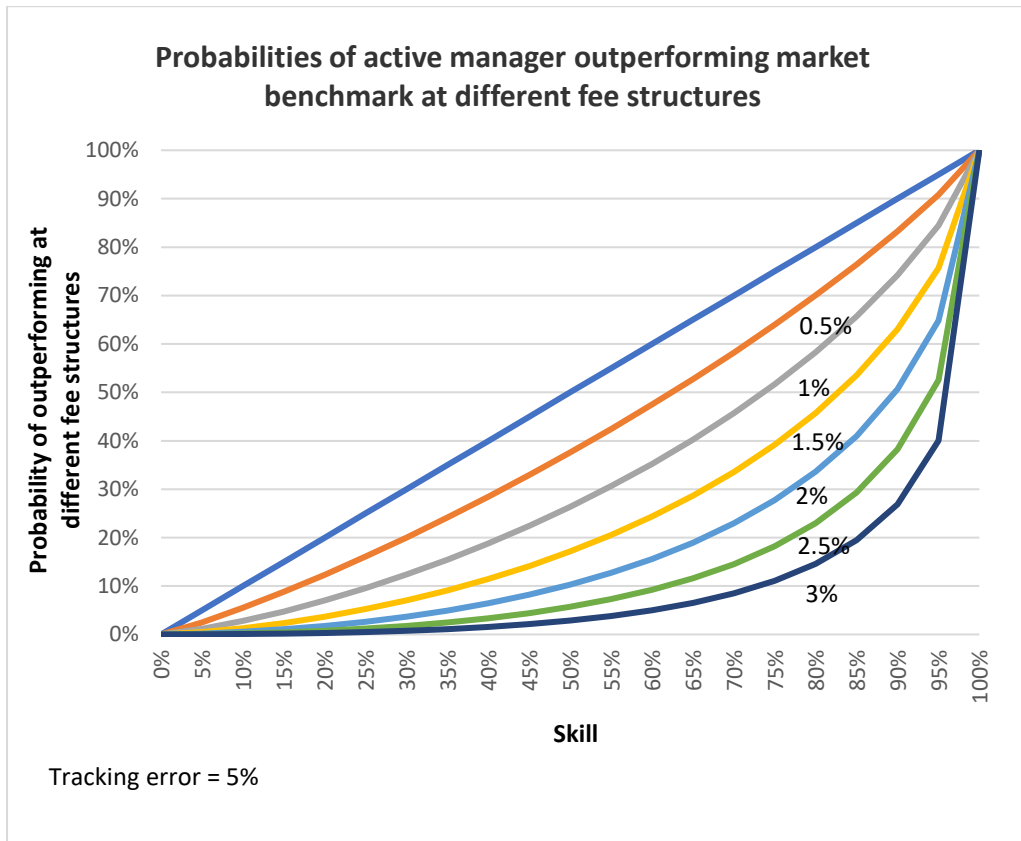
5-year period



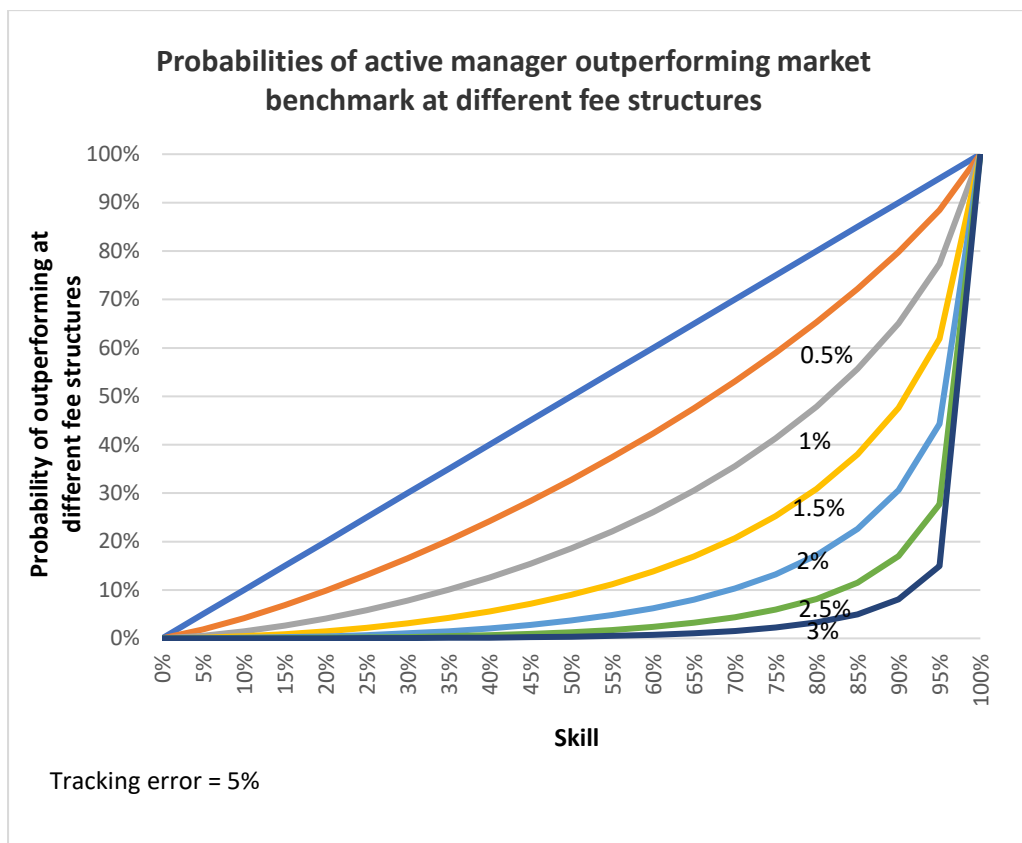
7-year period



10-year period



20-year period

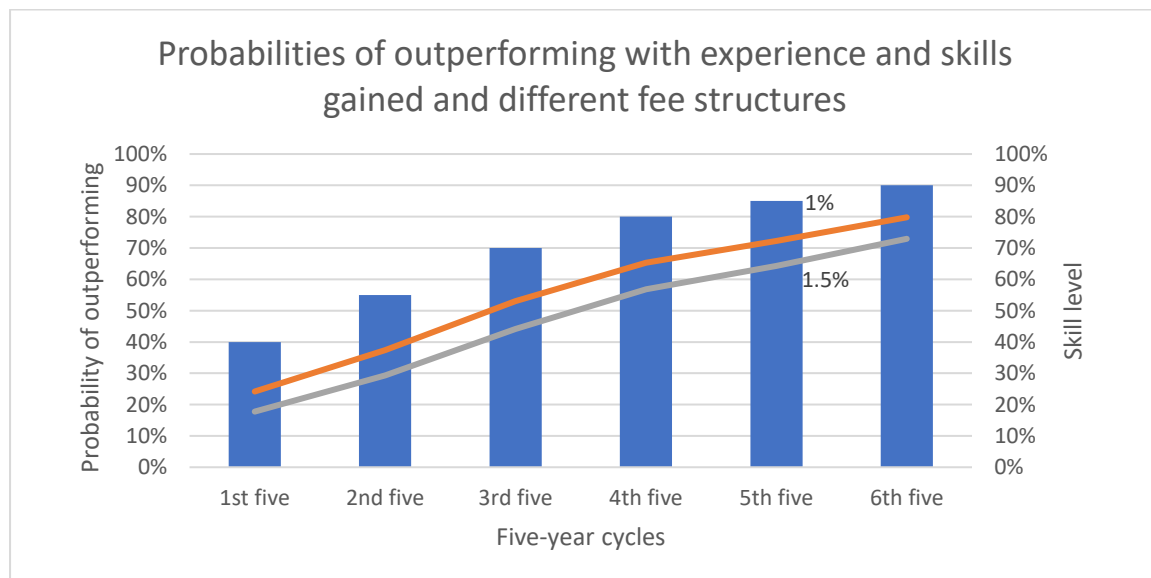


Only the best-skilled managers have realistic chances of beating the market over the long-term, and they can do it while charging relatively high fees. The only problem, and a big one, is that you don't have absolute knowledge of who the very best managers will be, i.e. you can rely only on observations, research, and trust in the processes of the manager.

Otherwise, most managers are doomed to be "also-rans", unless offering their services at lower management costs – which bring us to the attractiveness and sensibility of low-cost passive investing in any event, but that's a topic for another discussion.

Upgrading of skills...

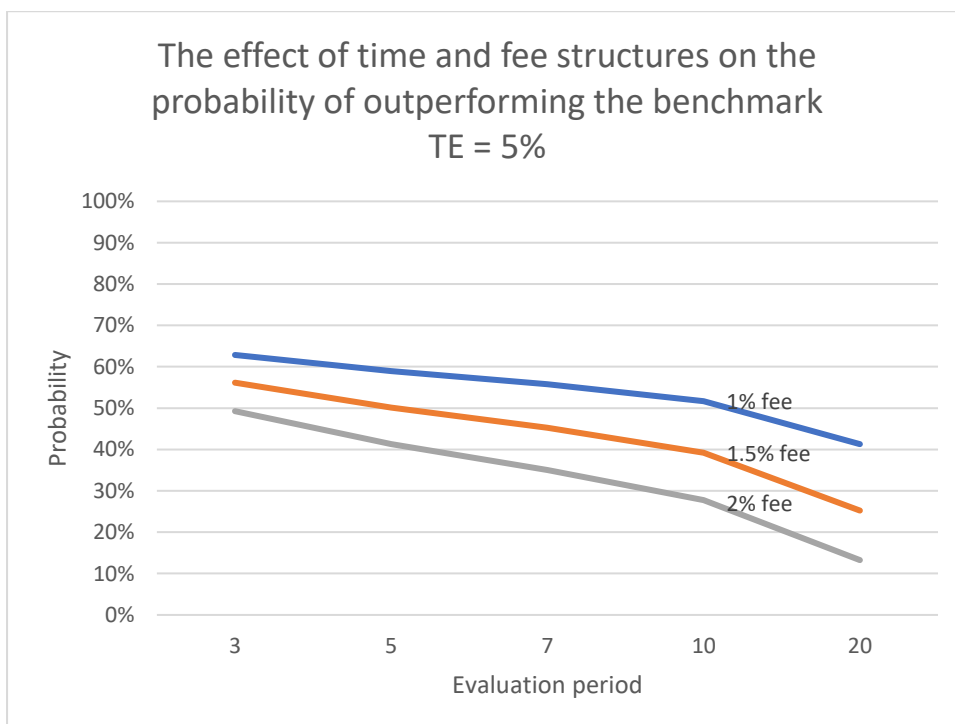
In the aforesaid I assumed a manager won't improve her skills over time (during her career), which is perhaps unrealistic, as we all do if we're dedicated to our profession. Let's assume a newly-appointed rookie manager who has a skill set of 40% (below-average) relative to all her peers in the industry. In the next ten years, she will gain experience and knowledge rapidly and move herself into an above-average skill set relative to other managers in the industry. Thereafter the skills gain will plateau, and as she becomes a senior and respected investment manager after twenty plus years' experience, she is regarded as one of the best skilled managers in the industry. In this case, the manager will have high odds in her favour to beat the market (with reasonable fee structures in place).



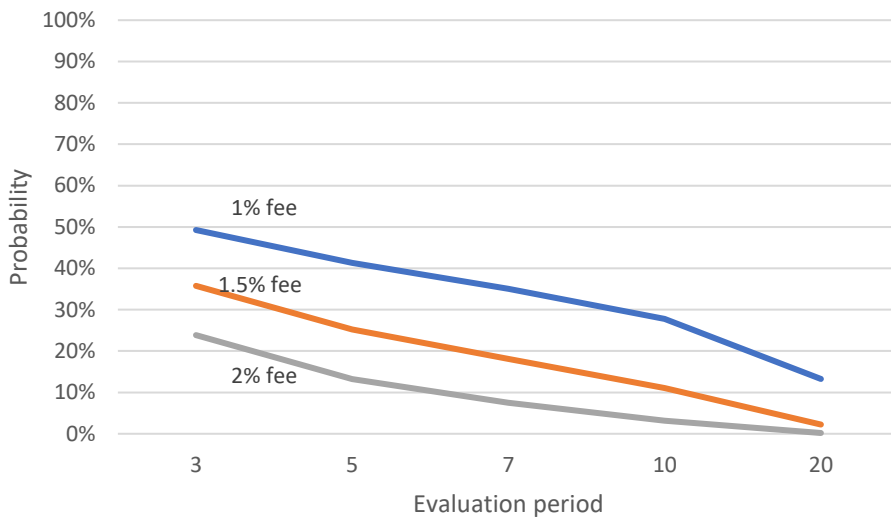
Obviously, not all experienced managers will end up as being regarded as one of the best in the industry, as in my example, but it was used to illustrate that all is not necessarily lost for an active investment manager entering the industry, as her investment skills gains will convert to higher probabilities of success over time.

When everything comes together....

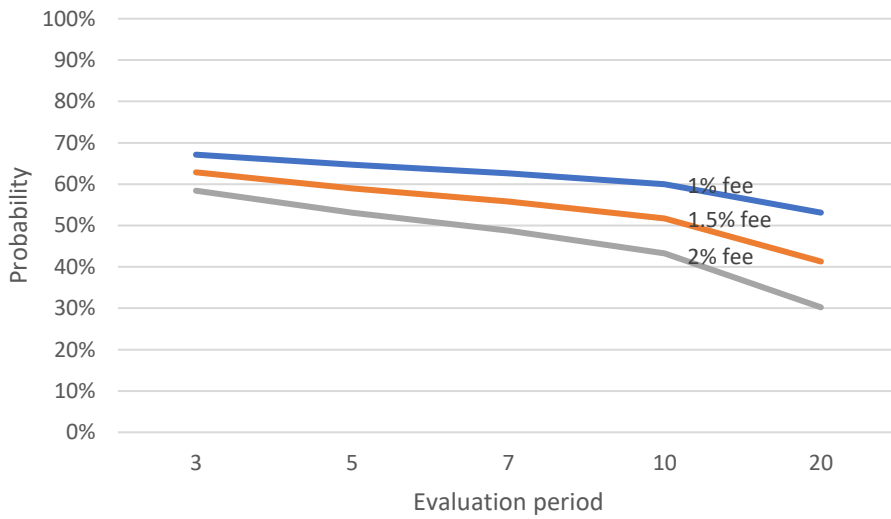
In summary, let's consider a top-quartile (75%) skilled manager. I show the probabilities of her outperforming the portfolio benchmark over different investment periods, fee structures and tracking errors. Clearly, all three variables have a major say in the stakes. If you consider an actively-managed portfolio with a 5% tracking error as the standard benchmark, then high investment fees and long investment periods (10 years plus) will have a significant detrimental effect on the feasibility of active management as an investment strategy. Moreover, one can readily assume many investors have an investment horizon beyond 10, 20 years, and therefore it seems plausible that active investment managers in general will have to reduce their fees to make it a more realistic mutual advantageous situation for investors and active managers.



The effect of time and fee structures on the probability of outperforming the benchmark
TE = 2.5%



The effect of time and fee structures on the probability of outperforming the benchmark
TE = 7.5%



Final thoughts...

While I used a theoretical model to illustrate some key concepts, and reality can be expected to be somewhat different, the fundamental truth of the mathematics will remain valid. Fund performance surveys, like Morningstar and SPIVA, confirm how difficult it is for active managers to outperform benchmarks, and it especially gets more difficult as the review period extends into time. Typically, only a relatively small group of active managers will outperform the market or selected benchmark, like 20-30% of the managers, and about 30-40% will outperform comparable low-cost passives.ⁱⁱ Moreover, it is more than likely that a top-performing manager in one review period, won't be a top-performing manager in a next. And it is not that active managers as a group don't know what they are doing or not trying hard enough, but because the costs of active management lessen dramatically the chances of outperforming.

Generally, as investors we commit two errors of judgement, one, we over-emphasize the value of short-term performance records and often make "false" conclusions and recommendations about it – the model I used, show it is relatively much easier for a relatively high-cost, mediocre-skilled active manager to outperform the market over a three-year or five-year period (not to mention one-year!) than ten years. Two, we totally under-estimate our investment period commitment. Many investors are looking at shorter-term periods, like five-year investment terms, while they should be thinking about twenty-year periods perhaps. This long-term perspective will change the outlook of your investment philosophy and specific investment strategies you will employ to improve the odds of attaining the best possible results over time. Undoubtedly, lower-cost investment options should feature strongly in that strategy.

ⁱ Richard M. Ennis, 2005. "Are Active Management Fees Too High?" *Financial Analysts Journal*, 61:5, September/October, 44-51.

ⁱⁱ In the South African context with its skewed market characteristics, due care should be taken when considering which equity benchmarks are used in analyses. The benchmark used, should resemble the investable universe and what fund rules permit to make it a fair comparison. The capped Shareholder Weighted Index is a better yardstick than the All Share Index.