Under the Hood: What's in *Your* Index?
(An Ongoing Series)

Diversification and the Active Manager: Part I

The Active Manager (and Allocator) of the Future – General Case
No concept in the investment world is as accepted as diversification. It is the most fundamental element of risk control. It is fairly well accepted that an index fund will provide better diversification at a lower cost than will an active manager. Investing in an exchange-traded fund that tracks the S&P 500 Index might cost no more than four basis points per annum. No active manager doing fundamental research could ever provide a diversified portfolio at such a low fee. Thus, as is well known, almost by definition, active managers, in aggregate, cannot possibly outperform the S&P 500 since, collectively, the managers are simply the S&P 500 with expenses. Unfortunately for the active manager, there is no answer to this argument.

Consequently, it is readily apparent that active managers should not collectively *be* the S&P 500. In any case, an active manager is not likely to have very profound knowledge of most of the firms in the S&P 500. However, it is possible that an active manager might have quite profound knowledge regarding a handful of firms in the S&P 500. How would the investment world be altered if the active manager simply abandoned the idea of offering diversified portfolios and offered only concentrated portfolios, properly disclosed as such, and placed the burden of proper diversification upon the client?

It should be immediately apparent that the manager would shed a great amount of cost. It should also be apparent that the number of active managers would greatly proliferate. There would, as well, be a great advantage in small size. In fact, if one reflects upon the matter, it would be difficult for a dominant specialty firm to exist for long.

Imagine the existence of a specialty firm that genuinely has a profound knowledge of the automobile industry. If this firm managed to raise substantial amounts of money due to its expertise, it would soon be recognized that there is information content in the trades of this firm. The required disclosures, such as the Form 13-F filing, would serve to proliferate this information. The firm would attract imitators and, by this method, lose its advantage.

On the other hand, disciplined managers would recognize this possibility and, with that awareness, decline to gather a large amount of assets (and would use a structure that precluded the need to disclose trades via regular SEC filings). The clientele would necessarily be a small group. A talented manager of this type would be highly desired, and would be able to command a substantial fee. Presumably, the returns would be sufficiently high such that, even after the fee, the client would still earn a substantial return.

Viewed from the perspective of institutional investors, capital allocators, and consultants, this would not be a good development. The superior manager, limited to rather small pools of capital, would undoubtedly charge incentive fees and be interested entirely in absolute return. The only way to locate such a manager would be to identify a rather lengthy period of good performance. However, by that time, the manager would already have attracted adequate capital and would no longer be interested in attracting more. The manager would look upon raising additional capital in much the same manner as the management of a well-run company that trades at a low P/E ratio: capital raises that are dilutive are not wanted. A capital raise in the absence of good ideas with which to continue to advance the track record should ultimately not be in the manager's interest.

In such a world, the good managers would not accept large institutional allocations. The large institutions would experience great difficulty in identifying managers. As a practical matter, the institutional investor would be largely confined to index strategies. The diversified active manager would largely disappear as a species.

There would be some scope, though, for adjustment in the asset allocation process, at least among some very modest contingent of asset allocators. Those allocators might seek out active managers who demonstrate a very specific and unusual value-added skill or analytical technique. These would be very idiosyncratic. Accordingly, these managers would not be evaluated relative to any standard benchmark, because the comparison would be so obviously erroneous. They would be judged on some absolute metric specifically relevant to what they do, and over a specifically relevant time frame. If they don't measure up, they would be dismissed and the funds reallocated to the indexes, which would be the default, until another promising manager could be identified. The point is that the default would be indexation, and managers would be chosen because they would contribute a differentiated and value-added characteristic. No room for index huggers or diversified style managers.

The Active Manager of Today – An ex-Ante Post-Mortem

The many studies that consistently document the underperformance of active, diversified managers relative to the S&P 500 do not merely study an exercise in the rational, albeit, suboptimal, allocation of capital. A rational, self-interested manager has a very powerful incentive to maximize assets under management. There is clearly a process underway of diluting good ideas with more capital. Unfortunately, because one cannot, on an ex-ante basis, know the proportion of so-called good ideas, one cannot measure with any precision the impact of capital raises upon performance. Nevertheless, it is well known that managers raising large amounts of capital generally experience a significant deterioration of investment performance.

Even if one ignores investment management fees, dilution from raising capital, and transactional friction expenses, the active manager presenting a well-diversified portfolio faces a number of insurmountable obstacles to the generation of superior performance to that of an index. If the manager is to be measured relative to the S&P 500 index, it is simply insufficient to select a given number of securities that will generate a positive rate of return. Relative performance requires that a manager select from the better securities in the index. The only way to know which securities in the S&P 500 are better than average is to know about all of the securities in the index. The problem is very much akin to selecting the best students in a school without reviewing all the students. Of course, how could any manager claim to have a good understanding, as well as a competitive advantage, in understanding 500 securities?

The next part of the problem is even more difficult. It is not sufficient to have a superior understanding of all the firms in the S&P 500, because each security in the index has a different weight. For example, Amazon is now 1.82% of the S&P 500 Index. Facebook is 1.71% of the index. Amazon, having appreciated by 28.2% in 2017 thus far, has produced 51 basis points of the entire index's year-to-date return which, at the time of this writing, is about 7.5%. Facebook has appreciated by 30.6% and produced, given its index weight, 52 basis points of the year-to-date return of the S&P 500. Hence, by merely misjudging two securities in the S&P 500 in terms of return potential, one is automatically at a return disadvantage of 100 basis points or more.

If one also happened to have the misfortune of misjudging Apple, which is the largest company in the S&P 500, with a 3.91% weight, one has another disadvantage. Apple has appreciated by 34.78%. If one decided not to own Apple, one now has a 136 basis points disadvantage relative to the S&P 500. If one wishes to continue this exercise, failure to own Microsoft produces another 26 basis point disadvantage. Failure to own Alphabet would place one at another 56 basis point disadvantage.

In sum, Amazon, Facebook, Apple, Microsoft, and Alphabet are responsible for 321 basis points of the S&P 500 return thus far in 2017. It is not easy to produce a return superior to the S&P 500 without owning these shares, if these shares actually outperform. Of course, there is no relative advantage to the S&P 500 by merely owning these shares at the S&P 500 weighting. One must be sufficiently knowledgeable to own these shares at a greater weighting.

Of course, one should not undertake the risk of overweighting these firms unless one possesses superior understanding of them. And, of course, obtaining a superior knowledge of these firms relative to the millions of people who know about them is no simple matter.

Even if one did have a superior understanding of the business fundamentals of Amazon and Facebook, this would not be sufficient, because Amazon and Facebook trade at high P/E ratios. Those P/E ratios can contract at any moment. One possible reason for contraction, but not the only reason, would be a rise in interest rates. Surely there are few managers who would claim to have superior interest rate forecasting ability, in addition to a deeper understanding of the many firms in the S&P 500 than do most investors.

However, even such an understanding, unobtainable as it is, is quite inadequate to solve the problem of valuation multiple contraction because, aside from rising interest rates as a causative factor, competition or technological advantage could arise at any time from a variety of sources, including private firms. Surely, the manager could not possibly have a profound understanding of firms—identifiable and not readily identifiable—that might one day become competitors, in addition to all the other stated knowledge requirements.

It is reasonable to assert that most proponents of indexation would agree with the conclusion that no manager is likely to exhibit superior knowledge to the sum total of the market participants across 500 different companies. In other words, let us dispense with the so-called knowledgeable market participants thesis, since they do not and cannot produce superior results. The consequence of this must be that the bulk of the purchase and sale decisions of securities comprising the S&P 500 and other indexes will not be informed by fundamental analysis, because the shares will be primarily purchased, sold, and owned by index funds. Alternatively, if the active managers decide to concentrate their efforts upon a narrow range of investments with a relatively small amount of informed capital competing with enormous sums of capital investing upon an entirely uninformed basis, this may prove to be a much better environment for an active investor.

In terms of the index investor, there might be no need to dispense with active managers. The active managers—as they now embody the term—would do well to dispense with themselves. In any case, index funds will dominate the investment landscape. The index fund operators might do well to keep in mind the following quotation from Oscar Wilde: “There are only two tragedies in life. One is not getting what one wants, and the other is getting it.”