Under the Hood: What's in *Your* Index?
Published on September 28, 2017 (updated in May 2018) - An Ongoing Series

Diversification and the Active Manager: Part I

The Active Manager (and Allocator) of the Future

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 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. But, it is possible that an active manager might have quite profound knowledge regarding a handful of those firms. 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.

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