



## MENDOZA COLLEGE OF BUSINESS



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### INTRODUCTION

1. New survey of the past 20 years of academic research on actively managed mutual funds
2. Goal: evaluate support of 'conventional wisdom' on active management
3. Conclusion: recent literature challenges conventional wisdom



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### THE CONVENTIAL WISDOM

**1. About 20 years ago, Mark Carhart published a landmark study on mutual funds**

**a. Data does “not support the existence of skilled or informed mutual fund portfolio managers”**

**b. About 13,700 citations (Google Scholar)**

**2. Helped form the ‘conventional wisdom’ that active management does not create value for investors**



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### THE CONVENTIAL WISDOM

**1. THE AVERAGE FUND UNDERPERFORMS AFTER FEES**

**2. PERFORMANCE OF THE BEST FUNDS DOES NOT PERSIST**

**3. SOME FUND MANAGERS ARE SKILLED, BUT FEW HAVE SKILL IN EXCESS OF COSTS**



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## 1. THE AVERAGE FUND UNDERPERFORMS AFTER FEES

### Support:

- Arithmetic of active management; Sharpe (1991)
- Many papers show the **average** actively managed mutual fund underperforms



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## 2. THE PERFORMANCE OF THE BEST FUNDS DOES NOT PERSIST

### Support:

- Funds that outperform in the past do not outperform in the future; Carhart (1997)



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**3. SOME FUND MANAGERS ARE SKILLED, BUT FEW  
HAVE SKILL IN EXCESS OF COSTS****Support:**

- Many managers beat market before costs, but few do after costs; Fama and French (2010)



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**RESULT OF THE 'CONVENTIONAL WISDOM'**

ASSETS SHIFTED AWAY FROM  
ACTIVELY MANAGED FUNDS TO  
PASSIVELY MANAGED FUNDS

Less than 8% of the  
assets in equity funds  
were passively  
managed in 1997

Over 40% were  
passively managed in  
2017



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### CHALLENGING THE 'CONVENTIAL WISDOM'

#### 1. THE AVERAGE FUND UNDERPERFORMS AFTER FEES

##### Support:

- Arithmetic of active management, Sharpe (1991)
- Many papers show the average actively managed mutual fund underperforms

##### Challenge:

- The average active fund outperforms an equivalent index fund by 36 basis points per year; Berk and van Binsbergen (2015)
- Standard performance evaluation methodology biased against finding active management creates value; Cremers, Petajisto, and Zitzewitz (2012)



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### 2. PERFORMANCE OF THE BEST FUNDS DOES NOT PERSIST

##### Support:

- Funds that outperform in the past do not outperform in the future; Carhart (1997)

##### Challenge:

- Evidence of persistence among top-performing funds; Bollen and Busse (2005)



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### 3. SOME FUND MANAGERS ARE SKILLED, BUT FEW HAVE SKILL IN EXCESS OF COSTS

#### Support:

- Many managers beat market before costs, but few do after costs; Fama and French (2010)

#### Challenge:

- Several studies identify groups of funds that have skill in excess of costs
- For example, funds with high 'active share' tend to outperform; Cremers and Petajisto (2009)



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### HOW DO ACTIVE MANAGERS CREATE VALUE?

#### Obvious ways

- Select stocks that outperform; Wermers (2000)
- Time the market; Jiang, Yao, and Yu (2007)

#### Less obvious ways

- Corporate oversight, Iliev and Lowry (2015)
- Tax management, Sialm and Starks (2012)



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### OTHER LIMITS TO THE CONVENTIONAL WISDOM

#### 1. Most research focuses on U.S. equity mutual funds

#### 2. Opportunities for active management may be more plentiful in other, less liquid, markets

- Bond funds, hybrid funds, international funds, etc.

#### 3. However, there is limited research available in those areas

- Drawing generalized conclusions about active management is difficult



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### Many research obstacles in evaluating active management

#### A. Asset pricing models are evolving rapidly

- “Zoo of new factors”; Cochrane (2011)
- Significant implications for performance evaluation

#### B. Data limitations hide fund’s investment process

- For example, we only observe a fund’s portfolio once per quarter
- Unobserved actions are important; Kacperczyk, Sialm, and Zheng (2008)



## CONCLUSIONS

- ***Active managers have a variety of skills and tend to make value-added decisions:***

*AFTER COSTS, MANY ACTIVELY MANAGED FUNDS  
GENERATE POSITIVE VALUE FOR INVESTORS*

- ***Active management is more promising than the conventional wisdom claims***