

Selecting Active Equity Mutual Funds: Don't Get Caught in the Middle!

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Article Highlights

- Truly active funds, on average, beat the market, after fees.
- Seek out smaller funds that poorly track their benchmarks and have a high level of portfolio concentration.
- Among the behaviors offsetting stock selection skill are growing too big, staying in a style box, and overdiversifying.

About 70% of active equity mutual funds are closet indexers that generally fail to beat the market after fees. On the other hand, the other 30% of funds outperform on average. Thus the task is to weed out closet indexers and only invest in truly active funds.



By truly active I mean taking high-conviction portfolio positions rather than trading actively. That is, invest either in the lowest-cost index funds or in truly active funds, but don't get caught in the middle, which is populated by the value-destroying closet indexers.

We identify truly active funds by focusing on the fund's investment strategy, how consistently this strategy is being pursued, and the extent to which high-conviction positions are taken. Each of these behaviors are objectively measured and those funds displaying the highest levels of consistency and conviction are the ones we rate the highest. After the fact, top-rated (i.e., truly active) funds, on average beat the market, after fees, and in turn best the lowest-rated (i.e., closet index) funds by 3% to 4%. Fund manager behavior—in terms of strategy, consistency and conviction—is predictive of future performance.

Past performance is not used for selecting funds, since it is not predictive of future performance, a result convincingly demonstrated by a number of research studies. Though some short-term (nine months) performance persistence exists, the negative predictive performance of three-year and five-year

past returns leads to past return aggregate measures, such as Morningstar Stars, being useless indicators of future fund returns.

The remainder of this article discusses the research underlying our methodology. I will also describe the specific fund behaviors driving subsequent fund performance. Beyond explaining the concepts of strategy, consistency and conviction introduced above, I will delve into the superior stock-picking skill that is pervasive among active equity funds along with the disappointing and destructive portfolio management decisions made by funds. In the next to last section, I provide a list of specific attributes you should look for when selecting a truly active fund. Feel free to jump to the end if you don't wish to wade through the research sections!

Self-Declared Investment Strategy

My firm, AthenaInvest, organizes the active equity mutual fund universe around the investment strategies being pursued by managers. This system is based on years of our own research and is consistent with independent studies conducted by academic researchers from around the country. Though it is proprietary, I discuss our approach here simply to give you insight into how we look at funds, with the intent that doing so will help you make better decisions.

Using a sophisticated, patented algorithm along with 60,000+ pieces of strategy information, Athena first identifies the self-declared strategy being pursued by active equity

mutual funds. Strategy is the way a fund goes about analyzing, buying and selling stocks. Once a mutual fund's strategy is identified, Athena forms Strategy Peer Groups consisting of funds pursuing the same primary strategy.

Athena Strategy Benchmarks, created from the composite return series of the Strategy Peer Groups, benchmark active equity managers by grouping funds that pursue the same primary investment strategy. The Strategy Benchmarks are composed of all open-end active mutual funds pursuing a stated investment strategy.

Strategy Benchmark composition is not determined by arbitrary portfolio statistics, but by active equity managers' own stated investment strategy, which can be found in the funds' prospectuses. Identifying and categorizing managers by their investment strategy leads to more meaningful peer groups within asset classes. Athena maintains and publishes monthly 10 U.S. Equity Strategy Benchmarks and 10 International Equity Strategy Benchmarks.

The strategy framework for organizing the active equity universe is an alternative to the performance-destroying style grid commonly used. The style grid based on market capitalization and price-earnings ratio was foisted

on the equity mutual fund industry by a leadership stampede that began in the early 1980s. Its major problem is that a style box has little to do with how funds go about making investment decisions. Requiring a fund to stay in a specific box (e.g., small-cap value) makes it difficult for the fund to outperform, since its choices are limited to a subset of stocks that are not best ideas based on its strategy.

Research shows that limiting a fund's choices to a style box reduces return by 3% as compared to allowing a fund to move freely around the equity universe in pursuit of a strategy. We refer to allowing a manager to consistently pursue a narrowly defined investment strategy as "adult portfolio management" versus "playpen management," which is an unintended consequence of the style-grid approach to organizing the active equity universe.

Strategy, Consistency & Conviction

We assign our own Diamond Ratings to funds based on the investment strategy being pursued by the fund, the consistency of that pursuit and the conviction demonstrated by the construction of the resulting portfolio. We

believe that behavioral factors such as strategy, consistency and conviction are better leading indicators of outperforming active equity mutual funds than traditional approaches such as past performance. The highly rated funds are those that are truly active and thus have the best chance of outperforming going forward, while the lower-rated funds are closet indexers that most often underperform.

Table 1 reports the April 1997 through September 2014 Diamond Rating (DR)

performance. As I argued would be the case, the truly active funds (DR 5 and DR 4) outperformed the global equity benchmark by 2.1% and 1.6%, respectively, while the highest-rated (DR 5) funds outperformed the lowest-rated (DR 1) funds ("closet indexers") by 3.1%. The middle-of-the-road DR 3 funds roughly match the benchmark. Thus, it is important to avoid the closet indexers and instead invest in the truly active funds.

On average, we hold funds for two to three years in our fund overlay portfolios, as the fund's rating deteriorates over time. As I will show in the next section, this is not because of a deterioration in stock-picking skill—which actually improves over time—but rather because of the imposition of a portfolio tax resulting from the destructive portfolio management decisions made by the fund.

Superior Stock-Pickers, Destructive Portfolio Managers

Active equity mutual funds underperform their respective benchmarks on average. Does this imply a lack of stock-picking skill? Indeed, this is the conclusion reached by many researchers and is the conventional wisdom swirling about the industry. But, as is often the case, the truth is much more complicated. (Portions of this section are excerpted from my article to be published in the November 2014 issue of *Investments & Pensions Europe Magazine*.)

A growing body of research challenges this conventional wisdom, revealing that stock-picking skill is common among active equity mutual fund managers, allowing them to generate returns that more than cover benchmark returns and fees. Collectively, these studies reveal a universe of equity mutual fund investment teams who are very good at identifying profitable investment opportunities and portray an industry where selection skill is the rule rather than the exception.

I, along with others, argue that the observed underperformance is due to non-performance pressures and

Table 1. AthenaInvest Fund Diamond Rating Performance

Fund Rating	Meaning	Guidance	Annual Return* (%)
DR 5	Highest Rating	Strong Buy	10.6
DR 4	Above Average	Buy	10.1
DR 3	Average	Hold	9.2
DR 2	Below Average	Sell	8.2
DR 1	Lowest Rating	Strong Sell	7.5
Benchmark**	—	—	8.5

*Calculated as simple averages of subsequent net-of-fees returns for funds so rated at the beginning of each month from April 1997 through September 2014.

**50% S&P 500 index, 50% MSCI EAFE index.

Source: AthenaInvest Inc. For greater detail about the construction and benefits of the Fund Diamond Rating methodology, please refer to the Academic Bibliography page at www.athenainvest.com. Past performance may not be indicative of future performance.

incentives that lead to building underperforming portfolios, rather than evidence of the lack of skill. (Jonathan Berk and Richard Green explained the profit maximization arguments for why funds choose to turn themselves into closet indexers and thus underperform in “Mutual Funds Flows and Performance in Rational Markets,” which was published in the *Journal of Political Economy* in 2004.) I refer to the reduction in fund performance resulting from these non-performance investment decisions as an implicit “portfolio tax” imposed on the fund by means of destructive portfolio management decisions. Fund performance suffers as a result. Thus, closet indexers underperform not because of a lack of skill, but as a result of imposing a portfolio tax that wipes out the benefits of selection skill.

A fund’s performance (alpha) can be thought of as the fund’s selection skill minus its portfolio tax. Using a large sample of active U.S. equity mutual fund returns, I estimate that skill averages nearly 6.0% (net of benchmark return) annually, while the tax deducts an average of 4.7%, resulting in an across-the-board negative alpha after fees. The impressive selection skill exhibited by funds is more than wiped out by the resulting portfolio tax and fund fees. In other words, the stock-picking skill of buy-side analysts is completely offset by the fund’s subsequent portfolio management decisions and fees. The implicit portfolio tax is on average nearly three to four times the explicit average fund fees (1.4%) and is thus the most important destroyer of performance.

Fund Performance Decomposition

Because of the interplay between skill and tax, it is not possible to estimate a fund’s skill directly from its returns. In order to address this issue, I regress one-month-ahead fund returns (net of fees and best-fit benchmark return) on measures of assets under management (AUM), how much the variability in a fund’s returns can be explained by the benchmark (R-squared), and overdiversification. Each of these measures have

been shown to negatively affect future fund returns. That is, the larger the fund’s assets under management, the higher its R-squared (more of the variability in returns is due to its benchmark), and/or the more it overdiversifies, the worse its future fund performance. This means a portfolio tax is imposed by growing a fund, closely tracking a benchmark, and taking an increasing number of low-conviction positions.

My test results, based on all active U.S. equity mutual funds over the period March 1997 through September 2014 and nearly 230,000 fund-month observations, are as follows:

- The average fund selection skill is highly significant, which provides further evidence of stock-picking skill among active equity mutual funds. That is, fund skill is sufficient to beat a fund’s benchmark by 6% annually.
- Over 90% of funds display enough skill to more than cover fees and the benchmark return. In other words, over 90% of funds are skilled enough at stock-picking to generate a net return that exceeds its benchmark return.
- On average, fund skill increases over time.
- On the other hand, funds engage in destructive portfolio management activities that impose an average portfolio tax of 4.7%.
- The combination of explicit fees and implicit portfolio tax wipe out all skill benefits, resulting in overall fund underperformance.

The conclusion is that none of the impressive value created by active equity manager skill is passed on to investors. Rather, the combination of portfolio tax and fees is large enough to destroy investor value relative to investing in the benchmark, a very disappointing result indeed.

Portfolio Tax

The portfolio tax is the result of destructive portfolio management decisions, as contrasted to stock-picking decisions, made by the fund. These

decisions make it increasingly difficult for the fund to consistently pursue its narrowly defined strategy and to hold only high-conviction positions.

The resulting tax is a consequence of the fund being forced to deviate from its core competency by investing in stocks for which there is no expectation of superior returns. Low-conviction stocks within the portfolio increase to the point where they vastly outnumber high-conviction stocks, and as a result performance deteriorates. Many portfolio decisions are driven by the desire to grow large colliding with the perverse requirements imposed by the U.S. fund distribution system.

Here are some of the tax-imposing decisions made by funds:

- Hiring a portfolio manager to make investment decisions not directly based on analyst recommendations (Stefan Frey and Patrick Herbst found that investment decisions based on analyst recommendations generated alpha and significantly outperformed portfolio manager decisions that deviated from analyst recommendations. Their paper, “The Influence of Buy-Side Analysts on Mutual Fund Trading,” is available on the SSRN website.)
- Implementing a risk management program.
- Managing volatility, drawdown, and/or tail risk.
- Closely tracking a benchmark.
- Staying in a style box.
- Overdiversifying beyond 40 stocks.
- Paying compensation based on assets under management (AUM), rather than on performance.
- Growing larger, particularly surpassing \$1 billion in assets under management.
- Team portfolio management rather than solo management.
- Prescribing sector and industry constraints for portfolio construction.

Many of these decisions are made with good intentions in mind, but as often happens, the law of unintended consequences has the last word. The bottom line is that portfolio decisions, beyond building a portfolio of the top 40

or so conviction-weighted analyst picks, impose some level of tax on the fund.

Separating the Truly Active From the Closet Indexers

I have just discussed the concepts and research underlying the methodology we use to select active equity mutual funds. Our approach requires considerable fund information and data, including fund strategies and portfolio holdings, that are not available to the individual investor. However, there are other more readily available measures that can be used to identify truly active funds. Most of these characterize funds that impose the least destructive tax rather than those with the most impressive skill. This is because it is easier to detect the imposition of a tax than it is to measure skill.

Look for funds with the following attributes:

- Fund returns poorly track benchmark returns;

- High active share, a measure of how different the fund's holdings are from benchmark holdings;
- Small number of stocks, with as few as 10 stocks needed for adequate diversification;
- All cap, go anywhere, not being restricted to a style box;
- Small size, with \$1 billion in assets under management being the critical value beyond which it is difficult to generate superior returns;
- Solo portfolio manager rather than a team managed fund;
- A portfolio manager who also acts as an analyst;
- Few if any risk management activities; and
- No industry or sector constraints.

Investing with these characteristics in mind allows for selecting truly active equity funds while avoiding value-destroying closet indexers. Expect to hold funds two to three years, the time span over which portfolio management decisions grow to the point of destroying

the value created by the stock-picking skill of the typical fund.

Conclusion

Contrary to conventional wisdom, active equity mutual fund managers are superior stock-pickers and their skill grows over time. Sadly, as the result of non-performance-driven portfolio decisions, a portfolio tax is imposed by the fund that more than wipes out the benefit of this skill. The tax collectively destroys value for fund investors relative to simply investing in a benchmark. The conclusion is that active equity funds are superior stock-pickers, but destructive portfolio managers.

By investing in funds with desirable attributes, a portfolio of truly active equity funds can be built, while at the same time avoiding closet indexers. This prevents you from getting caught in the middle between truly active funds and low-cost index funds, where value-destroying closet indexers reside. ▲

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Behavioral Finance

(continued from page 24)

and emotional responses.

For example, you could come up with rules for when you are going to sell a position that's at a loss. There are various things you might do in a taxable account: You could say, "When it's a couple months before the end of the tax year, I am going to sell my losing positions." This makes sense from a tax point of view and doing so gives you

the opportunity to break that emotional bond of holding onto losers.

Be careful about chasing performance: Don't buy something just because it went up last month or last year. Make yourself write down the reasons that you're purchasing a stock or fund. Another thing that Brad Barber and I found in our research is that a lot of investors simply buy stocks that catch

their attention. So generally, I'd say don't buy impulsively, don't buy something because—I'm sure none of your readers do this—because Jim Cramer recommended it. Don't even buy because you read about it in The Wall Street Journal this morning and thought, wow, that sounds like a great idea. Put a little more research into your decisions and try not to be impulsive. ▲

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