ECONOMISTS’ HUBRIS – THE CASE OF EQUITY ASSET MANAGEMENT

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Abstract
In this, the fourth article in the economists’ hubris paper series we look at the contributions of academic thought to the field of asset management. We find that while the theoretical aspects of the modern portfolio theory are valuable they offer little insight into how the asset management industry actually operates, how its executives are compensated, and how their performances are measured. We find that very few, if any, portfolio managers look for the efficiency frontier in their asset allocation processes, mainly because it is almost impossible to locate in reality, and base their decisions on a combination of gut feelings and analyst recommendations. We also find that the performance evaluation methodologies used are simply unable to provide investors with the necessary tools to compare portfolio managers’ performances in any meaningful way. We suggest a novel way of evaluating manager performance which compares a manager against himself, as suggested by Lord Myners. Using the concept of inertia, an asset manager’s end of period performance is compared to the performance of their portfolio assuming their initial portfolio had been held, without transactions, during this period. We believe that this will provide clients with a more reliable performance comparison tool and might prevent unnecessary trading of portfolios. Finally, given that the performance evaluation models simply fail in practice, we suggest that accusing investors who look for raw returns when deciding who to invest their assets with is simply unfair.

JEL codes: G11, G14, G23
Key words: Asset management, Fund management, Modern Portfolio Theory, Performance evaluation models, Efficient Market Hypothesis

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1 The views expressed in this paper reflect only those of the authors and in no way are representative of the views of Capco, Contango Capital Advisors, Institute of Management Technology, or any of their partners
This article is the fourth in the economists’ hubris series of papers that have so far investigated the shortcomings of academic thinking in the fields of mergers and acquisitions [Shojai (2009)], asset pricing [Shojai and Feiger (2009)], and risk management [Shojai and Feiger (2010)]. Our intention with this paper is to investigate whether academic finance has made any significant, and more importantly practical, contributions to the field of asset management. This specific discipline is of great interest to us since the wealth of a majority of the world’s future retirees will be dependent of how well these third-party fund/asset/money management firms manage the assets that have been placed in their care.

We should state from the onset that while the contributions of academic finance to the field of asset management cannot be denied, we are of the opinion that it has failed in its ambitions to allow investors to make informed decisions about who they select to manage their assets. We base our judgment on the premise that in order to allow investors make informed decisions about who they select to manage their assets they need to be able to compare performances of different managers on a risk-adjusted basis. However, the reality is that since most of the performance models are founded on CAPM, which has not been very successful in providing risk-adjustment figures for simple stocks [Shojai and Feiger (2009)], they are unable to provide us with a reliable risk-adjusted performance figure for each portfolio manager. Consequently, basing one’s judgment purely on an asset manager’s unadjusted performance, irrespective of the risk of his/her portfolio, might not be as sacrilegious as many academics have been suggesting for decades, since the denominator might have no relationship to reality whatsoever. More importantly, if the denominator is inaccurate it would mean that there are portfolio managers who do indeed perform very well, and not just the well-known ones, but whose performances are discounted by the wholly questionable methodologies used to adjust their performance for risk.

Sadly, the magnitude of failure of these models seems to be somehow correlated with the number of different asset classes that are added to the portfolio. For example, while comparing vanilla-structure pure equity-based mutual funds might not be too hard, though they are still scientifically questionable, when you introduce other asset classes, especially those with more peculiar distributions, you find that they are simply inaccurate. Consequently, we have decided to focus in this paper on the applicability of these models for the simple asset classes that they were developed for, namely equities, since if we find that they have difficulties with this asset class then their applicability to multi-asset class portfolios would be highly questionable.

Our objectives with this paper are to prove that the previous literature in this area has predominantly attempted to play catch up with what is actually taking place within asset management companies, that the models are simply unable to provide reliable risk-adjusted performance data, and as a result have skewed the system to benefit those who are not necessarily the best managers. This inability to reliably compare like with like has also meant that some investors are unable to prevent their managers from taking actions that are in their best interest rather the portfolio manager. It should be said that sadly agency costs [Jensen and Meckling (1976)] are at their most extreme in the field of asset management, where asset managers only share in the gains made by their clients as a result of their investment policies and not losses, and unless new ways of looking at the industry are developed we will be unable to mitigate them.

Having set the stool out on what our position is vis-a-vis portfolio performance evaluation models, we will now provide an overview of the literature to see how academics have been able to contribute to the field of asset management. Given the vast array of articles in this space, we are once again forced to focus on those small number of articles that most other studies reference. We will start with a short review of the history of modern portfolio theory, and examine whether asset management firms actually apply the principles developed. We will subsequently look at the performance evaluation methodologies and assess whether they are fit for purpose, and whether the large numbers of studies that examine mutual fund performance help us change the way these institutions actually manage money, how they are selected by clients, and compensated.

**History of Modern Portfolio Theory**

Few can deny the tremendous contribution that Harry Markowitz has made to the discipline of finance, and in specific asset management. Prior to his seminal work few undertook the necessary task of evaluating the risk-adjusted returns of their investments [Markowitz (1952, 1959)]. Markowitz made it possible to compare different assets based on their risk-adjusted returns. Of course, the asset pricing models that developed in response to his contribution, irrespective of whether they actually work in practice or not [Shojai and Feiger (2009)], were developed as a consequence to his work in the field of portfolio management. The recognition that a number of less than perfectly correlated assets within a portfolio will have a better risk-adjusted profile than a single stock helped the development of the Modern Portfolio Theory (MPT), the extension of which was the identification of the efficiency frontier and the market portfolio.
If we accept that MPT works, then one should expect most portfolio managers to try and locate portfolios that are located on the efficiency frontier and select the ones that most closely meet their own level of risk aversion. Sadly, however, trying to locate the efficiency frontier has eluded most who have attempted it, even those who are advocates of the efficient market hypothesis [Fama and French (2004)].

In reality we find that few, if any, of the portfolio management companies even try to look for the efficient portfolios in the way that theory tells us. If one looks at the institutional asset management market we find that most use different methodologies to describe a mechanism that is nothing more than a glorified stock picking process. They can call it a top-down or bottom-up asset allocation policy, or whatever impressive name that their marketing departments can generate, but at the end of the day, most portfolio managers rely on their own gut instincts and the recommendations of sell-side analysts. Of course, that is assuming that they have any say in what investments they make, given the huge restrictions placed upon them by the investment consultants who act as auditors on behalf of the pension and insurance funds whose funds are being managed. Now, we are not suggesting that using a combination of gut instincts and analyst recommendations is necessarily a bad thing. Many successful portfolio managers have generated huge returns for their investors this way.

In the retail fund management world, such asset allocation processes are replaced by a process of segmentation, which should allow the portfolio managers to differentiate themselves from their peers and hence attract new clients. Whichever investment vehicle one looks at, the one common thread that they share is that they do not look for efficiency frontiers. Of course, this fact has not stopped finance academics to look for alternatives to Markowitz’s mean-variance methodology [Lee (1977), Elton and Gruber (1974)], though they were found to be even less appealing. Elton and Gruber (1997) provide a rather exhaustive and useful review of the literature on MPT, but find that most fail when placed under a practical reality check. The literature seems to be useful for writing future articles on the subject, but has “not had a major impact on the implementation of portfolio management.”

If we find that portfolio management companies do not invest in ways suggested by academic theoreticians, then should we expect to find that the tools that have been derived by them can be used to evaluate their performance? In the next section, we will look at some of the most widely cited methods for evaluating portfolio performance and assess whether they are actually of any use in helping us determine how well a portfolio manager has actually done.

**PORTFOLIO EVALUATION MODELS**

Although there are numerous methodologies developed for evaluating the risk-adjusted performance of a portfolio, there are six models that are mostly quoted in academic literature, though only one, or perhaps two, are actually referred to by practitioners.

The first and most widely known methodology is the Sharpe Ratio [Sharpe (1966)], which divides the portfolio’s average excess return over a risk free asset by the standard deviation of the returns. Most investment management companies compare their performance with their peers by presenting the Sharpe Ratio \( \frac{(\tilde{r}_P - \tilde{r}_f)}{\sigma_P} \).

The second method, known as the Treynor’s ratio [Treynor (1966)], replaces the total risk, standard deviation, measure with systematic risk, beta, since the assumption is that the portfolio will have diversified away the unique/unsystematic risks of the individual shares in the portfolio \( \frac{(\tilde{r}_P - \tilde{r}_f)}{\beta_P} \).

The third methodology is known as the Jensen’s alpha [Jensen (1968, 1969)], which calculates the average return on the portfolio in excess of what CAPM would predict \( \alpha_P = \tilde{r}_P - [\tilde{r}_f + \beta_P(\tilde{r}_M - \tilde{r}_f)] \).

The fourth methodology is known as the Information ratio [Treynor and Black (1973)], which divides the alpha of the portfolio by the nonsystematic risk of the portfolio, the tracking error. It evaluates the portfolio manager’s ability to generate excess returns relative to a benchmark and their consistency \( \frac{\alpha_P}{\sigma(\epsilon_P)} \).

The fifth methodology is the M² measure [Modigliani and Modigliani (1997)], which makes interpretation of the Sharpe ratio easier. Basically, it assumes the creation of a portfolio of equities and U.S. T-bills with the allocation to each being determined by the volatility of the managed portfolio vis-a-vis the selected index. The adjusted portfolio will have the same standard deviation as the index, which allows for a simple comparison to determine excess returns \( M² = \tilde{r}_P - \tilde{r}_{m*} \), where \( P* \) is the adjusted portfolio.
Finally, there is the ratings issued by Morningstar Inc., which ranks mutual funds using a star system that most investors can easily understand. Morningstar starts off by dividing all the mutual funds it covers into four asset classes, such as domestic stock funds, international stock funds, taxable bond funds, and municipal bond funds. It then calculates the returns generated by the funds in each class by dividing the load-adjusted excess return generated by each fund by the average excess return for that class. It adjusts the returns for risk by working out how many months the fund generated negative excess returns and comparing that figure with the number of months its asset class generated negative returns. It deducts the risk figure from the return figure to arrive at the rating. The funds are then ranked according to where they are placed and given stars. For example, the top 10% receive 5 stars, the next 22.5% receive 4 stars, etc. [Simons (1998)]. Simons (1998) finds that the correlations between funds ranked by the Sharpe Ratio and Morningstar are in excess of 98%. And, according to Damato (1996) 90% of new money invested in equity funds in 1995 went to those rated 4 or 5 stars, which means that investors do value Morningstar’s rating system and certainly use it to select which funds they invest in.

Pretty much all of the aforementioned models have significant difficulties in helping us evaluate the performance of a portfolio in a way that can allow us to compare it with other portfolios, which is their main objective. The Sharpe Ratio is far too simple a model to capture the performance of a portfolio, yet it is probably the most cited ratio among practitioners. The reason practitioners like quoting the Sharpe ratio is that, similar to the P/E ratio used in share pricing, it is very easy to calculate and also very simple to manipulate. Even its founder is not convinced it is able to help us determine which funds perform better, risk-adjusted. Sharpe states that: “The Sharpe ratio was developed to answer the following question: if you had to choose one number to describe the desirability of a portfolio going forward what number would I suggest? Let me take each aspect of that sentence in turn. First of all, the task is to compress everything into one number. In many, if not most, cases a single number is not sufficient. It is like saying, here is a probability distribution of the return from a portfolio next year; I won’t let you draw the graph but you need to give me one number to indicate whether this is a good portfolio or not. Or if I am choosing between portfolio A and portfolio B but I won’t let you see the graphs, only a single number for each one. One response to the question that is posed is that it is a dumb question. We now have computers. Why not use more information when you make your decisions?

That is a valid response, but people still want a single number to make choices simple. The Sharpe ratio is a candidate. So what is it? It is a measure that attempts to capture aspects of both the risk and the expected return of the portfolio. More precisely, it focuses on the difference between the return on a portfolio and that of a benchmark. You estimate the expected value of that difference then divide that figure by an estimate of the risk associated with that difference, measured by its standard deviation. There is a setting in which you can say that if portfolio A has a higher Sharpe ratio than portfolio B and you can invest in only one of them, you should choose A. It was in that setting that I derived the measure, using a riskless security as the benchmark. Let me give you the conditions under which this is sufficient. First, an investor must care only about the expected return and standard deviation of a portfolio’s return. Second, it must be possible to borrow and lend at a single riskless rate. Finally, the comparisons are to be made at the level of the overall portfolio, with only one of the candidates to be chosen. Most investment decisions fail to meet some or all of these conditions. So before basing a choice on a comparison of Sharpe ratios you need to ask whether the setting is close enough to the original one to make such an approach good enough. In the common case in which a choice is being made concerning investment of a portion of an overall portfolio the original Sharpe ratio using a riskless security as a benchmark is likely to be inappropriate. However, there is a variant that may be useful. In this version the benchmark is an index fund or combination of such funds with the same ‘style’ as the manager in question. For example, if you are evaluating a U.S. growth fund manager you could use as a benchmark an index fund of U.S. growth stocks. A measure based on such a benchmark is often called an ‘information ratio.’ Interestingly, for a classic hedge fund the appropriate benchmark may actually be a riskless security. In this case the original Sharpe ratio may be useful, even if the fund is to be used only as part of a larger portfolio. The key point is to recognize that the Sharpe ratio and the information ratio only include aspects of expected return and risk. They both ignore any correlation of the difference in return from that of the benchmark with returns in other parts of an investor’s portfolio. Only if such correlations are small, absent, or the same among all possible choices does this make sense. There are also huge problems associated with the common practice of using ex-post average returns and the ex-post variabilities of returns as estimates of future expected returns and future risks. This is particularly true for many hedge funds that have what we call ‘tail risk’ — that is they take on a small probability of a disastrous outcome. A hedge fund that is asking for a new investment is not likely to have experienced a disastrous outcome, so their ex-post results will not be representative of their ex-ante possible returns. There are many reasons why you should be reluctant to choose investments based solely on ex-post Sharpe ratios. We now have computers. It is better to estimate more aspects of risk and return and put these estimates in a good portfolio optimization program” [Sharpe (2008)].
Treynor’s ratio has similar problems, with the additional difficulty of requiring the portfolio companies to calculate betas, whose value has to be questioned for basic equities let alone their portfolios [Shojai and Feiger (2009)]. As for Jensen’s alpha, the main issue is that one needs to find an efficient index otherwise the performance of the portfolio becomes a function of that index [Roll (1978)]. More importantly, it is difficult to determine what the correct index should be. Many variations to Jensen’s single-index model have been developed [Ross (1978), Gneebblatt and Titman (1987), Sharpe (1992), Elton et al. (1996)], however, none are able to help us accurately calculate, and more importantly compare, the performance of portfolios.

The situation becomes that much precarious when one starts introducing different asset classes, rather than just equities, to the portfolio, as is the case with most hedge funds, or customization, which is the case with institutional asset management and wealth management. In the case of hedge funds, they can, and many do, invest in assets that have distributions that are anything but normal. Yet, many use performance evaluation models that assume normality. The fact is that once you introduce combinations of assets then the models are simply not fit for purpose.

If determination of risk-adjusted returns of investments is as inaccurate as we find above then why are investors accosted by academics for choosing to invest their funds with those managers who are found to have simply performed better, irrespective of the risk they have, in the past and constantly trying to tell them that past performance is no guarantee of future performance. If markets are not as efficient as academic believe they are, such that opportunities for excess returns exist, and the risk of the manager cannot be evaluated with any degree of accuracy, then investors are fully within their right to choose those managers who have performed well in the past, since that is the only measure they can go with2.

More importantly, does it really matter how much more risk an asset manager is deemed to have taken if we cannot quantify it in any meaningful way? The risk of the manager only matters when he/she starts losing investors’ capital during downturns, at which point investors suddenly become more interested in absolute returns, not when they and the rest of the market are performing well. And, how can you say that a manager that is generating more returns has higher risk, or even similar risk to another manager, when the models are unable to accurately quantify it?

For example, if one finds that manager A has generated returns of 16% per year for the past four years, but is found to have a lower risk adjusted return, using the questionable methodologies above, over this period than manager B, who has been generating returns of 12%, which one should investors choose? Academic thought suggests the latter, yet it could be that manager A continues to perform better for the next 5 years. The fact is that since there is no scientific way of evaluating risk-adjusted performance many managers that are able to generate exceptional returns are ignored simply because they are more interested in generating returns than to manipulate their data to generate a lower raw return but a higher risk-adjusted one. Alternatively, many not so great managers are able to hide their inability to generate genuine alphas by manipulating the performance of their portfolios to obtain higher risk-adjusted returns.

If one accepts that argument, then all that matters is how well a manager performs and investors should not be accused of stupidity for using raw returns data for deciding who manages their assets. Obviously, this simple fact has not prevented academics from suggesting that those who simply look for great managers are able to hide their in

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**WHAT ACADEMICS SUGGEST INVESTORS SHOULD DO**

Academics suggest that irrespective of the accuracy of the risk-adjusted return calculations investors should take risk factors into account when selecting funds. But, how can you compare those funds? For example, one of the main methods by which mutual funds market themselves is via segmentation [Shojai and Preece (2001)]. This obviously goes against Markowitz portfolio optimization theorem [Markowitz (1952, 1959)], which requires a handful of stocks with negative co-variances to achieve the diversification required for optimal portfolio performance. The main reason that mutual fund managers use segmentation is that it allows them to differentiate themselves from their peers. It is also very hard to then compare their performance, since there would no longer be an appropriate benchmark to compare them against. For example, if two managers have international allocations and one is called the Indonesian Small-Cap Fund and the other is the Malaysian Mid-Cap Fund, which indices would you use to assess their performance, and how would you compare the risk-adjusted performance of the two?

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2 In reality, many investors invest in funds that are on the preferred/recommended list of the major brokerage firms, and to get on that list requires more than just performance.
What is most fascinating is that almost all scientific studies suggest that investors should invest their monies with mutual funds that generate long-term performance, and that the fund’s positioning as innovative does not really matter. For example, Carhart et al. (2000) find that five-year performance is the determining characteristic for a mutual fund’s survival in the long run (although one-year performance does have some explanatory powers). Their findings are corroborated by Carpenter and Lynch (1999), among others, who find that the future success of the industry will be determined by its overall long-run performance. Yet, when experiential evidence is used one finds that the variations can be huge between people. Sadly, none of the studies actually take the time to ask the investors themselves. For example, Hahn (2002) demonstrates that investors select funds not even on actual performance but perceived performance (Table 1). It is also important to note that the ranking is based on an asset-weighted basis, not risk-adjusted. The power of brokers will also determine which funds are selected by investors; hence the efforts expended by fund companies to appease the major brokerages.

Academics not only suggest that investors should look for long-term returns, even though hedge funds do not have anything remotely approaching long-term track records, they also suggest that their managers will typically not do a good job of managing their money. For example, Wermers (2000) found that although investment managers have outperformed their market benchmarks by an average of 1.3% per year, their net returns underperform the markets by 1%. About 1.6% of this 2.3% difference is explained by transaction and management costs, with the other 0.7% being explained by the underperformance of the non-stock holdings in the portfolios. Underperforming the markets is not limited to mutual funds. Hedge funds were also found to underperform the standard market indices, although they outperform mutual funds [Ackermann et al. (1999)]³. More recently, the focus has turned to comparing passive against active fund management and most find that investors actually come off worse when they choose the latter [French (2008), Fama and French (2008)], or that their risk-adjusted returns, using models that are founded on CAPM.

<table>
<thead>
<tr>
<th>Fund company</th>
<th>Actual return performance¹</th>
<th>Perceived performance²</th>
<th>Net sales (1999)</th>
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<td>Janus</td>
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<td>Fidelity</td>
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<td>U.S.$14 Bln</td>
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<td>#37</td>
<td>#3</td>
<td>U.S.$14 Bln</td>
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<td>Blackrock</td>
<td>#8</td>
<td>#81</td>
<td>U.S.$0.005 Bln</td>
</tr>
</tbody>
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* 1999 total return for a representative sample of the company’s funds, as measured against other funds with similar strategies, using asset-weighted figures.

³ Based on survey of 4,700 U.S. households conducted by Financial Research Corporation and Market Facts, Inc.

Of course, it is almost impossible to determine whether mutual fund managers do actually consistently do badly, risk-adjusted, if, as mentioned above, the risk factor is questionable at best, and all of these studies try and find their risk-adjusted returns, using models that are founded on CAPM.

What we suggest is that given that it is not possible to compare one manager against another due to the methodological problems mentioned above, the best way to assess the performance of a manager is to compare them against themselves. This idea, called inertia, was suggested to one of the authors during a meeting with Lord Myners a number of years back, when he had finished compiling his report on the U.K. asset management industry [Myners (2001)]. According to Lord Myners, inertia basically compared an asset manager’s end of year performance against making absolutely no changes to the portfolio during that year. In other words, compare the returns the manager generated after actively managing the fund against holding the portfolio unchanged from January 1st to December 31st of the year. We cannot divulge what the findings of this exercise were for Gartmore, where Lord Myners was the Chairman at the time the report was compiled, but we have decided to test that hypothesis using a number of students at the Institute of Management Technology. The idea, though far from scientific, would allow us to take more factors into account when deciding whether a portfolio manager has indeed done well during the year and how he/she should be compensated.

This is important because portfolio management companies are compensated in two ways. The first is as a percentage of assets under management, and this varies widely between active and passively managed funds. This should act as a stimulant to the managers since as they perform better the amount of assets under management increases and so does their compensation. Simply put, if they have a billion dollars under management and they charge 1% of that amount, their compensation is $10 million. If they generate 10% during the year, the amount of assets under management increases to $1.1 billion and their compensation also increases to $11 million. Many asset management firms also have a share in the upside of performance, especially hedge funds, so they are further enticed to beat the index that they are to be compared against.

³ Hedge funds were found to outperform mutual funds. This superior performance was found to be associated with the very attractive incentive fees charged by the managers. Hedge funds were also found to be on average more risky investments than mutual funds.
Their other source of income is trading revenues, which actually costs the clients, since they bear the full costs of that. Now, we do not intend to get into the debate of whether some managers simply trade a lot to increase their income, and perhaps even soft commissions [Myners (2001), Bogle (2009)]. What we do believe is that excessive trading can result in wasting client assets and that mechanisms should be put in place to more closely align portfolio managers’ compensation with those of their clients such that they are not as trigger happy as some seem to be. The fact that managers know that they can only benefit from trading excessively means that they might end up making trades that they might otherwise have not had they also been forced to pay part of that fee themselves. This situation becomes exacerbated for managers who are simply unable to produce genuine alpha. They make up for their performance shortfall by trading a lot to increase trading income.

Based on the aforementioned discussions, we hold the following hypotheses:

Firstly, academics miss the point of what a passive fund really is. Simply because a portfolio manager follows a simple index it does not mean that they do not incur trading costs. If the portfolio needs to be rebalanced regularly it does cost a lot to rebalance, perhaps significantly more than active funds. The cheapest way would obviously be for investors to either invest in ETFs (exchange-traded funds) [Engle and Sarkar (2002)], although they have their own pricing problems and issues [Huang and Guedj (2009)], or, even better, to simply roll-over futures contracts on indices. In the case of the latter they even save the cost of the manager and his/her fund management company.

Secondly, if we accept that risk-adjusted returns cannot be determined with any degree of accuracy, such that portfolios, and their managers, cannot be compared in any meaningful way, then the best way to determine how well or bad they did during the year(s) is to compare them to doing absolutely nothing during that period. This calculation can easily be done and if it is found that managers are in fact unable to beat themselves, as well as the indices against which they are compared, then maybe it is time for asset management companies to revert to investment committee asset allocation selections for long-term holdings, and allow those who are unable to do well to set up hedge funds and hide their lack of performance behind the veil of secrecy that hedge funds provide. Of course, if hedge fund managers are also evaluated in this way maybe their own compensation packages might also be modified.

It should be noted that we are in no way suggesting that this is a scientific way of determining how good a manager really is. What we are suggesting is that their performance-based compensation should take account of the fact that their efforts during the year has in fact added to, or subtracted from, what the client could have earned had the portfolio remained genuinely passive. More importantly, we are suggesting that fund managers might be more careful about how many times they turn a portfolio over during the year, at a huge cost to their clients, if they know their performance will be compared with their own fund without the cost of trading.

We decided to test this hypothesis using a number of graduate students who were asked to see if they could beat well-known stock indices and being totally passive for three years. The results are provided below.

THE RESULTS OF THE STUDENT’S ASSET MANAGEMENT INITIATIVES

In our exercise, 12 groups of students were asked to select 23 shares each from a given major index in the U.S., where we used the S&P 500, in the U.K., FTSE 100, and Germany, the DAX, and they were allowed to change their allocations once a month, taking into account the cost of trades and the spreads, calculated via the figures provide by Elkins McSherry. Given that the portfolios had only $100 million in the U.S., £100 million in the U.K., and €100 million in Germany we did not take account of market impact. The students rarely traded, at most sold two shares and bought two replacements a month.

The period of the study was January 1st, 2003 to December 31st, 2005. We chose this period since no major crises took place as far as we could remember. Sadly, finding a period where nothing major happens is not easy. Our hope is that the students did not cheat to improve the performance of their portfolios, and are quite confident that they did not. However, even if they did, the bias would actually work against us, in that their active portfolios would do better than the completely passive ones. They were allowed to choose any logic they wished to select the portfolios, and were told they would be given higher marks for their projects if they could substantiate their buy or sell decisions using analyst recommendations. Interestingly, given the period, such analyst recommendations were somewhat easily available. It goes without saying that most selected companies with whose names they were familiar, which could once again be considered a bias, though not definitely, since

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4 We asked each group to have 23 shares in their portfolio in order to make sure that their portfolios are well-diversified.
they tend to do better and it is surprising that more fund managers don’t choose their own investments using such a methodology. We all know that analyst recommendations, unless they come with access to IPOs from their investment banking brethren, are not really of much benefit. Nevertheless, most students made their buy and sell decisions based on their recommendations, like their professional peers, in order to hopefully have a better performance, and obviously a higher mark in their projects.

At the end of the project, they were asked to compare their performances against their respective indices and their original portfolio without any transactions during the three years.

The results of the study, which we repeat is anything but scientific, were that when we compared the totally passive funds with the somewhat active funds we found that in 2003, 75% of the passive funds beat the active funds, in 2004, 66.67% of the passive funds beat the active funds, and in 2005, 58.3% of the passive funds beat the active funds. Overall, on average, 66.67% of the passive funds beat the active funds during the three year period, with an average outperformance of 3.89%. This is quite an astonishing finding. Granted that these students are not professional money managers, but we feel confident that many money managers would also be unable to beat themselves if such an exercise was performed on their funds as well.

Of course, to test just how good or bad these students really were in managing money, we compared their performance against their respective indices. When we compare the performance of both passive and active funds with their respective indices we find that in 2003, 58.30% of the active funds and 75% of the passive funds beat the market, in 2004, 75% of the active funds and 91.67% of the passive funds beat the market, and in 2005, 91.6% of active funds and 83.3% of the passive funds beat the market. Overall, on average, 74.97% of the active funds and 83.3% of the passive funds beat the market during the three year period. On average, passive funds had an excess return of 13.06% over their respective indices compared to 9.04% for the active funds. This means that they are just as good, or bad, as an average portfolio manager. Obviously, if we also take account of management fees their performance might also come in just under or over the indices, but the fact remains that the totally passive funds did perform significantly better during this period.

Our proposition is that if money managers do spend more time thinking about the costs they incur when they keep on trading their investments, costs that are predominantly borne by the clients, then they might take more strategic decisions when they buy or sell the shares, or other asset classes, that they invest in. The current model, with the serious accusations that many of these trades are made for soft commissions, per the Myners report, or to get access to IPOs, or free research whose benefit is highly questionable, cannot be allowed to continue. Investors must be protected and if academic analyses cannot help them do that then may be its time to reassess how money managers are compensated, and a simple tool would be to compare them to themselves. In this case, one really does not need to use risk measures that even academics find to be of little benefit.

**CONCLUSION**

In this, the fourth article in the economists’ hubris paper series we look at the contributions of academic thought to the field of asset management. We find that while the theoretical aspects of the modern portfolio theory are valuable they offer little insight into how the asset management industry actually operates, how its executives are compensated, and how their performances are measured. We find that very few, if any, portfolio managers look for the efficiency frontier in their asset allocation processes, mainly because it is almost impossible to locate in reality, and base their decisions on a combination of gut feelings and analyst recommendations. We also find that the performance evaluation methodologies used are simply unable to provide investors with the necessary tools to compare portfolio managers’ performances in any meaningful way. The fact that these models are based on CAPM, whose own contribution to asset pricing is highly questionable, means that their application to portfolios of assets is simply not viable.

We suggest that since portfolios cannot be compared in any meaningful way, selecting portfolios that simply perform better than their peers, irrespective of their so-called risk, might not be a bad idea. The performance of many successful portfolio managers have been wrongly discounted using these models and perhaps resulted in their difficulties in attracting the kind of assets that they deserve, possibly resulting in their decision to leave traditional money management and establishing successful hedge funds. This might be interesting area of research.

Finally, we believe that while providing asset managers with a percentage of assets under management as compensation acts to stimulate performance, placing the full costs of trading on the clients can result in excessive trading. This situation can be remedied by using the inertia concept, which incorporates a comparison between the performances of asset managers at the end of each period with what they would have generated had
their original portfolio remained unchanged during the period used to determine their compensation schemes. By incorporating the inertia concept, portfolio managers who are unable to generate genuine alphas might be prevented from using trading revenues to make up for performance related income shortfalls, since they would find that they are also paying for them indirectly. Finally, it might finally put an end to the use of excessive trades in return for soft commissions.

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