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The Validity of Active Investment Fund Management

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Abstract: *This paper considers basically the validity of active investment fund management especially as it concerns generating more profit for an investor. The paper recognises that in other to fully appreciate the validity of active investment fund management it should be compared with passively managed funds. Both forms of fund management have their merits and demerits. The paper therefore, goes into detail in comparing and contrasting the advantages and disadvantages of both forms of funds management. The paper concludes by noting that actively managed funds have a higher potential of yielding better returns in an inefficient market. It further recognises that it may be better to adopt passive management strategy in a highly efficient market. However, the final choice of which among these two strategies to adopt rests with the investor' expectations and what he intends to make out of his investment.*
Keywords: *investment, management, funds, active, passive*

I. Introduction

Active investment fund management is the use of specialized means to manage a fund's portfolio with the aim of outperforming the market. Active investment managers basically aim to take advantage of inefficiencies in the market by buying securities that are undervalued and in cases of overvalued securities they adopt short-selling option. Active investment management could be achieved by employing the services of a single manager or a group of managers who will use their experience, analytical research, forecast and experiential knowledge and acquired skills to make intelligent market decisions. They decide when and what securities to buy, hold or sell. Some of the methods used by active investment managers include quantitative measures such as price/earnings ratio, deep understanding of the market dynamics for example focusing mainly on banking stock/bonds during a given period as a result of the prevailing economic situation at the time. By reason of this strong understanding of the market they are able to fish out companies that may be having some problems and selling their stocks and may be bonds at a discounted value in desperation to raise more capital. This expertise analysis and research effort put in by active managers cost money. This cost is transferred to the investors by way of fees paid to the active managers for their services. This ends up impacting on the investments net return. However, if all goes well the fund manager may still be able to outperform the market after deducting all costs giving more returns to the investor (Arnerich, T. et al 2007).

Active managers may use the above strategies independent of one another or use them in combination. Active managers aside from generating returns that exceed the benchmark index may also strive to maintain portfolios that are less volatile than the benchmark. Investors who follow the principles of active investment management believe it is generally possible to identify and exploit mispriced securities. In essence these investors do not believe in the efficient market hypothesis. The underlying reason investors embark on active management is to generate better returns relative to passively managed index funds. Nonetheless, some investors recognise that active investment is quite demanding in terms of skills and time and may therefore opt to go with passive investment, which does not require sophisticated skills. The investors simply buy and hold the security with the intention that the security will closely follow a specified index.

Passively managed funds typically have lower cost than actively managed funds. In an efficient market where there is free flow of information (and investors have knowledge of what is going on in the market) passive investment is a good strategy to adopt. By adopting the passive investment option an investor can avoid the risk of an active manager investing wrongly and causing the investor huge loss. Earlier studies dating back to Treynor & Mazuy (1966) and Henriksson & Merton (1981), as well as recent studies such as Becker, Ferson, Myers, & Schill (1999) and Jiang (2003), all find that the average market timing performance of mutual funds is insignificant and sometimes even negative. However, a passively managed fund cannot take advantage of opportunities that may come about in the market as a result of say stock mispricing as mispricing opportunities in the market can only be better understood through thorough investigation (Arnerich et al 2007).

The rest of the paper is organized as follows; the next section considers the attributes of a good investment manager. This is followed by an attempt to answer the question "is active investment management better than passive investment management"? And finally the paper reaches a conclusion.

WHO IS A GOOD INVESTMENT MANAGER?

The success of actively managed funds is a function of the skills and expertise of the investment managers behind the management of the funds. It is therefore, important to understand those characteristics that make a good investment manager. A good investment manager is one who is able to react quickly to changes in the market. He is able to understand and follow the market momentum (the measure of the rate of rise and fall in stock price) (Mulvey & Kim 2008). Good managers learn to follow and take advantage of momentum effect, since it is reported by Grinblatt, Titman, & Wermers (1995) that about three-quarters of equity funds track momentum.

In selecting a good investment manager investors may want to consider the past performance of the manager. For this reason and to readily convince potential clients managers maintain a composite; a compilation of all the portfolios they managed in the past. The composite presentation gives potential investors a fair idea of the manager's past strategies and how well those strategies were implemented. Composite performance can be presented in a lot of ways but the main standard is the Global Investment Performance Standard (Alliso 2010). The composite format should at least reveal the followings: Gross-of-Fee and Net-of-Fee Total Returns, indicate investment benchmark total returns for all periods, total number of portfolios and total composite assets, and the variability of the returns on the various portfolios.

Choosing a good manager involves analysing his historical performance and taking a close look at the strategies and plans he has for the future, (Schmidt 2010). It is not enough to choose an investment manager simply on accounts of his previous performance. The consistency of his past performance has to be taken into consideration. This can be achieved by comparing the manager's performance over the last say ten years with the performance of other managers. Comparison should also be made between the manager's investment portfolio absolute return with indexes and portfolios with similar characteristics (such as comparing a growth stock with other growth stocks or value stocks with other value stocks). This could also mean for example comparing a typical US large cap stock with the S&P benchmarks. It should be investigated to determine how well the manger followed his initial strategy and plan. A manager consistently outperforming his benchmark may sound like a good thing but it may not necessarily be. The reasons for achieving a low correlation between the actual returns and the expected returns may be as a result of the fund manager possessing strong market timing skills and good sense of picking the right stock. Alternatively it could be that the manager is not in control of what he is doing and was merely lucky or simply just following the trend. Some investors may prefer to go with managers who consistently follow set plans while others may not care as long as the fund manager generates returns that are better than the benchmark (Schmidt 2010).

Knowing how fund managers perform during various market cycles is very important. This helps to reveal whether the fund manager shows varying levels of performance during market downturns and market upturns or whether he is consistent irrespective of the market cycles. It could reveal whether a manager performed relatively well during both cycles compared to other fund managers. Finally it is important to know how committed and confident the fund manager is to his fund. An investment manager that does not invest in his own fund obviously does not trust his ability to make reasonable returns. This is a very important criterion and should not be taken for granted. A fund manager who has faith in his ability and skill will be more than willing to invest in his own funds.

IS ACTIVE MANAGEMENT BETTER THAN PASSIVE MANAGEMENT?

Portfolio investment managers carry out due diligence on a particular security before taking a decision whether to invest in the security. Before buying a particular stock or bond they consider issues such as the quality and value of the company, its past and future potentials, the industry and country in which the company is situated and other factors and its credit rating. They basically ensure that capital is judiciously and prudently allocated among securities. Because active management entails prudent allocation of capital between the securities that are traded in the secondary market through due diligence many argue the process guarantees reliability and trustworthiness of the security market (Adkins, 2007). In choosing a fund manager to a large extent the investor trusts that the manager will invest the money wisely. The investor trusts that the manager's investment discretion will yield good returns. This however, may not always be the case. The manager may make bad decisions or adopt strategies that are counterproductive (Boyle 2008).

The behaviour of security market is influenced by a couple of factors including inflation, interest rates, domestic unrest, oil price fluctuations, terrorism and even earnings. These factors interact with each other and consequently affect the dynamism of the market causing the market to behave in unpredictable ways. The market behaviour or movement can also be influenced by a phenomenon referred to as 'herding'. This is a situation where there is unsupported rallied or sell-offs in the market. Herd behaviour is said to occur when individuals mimic the behaviour of a larger group irrespective of whether the decision to follow the larger group is the right decision or not. This can be attributed to social pressure to conform to what may be considered as a norm or the right thing at the time (Phung 2010). The complex and unpredictable nature of the market make investors seek ways of avoiding the volatility of the market and ways via which they can outperform the market. Even though there may be no clear cut formula for beating the market investors believe that active management can be used to overcome the threat of market volatility. Investors believe that active managers have the requisite skills and better understanding of the behaviour of the security market. Investment managers are assumed to have the time and tools to adequately analyze and predict the market. They are believed to have the correct software applications to carry out this analysis and that they can also predict and time the market by reason of the experience they have acquired over time on the job. Active investment managers could work individually or as a team to fulfil their client's investment objectives. This could be with the aim of outperforming a given benchmark or by tracking a specific yardstick set by the investor. This yardstick may not track any known benchmark (Brown 2010). It is also argued that the activities of active investment managers in the overall help to make the market more efficient as it helps improve the accuracy of financial prices and provides room for efficient capital allocation (Swedroe 2009).

It is common for the performance of an actively managed investment portfolio to be compared to a given benchmark index, this technique was originally developed by Jensen (1968). However, the methods adopted in the past for the measurement of the performance of securities assume that the risk level of the portfolios remain constant throughout the period of the evaluation. It also takes for granted the fact that the expected rate of return of the portfolios may vary with the economic climate (Lee 1999). According to Lee (1999) many of the challenges seen in previous performance studies echo the inability of traditional measures to properly take into consideration the unstable pattern of security returns. In other to eliminate these shortcomings in future measurement techniques Ferson and Schadt (1996) and later Lee (1999) suggested an approach called conditional performance evaluation*,* which adds market indicators. With this performance evaluation approach it was discovered that the average fund performance show significant improvement when compared with previous traditional methods of funds performance analysis.

Many authors have argued against the ability of fund managers to accurately anticipate the behaviour of the market (Knigge et al. 2004) and Fung et al. (2002)). Also the work by Roy and Deb (2004) found that there does not exist significant market timing coefficients. Following the findings by Roy and Deb (2004) one may then argue that fund managers do not bring any significant value and their funds management ability can therefore be said to be inefficient. Furthermore other studies such as Becker, Ferson, Myers, and Schill (1999) and Jiang (2003) including earlier studies by Treynor and Mazuy (1966) and Henriksson and Merton (1981) all suggest that market timing performance of mutual funds is insignificant and sometimes return as negative. They suggest that there is no clear cut formula for predicting the market. The reasoning is that if there is any such formula everybody will adopt the formula and sooner than later the formula will become common knowledge and give no investor/manager any edge. However some other authors such as Jiang et al. (2005) and Lee (1999) argue that it is possible for fund managers to possess accurate timing ability. Jian et al., (2005) propose in their paper new measures of market timing based on mutual fund holdings thereby eliminating the possibility of artificial timing biases.

Malkiel (2003) in his paper argues that passive management is a better strategy to adopt rather than active management irrespective of whether the market is efficient or not, domestic or international market, and small capitalisation stocks or large capitalisation equities. The paper demonstrated that passive management is more profitable due to the high cost of running an active portfolio. These costs include management fee which is significantly higher for actively managed funds. Also for taxable investors passive management has higher tendency to minimise taxes and reduce turnover. Reduction in turnover means reduction in brokerage costs and also reduction in the spread between bid and asked prices and the negative market impact that emanates from selling blocks of securities. This is in consonant with the findings of Wermers (2000) and Kaushik and Barnhart (2008). These authors carried out investigation on actively managed mutual fund performance and reported that an average well diversified mutual fund tends to under-perform passive market benchmarks after adjusting for transactions cost, risk and other trading expenses.

The cost of active investment management is seen to erode the gains achieved by investing actively as against investing passively. Various authors including Fandetti (2010) and Pittman, Kirk, and Dillon (2009), all argue that active investment fees are high enough to significantly reduce the extra profitability of using fund manager. Furthermore if the manager engages in frequent trading this will generate huge transaction cost and further reduce the returns. Worst still if such finds are held in taxable accounts the returns will further be reduced. In the research carried out by Pittman, S., Kirk, M., and Dillon, B. (2009) in which 3, 5 and 10 year sample periods were examined it was discovered that the average returns generated by active managers did not outperform the S&P IFCI Emerging Markets index after costs. Instead the findings revealed that the average manager's performance before cost was similar to the index and after cost was deducted from the returns it was found to perform less than the index. These findings are in line with Sharpe's assertion (Sharpe 1991).

It is also worth pointing out that as actively managed portfolio attends success and grows it tends to begin to behave more like an index as the asset base becomes more diversified. Furthermore this success may lead to laxity and lack of focus on the part of the managers. Another problem active investment companies and invariably actively managed portfolios face is that key managers within the investment company may leave for greener pasture by joining other organisations or simply starting their own business. These companies may begin to lose focus due to overconfidence and may generally become sloppy and pay little attention to the changing dynamics of the business environment (Voicu 2010).

IMPLICATION

Active investment is a strategy that can be used to outperform the market. However, in an efficient market this becomes more difficult as there is better flow of information and this information is readily available to all. Whether it is taking advantage of mispricing opportunities within an efficient market or taking advantage of the broader opportunity base in an inefficient market it requires a reasonable level of expertise. To optimally take advantage of the opportunities that may come up in the security market an investor may be better off employing the services of an investment manager.

Active investment managers can choose to invest in less risky, high quality companies instead of investing randomly in selected stocks. By so doing the manager is able to control volatility of the fund. Take the fall of the tech sector in 1999 and the banking sector in 2008 which comprised over 20 percent of the FTSE 100 index. It is only with active investment that an investor can avoid such risks in certain stocks especially decline in the market that affects specific stocks that hold a huge percentage of the index. If say during the recent decline in BP's share value as a result of the oil spill in the Gulf of Mexico, Shell and HSBC also had problems that resulted in there share values dropping that will mean a huge drop in the value of the FTSE 100 index. This will be particularly so since these three companies alone hold over 20 percent of the index. This sort of risk can only be avoided through active investing (Kearney 2010). Alternatively the manager may choose to invest in stocks with higher risk with the aim of obtaining higher returns. He may choose to combine these various stocks with the aim of diversifying the portfolio (having investments that are not highly correlated with the market) and possibly reducing the portfolio volatility. Active managers can help an investor generally meet his investment objectives. These objectives could mean investing in specific industries, specific categories of stocks or even in emerging markets with significant level of market inefficiency (Malkiel 2007).

For an active investment management company to be successful it must be ready to engage in continuous research, be extremely disciplined and must always follow simple and well defined processes. It must not incur huge expenses as this will end up impacting on the overall returns to the investor. Lastly it must have real passion for investing. For an investment company the managers must share common objectives of maximising shareholders interest and at the same time ensuring that investors get expected returns on their investment (Voicu 2010). The management team must work together, share market information freely and be committed to ensuring that right investment decisions are made at all times.

The final choice of whether to invest actively or passively lies with the investor. It is all dependent on what the investor wants to get out of his investment and the level of risk he wants to take.

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