



Active Management Unleashed: Addressing Mutual Fund Design Flaws and Reestablishing Value

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Active Managers have continued to lose ground to Passive solutions over the past decade in terms of net flows and perceptions of value. After years of debate and analysis, can Active Managers turn the tide on this trend? The report “**Active Management Unleashed: Addressing Mutual Fund Design Flaws and Reestablishing Value**” provides 1) Advisor perceptions of active vs passive investments, 2) validation of active managers’ skill in selecting securities and, 3) identification of mutual fund design flaws that impede active managers’ performance.

This White Paper provides valuable insights and cost-effective recommendations that can benefit executives at fund companies, ETF providers, as well as large consumers of active management such as broker-dealers, insurance firms, and institutional investors.

The 40-page whitepaper employs an in-depth and prescriptive analysis that isolates and evaluates high conviction stock selections from top-rated actively managed mutual funds to determine active manager skill, and involved an online survey of over 200 Financial Advisors that explored a variety of attitudes and perspectives regarding Active and Passive Management. But perhaps most importantly, the Paper provides actionable and achievable recommendations for performance improvement.

The White Paper provides buyers with the following insights:

- Advisors’ perceived value of Active vs Passive Management
- Advisors’ current and future use of investment solutions in client portfolios
- Critical perceptions regarding commoditization of active management and advice
- Evidence that Active Managers have skill in securities selection
- The trade-offs between tracking errors and the diluting effect of **Beta Anchors**
- The tangible benefits of diversification at the process level
- Prescriptive recommendations to employ and improve performance

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I. Introduction

One of the most impassioned debates in the investment industry has been the argument over ‘active vs passive’. But over the past several years the shouting and trumpeting have seemingly settled down to a quiet buzz. From many quarters, it appears the argument has been won, with passive claiming the prize. Certainly, net flow data would appear to confirm this view: net flows into passively managed US equity funds and ETFs have exceeded the corresponding net flows into actively managed funds for 11 consecutive years.

The advocates on the passive side consistently invoke their fee advantage and add a claim that the markets are too efficient and/or active managers do not have the skill necessary to reliably outperform index products. But is this truly ‘settled science’? Does the fee differential between active and passive products adequately explain the habitual underperformance of actively managed funds, and is there proof that active managers are devoid of stock selection skill? Or are there other contributing factors?

Setting aside marketing assertions, this White Paper attempts to determine whether active managers are fated to permanently underperform their low fee, passive counterparts, and if industry fee pricing standards and market efficiencies are too onerous a set of challenges for active fund managers to overcome. Specifically, this White Paper explores the answers to the following questions:

1. Do active investment managers have tangible and repeatable skill in selecting stocks?
2. If active fund managers do have skill, are there obstacles with the legacy design and structure of the mutual fund that are inhibiting fund managers’ ability to reliably translate their skill into benchmark outperformance?

In regard to the latter question, a series of interviews with industry thought leaders generated three areas of mutual fund design to focus on, each reflecting potential structural flaws:

- The traditionally higher expense ratios of actively managed funds.
- The diluting effect of an oversized ‘Beta Anchor’, where a **Beta Anchor** is defined as the portion of a fund’s portfolio (stocks and corresponding allocation weights) that are used primarily to maintain a tight tracking error to the fund’s benchmark.
- The standard template of using a single manager and investment process per fund – as opposed to a multi-manager, multi-process approach, and the resulting added layer of diversification.

As a final note, it is important to recognize that the purpose of the White Paper is to introduce new insights into the long-standing debate between active versus passive management, question the status quo regarding how the industry creates value, and perhaps trigger discussion and debate that can lead to better outcomes for investors. The data provided is robust, but sample sizes are typically too small to achieve statistical significance. Therefore, while at least some of the conclusions and outcomes presented might be considered disruptive (e.g., re-thinking the design of the mutual fund), they should be considered as directional, rather than conclusive, conclusions.