Elston

Insights

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Understanding SPIVA

- Long-only retail active management is a zero-sum game
- The evidence from SPIVA
- Adopting a more nuanced approach to find alpha

Active management is a zero sum game

In game theory, a zero-sum situation occurs when one person's gain is equal to another's loss. And as set out with breath-taking simplicity in Nobel-prize-winning economist William Sharpe's 1991 paper "The Arithmetic of Active", active management is a zero-sum game. Rather than have us try to reinvent the wheel, here are Eugene Fama & Kenneth French explaining the idea in a 2009 essay:

"Suppose we define a passive investor as anyone whose portfolio of U.S. equities is the cap-weight market portfolio described above. Likewise, define an active investor as anyone whose portfolio of U.S. equities is the not the cap-weight market portfolio. It is nevertheless true that the aggregate portfolio of active investors (with each investor's portfolio weighted by that investor's share of the total value of the U.S. equities held by active investors) has to be the market portfolio. Since the aggregate portfolio of all investors (active plus passive) is the market portfolio and the aggregate for all passive investors is the market portfolio, the aggregate for all active investors must be the market portfolio. All this is obvious. It is just the arithmetic of the fact that all U.S. equities are always held by investors. Its implications, however, are often overlooked."

What Bill Sharpe was saying to us was this: the performance of all active managers is, in aggregate [for a given asset class] that of the index less active fees. Which is a considerably worse deal than the charge often levelled against passive funds, namely that investors are paying for the performance of the index less passive fees.

A note on the terms 'active' and 'passive'

We make no suggestion that an actively managed asset allocation cannot add value relative to a policy benchmark. Indeed, given that asset allocation is the primary driver of portfolio performance outcomes, this should be a primary investment objective. We therefore discourage using "active" and "passive" terms when discussing asset allocation and prefer instead to refer to a "dynamic allocation approach" or "static allocation approach" to reflect how an asset allocation is managed.

The active vs passive debate is focused on security selection within an asset class. An asset class can be identified by an investable benchmark representing an opportunity set. The debate is relevant to long-only strategies, as represented by holding a portfolio of direct securities for that asset class or a collective investment scheme for that asset class. Given these limited parameters, we feel the term 'passive' is woolly and unhelpful and prefer instead to refer to 'index investing'.

What does the evidence say?

The SPIVA scorecard is a robust, widely-referenced piece of research, conducted and published by S&P DJI. It compares actively managed funds worldwide against their appropriate benchmarks on a semi-annual basis and over time, certain themes have emerged. One is that actively-managed funds have historically tended to underperform both in the short-term and over longer periods. Another recurring theme is that even when an active manager has outperformed over a particular period, they usually fail to outperform consistently over multiple periods.

The retail investment sphere is complex to measure, a circumstance that has long been exploited by active managers looking to present their performance in the most advantageous light. The methodology adopted by SPIVA makes considerable efforts to account for and iron out data that can potentially skew results, ensuring that the findings published are as reliable and representative as possible. Measurement techniques, universe composition and fund survivorship are all taken into account, with allowances made to accommodate and adjust for asset-weighted returns, benchmark suitability and consistency of style ie, a fund altering its scope or focus.

Persistency

The SPIVA scorecard has a particular focus on what is termed persistency ie, consistently outperforming over time. In the real world, persistency is challenging and rare, meaning that over time it is very hard, in efficient markets, for active managers to consistently outperform the index. SPIVA research has demonstrated that actively-managed funds generally underperform their respective indices over the long-term and not only that, but that one of the main determinants of performance persistency is fund expenses. Put simply, lower fee funds offer better value for money than higher fee funds for the same given exposure.

In practice, the majority of GBP-denominated funds available to UK investors have underperformed a related index over longer time horizons. Whilst the percentage of funds that have beaten an index over any single year may fluctuate from year to year, no active fund category evaluated has a majority of outperforming active funds when measured over a 10-year period.

Survivorship

Survivorship bias refers to the fact that funds with poor performance records can be shut down, meaning that over a longer period – say 5 or 10 years – if performance data used is from the end of that period, those funds that have dropped off the radar are missed and an inaccurate picture is presented. This works in favour of active funds, given that only the stronger ones survive, so in order to account for this, SPIVA adopts three measures: it uses the opportunity set from the outset of the period, not the end, it explicitly displays the survivorship rate (ie, the percentage of funds from the start of the period that are still in existence at the end of the period) and it also constructs a peer-average return series for each category, also based on the data set from the start rather than the end of the period.

Methods for adjusting for survivorship bias in performance data differ significantly and can be a source of some controversy given that some funds suffer from idiosyncratic shocks rather than low alpha but in general, the practice is useful and has acquired widespread acceptance.

Asset-weighted returns

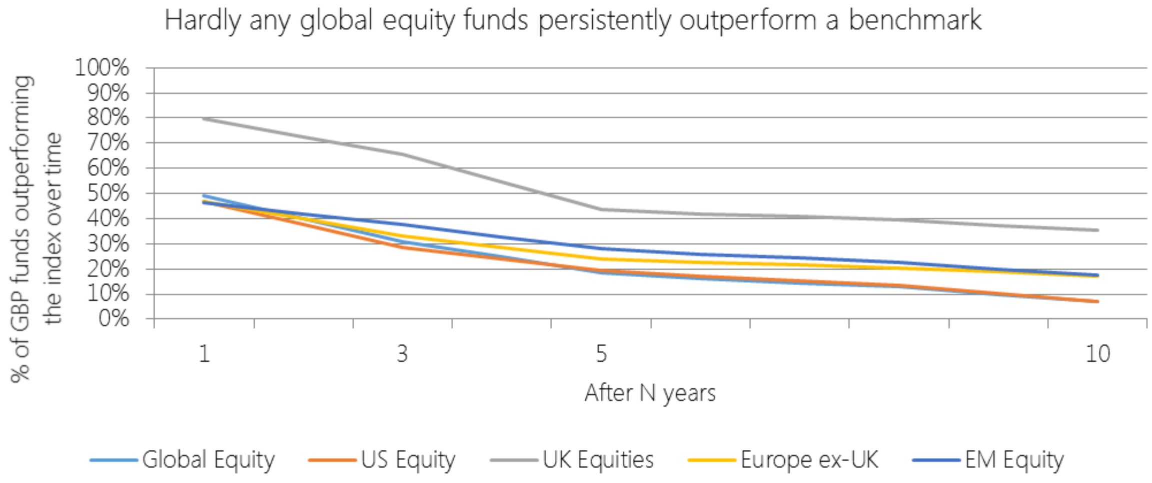
Asset-weighted returns are a better indicator of fund category performance because they reflect the returns of total money invested in a particular style category with more accuracy. SPIVA ensures this is accounted for by calculating a weighted average return of all funds within a category in a particular month, with each fund's return weighted by its total net assets.

Our analysis of SPIVA data

SPIVA scorecards reveal any number of fascinating and pertinent insights into active versus passive performance, but some of the conclusions we find particularly interesting are as follows:

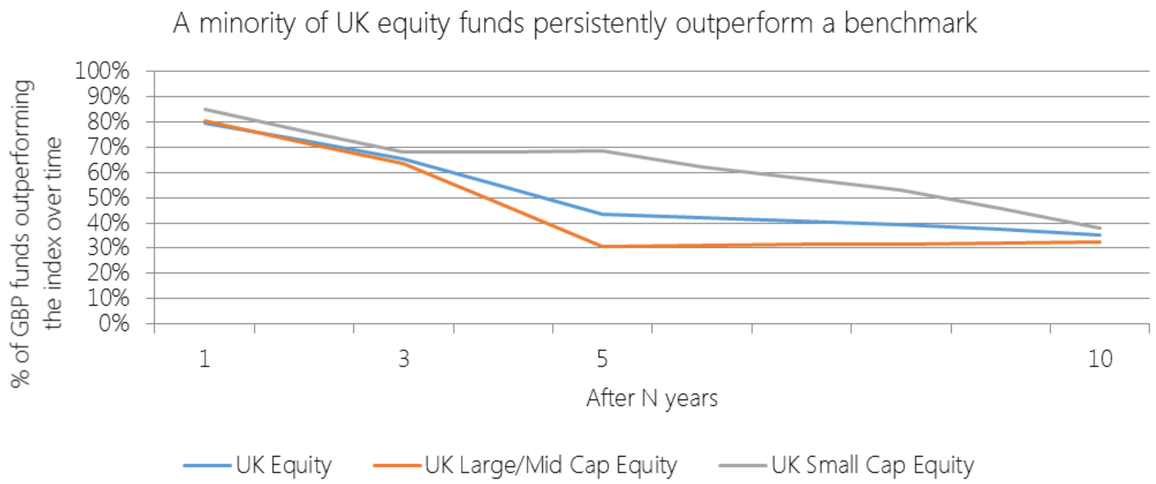
Regional variations

Looking at the chart below, it looks possible that regional variations are a function of market efficiency ie, the market is more fully invested and participants are more professional which makes information advantage harder to achieve.



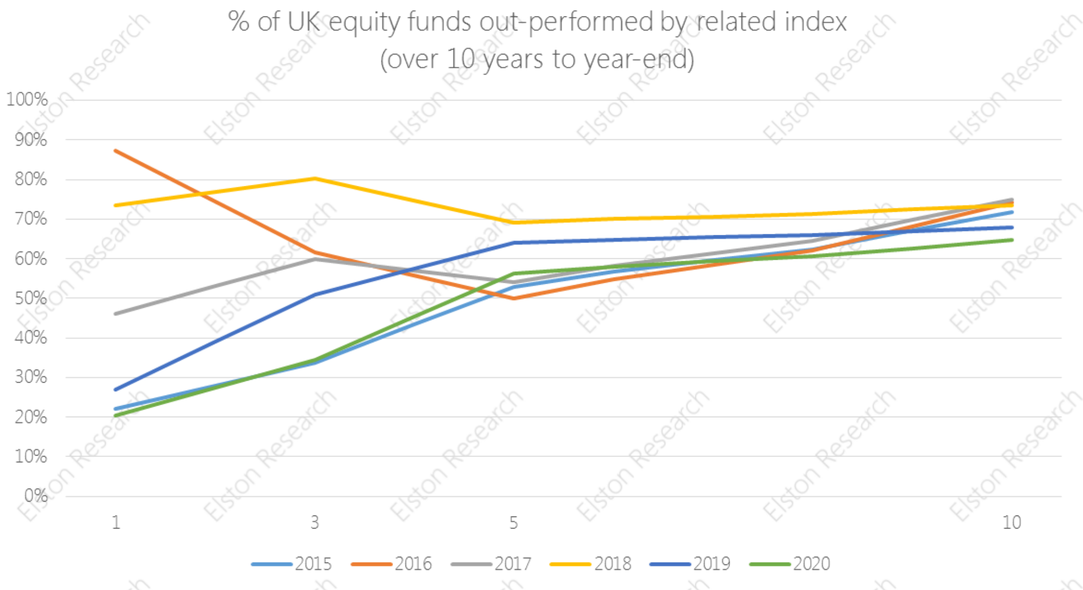
Segment variations

Within a market, we would expect the small cap sector to be less efficient than the large cap sector. For the UK, this seems to hold true over a 5-year period, but the anomaly falls away over 10 years.

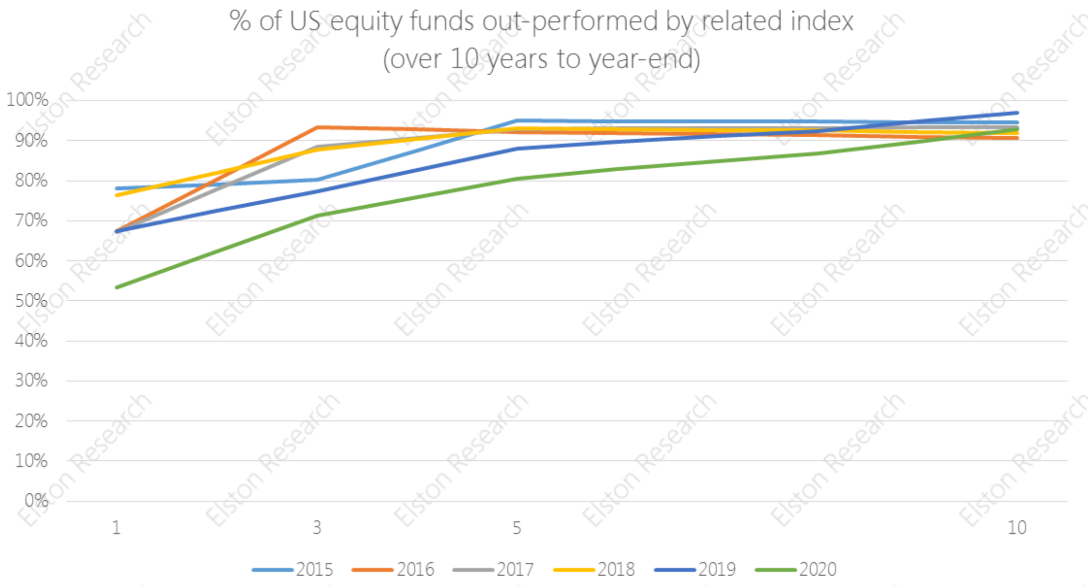


Sequencing variations

Regional variations are also present across different market regimes. Looking at the chart on the UK below, we can see considerable inconsistency over the short term, most likely on account of market volatility around Brexit, but this variability fades away over time with 70% underperformance in active management over the longer term.



In the US we are presented with a more consistent picture: in the near-term underperformance is prevalent, in the long-term it is almost endemic at 90%.



Adopting a more nuanced approach to obtain alpha

In conclusion, in order to avoid the underperformance inherent in active management, investors need to think more about how to find 'true' active. This can be achieved by focusing on asset allocation, static vs dynamic, systematic and non-systematic tactical allocation, index-investing and non-index investing. Available to investors are traditional index-weighting but also alternative index-weighting schemes that can capture alpha more cleverly. The use of any or all of these disciplines requires active choices by investors or managers beyond simply picking an active fund manager and hoping (in vain mostly!) that you have selected one of the extremely rare outperformers.

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