

# Is Active Management Getting Harder?



**Craig Lazzara**  
Managing Director  
Index Investment Strategy  
S&P Dow Jones Indices

*This piece originally appeared in the December 2017 edition of Indexology Magazine.*

In a word, yes.

The data are clear. Our year-end 2016 SPIVA® U.S. Scorecard, e.g., showed that 66% of large-cap mutual funds underperformed the S&P 500 in 2016.<sup>1</sup> Results were even worse for mid- and small-cap managers. Nor were 2016 results unusual—in the 15 years we’ve produced SPIVA, active managers beat the S&P 500 only three times. Moreover, when active success has occurred, it has tended not to persist. Our Persistence Scorecards demonstrate that an investor has a better chance of flipping a coin and getting four heads in a row than he does of identifying a fund manager who will be above average four years in a row.<sup>2</sup>

Successful active management is obviously difficult, and there are two reasons to suspect that it may become even harder.

First, **there is no natural source of outperformance (or, in technical jargon, “alpha”).** One investor can earn a positive alpha only if some other investor earns a negative alpha. Successful (or lucky) active managers, in aggregate, can only produce positive alpha if less successful (or unlucky) managers endure negative alpha, and the aggregate value of the winners’ gains is exactly offset by the losers’ underperformance. Since trying to earn alpha costs more than passive management, whether the quest is

successful or not, it’s not surprising that most active equity managers typically underperform a passive benchmark; nor is it surprising that passive management has consistently gained market share relative to active management.

But what happens when passive management gains share? Where do the passive assets come from? If some active managers are more skillful than others, and their skill is manifested in outperformance, then presumably it is the least skillful

<sup>1</sup> Soe, Aye M., and Ryan Poirier. “SPIVA U.S. Year-End 2016 Scorecard,” April 2017. <http://spindices.com/documents/spiva/spiva-us-year-end-2016.pdf>.

<sup>2</sup> Soe, Aye M., and Ryan Poirier. “Does Past Performance Matter? The Persistence Scorecard,” June 2017, <http://spindices.com/documents/spiva/persistence-scorecard-june-2017.pdf>. Poirier, Ryan, and Aye M. Soe. “Fleeting Alpha: Evidence From the SPIVA and Persistence Scorecards.” February 2017, <http://spindices.com/documents/research/research-fleeting-alpha-evidence-from-the-spiva-and-persistence-scorecards.pdf>.

active managers who lose the most assets. In that case, the existence of a passive alternative raises the quality of the surviving active managers, thus contributing to market efficiency.<sup>3</sup> By reducing the number of potentially underperforming active managers, indexing makes it harder for those who remain.

Second, a new generation of index-linked products makes it possible to **indicize strategies that were formerly the exclusive preserve of active managers**. Smart beta or factor indices provide exposure to a wide range of attributes which investors may find attractive. Consider, e.g.,

an active manager who historically has tilted away from his or her cap-weighted benchmark in a systematic way (perhaps by emphasizing value, or small size, or low volatility). The manager's clients have had no way of disentangling how much performance is attributable to factor tilts and how much is attributable to stock selection beyond the factor. Now, factor indices make it possible for the client to access the factor, without paying for a manager's stock selection, and to do so transparently and at low cost. Thus smart beta may also make life more challenging for active managers.

SPIVA tells us that most active managers underperform most of the time; the growth of both cap-weighted and factor-based passive investing suggests that the future of active management is likely to be just as grim as its recent past. Of course, what is true across the population of active managers does not mean that individual managers cannot be exceptions. Indeed, managers like Warren Buffett and Peter Lynch are famous because their performance was exceptional. If most active managers could outperform consistently, we wouldn't celebrate the few who do.

<sup>3</sup> Note, though, that increasing the ability of the average manager doesn't translate to outperformance for the average manager's clients – a conundrum first noticed by Charles Ellis (in "The Loser's Game," <https://www.cfapubs.org/doi/pdf/10.2469/faj.v51.n1.1865>) more than 40 years ago.

#### GENERAL DISCLAIMER

Copyright © 2017 S&P Dow Jones Indices LLC, a division of S&P Global. All rights reserved. Redistribution or reproduction in whole or in part are prohibited without written permission. STANDARD & POOR'S and S&P are registered trademarks of Standard & Poor's Financial Services LLC, a division of S&P Global ("S&P"); DOW JONES is a registered trademark of Dow Jones Trademark Holdings LLC ("Dow Jones"); and these trademarks have been licensed for use by S&P Dow Jones Indices LLC. S&P Dow Jones Indices LLC, Dow Jones, S&P, their respective affiliates, and their third-party data providers and licensors (collectively "S&P Dow Jones Indices Parties") makes no representation or warranty, express or implied, as to the ability of any index to accurately represent the asset class or market sector that it purports to represent and S&P Dow Jones Indices Parties shall have no liability for any errors, omissions, or interruptions of any index or the data included therein. Past performance of an index is not an indication or guarantee of future results. This document does not constitute an offer of any services. All information provided by S&P Dow Jones Indices is general in nature and not tailored to the needs of any person, entity or group of persons. S&P Dow Jones Indices receives compensation in connection with licensing its indices to third parties and providing custom calculation services. It is not possible to invest directly in an index. Exposure to an asset class represented by an index may be available through investable instruments offered by third parties that are based on that index. S&P Dow Jones Indices Parties do not sponsor, endorse, sell, promote or manage any investment fund or other investment product or vehicle that seeks to provide an investment return based on the performance of any Index. S&P Dow Jones Indices LLC is not an investment or tax advisor. S&P Dow Jones Indices Parties make no representation regarding the advisability of investing in any such investment fund or other investment product or vehicle. A tax advisor should be consulted to evaluate the impact of any tax-exempt securities on portfolios and the tax consequences of making any particular investment decision. Credit-related information and other analyses, including ratings, are generally provided by licensors and/or affiliates of S&P Dow Jones Indices, including but not limited to S&P Global's other divisions such as Standard & Poor's Financial Services LLC and S&P Capital IQ LLC. Any credit-related information and other related analyses and statements are opinions as of the date they are expressed and are not statements of fact. S&P Dow Jones Indices LLC is analytically separate and independent from any other analytical department. For more information on any of our indices please visit [www.spdji.com](http://www.spdji.com).