Broad markets conducive to active management, says Dutch firm

By Editor Test *Mon, Aug 29, 2011*

On average, active managers will underperform a portfolio of investable index funds. But 20-40% of managers show persistent outperformance, says Dutch asset manager Robeco.

Outperformance from active management is no more or less likely in efficient or inefficient markets, but it is a lot more likely in broad markets than in narrow markets, according to a recent study by Dutch active asset manager Robeco, IP&E.com reported.

The more independent investment opportunities there are available, the greater the potential for active manager outperformance and vice versa, said Hans Rademaker, member of Robeco's management board, during a recent seminar on active management in Rotterdam.

Robeco analysed the performance of active managers in a variety of markets, including the US and European bond and equity markets over a period of 20 years. On average, active managers underperform net of fees, the research shows.

But 20-40% of managers show persistent outperformance relative to a portfolio of investable index funds. The tricky part is selecting winning managers and avoiding losers, Rademaker said.

"If you don't believe it's possible to predict the winners, or if you don't have the budget or resources to invest in a rigorous selection process, you're probably better off opting for passive management."

Which is not to say passive investment management is a picnic, he added. "Passive investments can be incredibly complex," he said. "And some index products aren't as passive as they may seem, considering their significant risks of underperformance."

The conventional wisdom that active strategies thrive on inefficiencies and fall flat in efficient markets isn't true, says the Robeco research. "The added value of active management is not correlated to market efficiency," said Rademaker. Even in very efficient markets, such as the US large-cap equity market, active managers can deliver outperformance.

Conversely, market inefficiency is not indicative of active manager success. The research shows no evidence of any indication that active strategies are more likely to outperform in inefficient markets such as high-yield corporate bond markets.

But market breadth is conducive to active management. "The potential for outperformance of active managers turns out to be higher in markets with many independent investment opportunities and lower in markets with fewer independent investment opportunities," he said.

In addition, the number of independent investment opportunities within a specific market varies over time.

Rademaker said: “The government bond market, for instance, offered very few independent investment opportunities for a long time. But the number of independent opportunities has increased quite a bit over the last few years, changing the picture with regards to whether it makes sense to opt for active strategies in this area.”

So assessing market breadth gives investors an instrument to help them determine when and where it might pay to employ active strategies, and where it might be better to opt for passive management.