



LGL PARTNERS INVESTMENT BRIEF

Active management or not?

December 2010

Summary

Some investment advisors and high net worth investors are strenuous proponents of active management. Others, forswear it, and embrace the Bogle “Vanguarding” strategy of buying cheap beta and not paying any fund manager anything extra for security selection, industry selection, or over or underweighting decisions. While many books and innumerable academic papers have been published on this debate, and a fair analysis would be far beyond the scope of this brief, LGL Partners, as a data-driven firm, can make some empirical observations and incorporate those into our client portfolios.

The short take is that active management can be beneficial, but not always. The decision to engage an active manager is to effectively outsource the asset allocation decision, as the benefit of active management seems to be to time the market and to turn on or off market exposure. The data suggest this is more effective when markets or sectors are swooning.

Data and Process

We analyzed thousands of open-end mutual funds that reported to the Morningstar databases over the past ten years. There are thousands of these. We divided them into the appropriate categories, sorted into the top and bottom deciles and compared those to the best and worst funds (acknowledging there is probably a survivorship bias issue) and compared those to the passive benchmark and the overall strategy average.

Active Manager Performance Deciles (annualized performance) vs. Passive Benchmarks
2000-2010

Manager Style		Name	Return
Large growth	Best	CGM Focus	16.75
	Average of top decile		2.50
	Large growth average		(4.05)
	Benchmark	Morningstar Large Growth TR USD	(7.31)
	Average of bottom decile		(8.84)
	Worst	ProFunds UltraNASDAQ-100 Svc	(25.78)
Large value	Best	Yacktman Focused	13.75
	Average of top decile		6.90
	Benchmark	Morningstar Large Value TR USD	2.96
	Large value average		2.44
	Average of bottom decile		(0.36)
	Worst	Legg Mason ClearBridge Dividend Strat B	(2.83)
Midcap growth	Best	FBR Focus Investor	11.70
	Average of bottom decile		7.25
	Benchmark	Morningstar Mid Growth TR USD	(0.36)
	Midcap growth average		(0.39)
	Average of top decile		(4.87)
	Worst	Brown Advisory Opportunity Instl	(9.79)
Midcap value	Best	The Delafield Fund	12.79
	Average of top decile		10.35
	Benchmark	Morningstar Mid Value TR USD	9.05
	Midcap value average		6.75
	Average of bottom decile		2.42
	Worst	Rochdale Dividend & Income	1.25



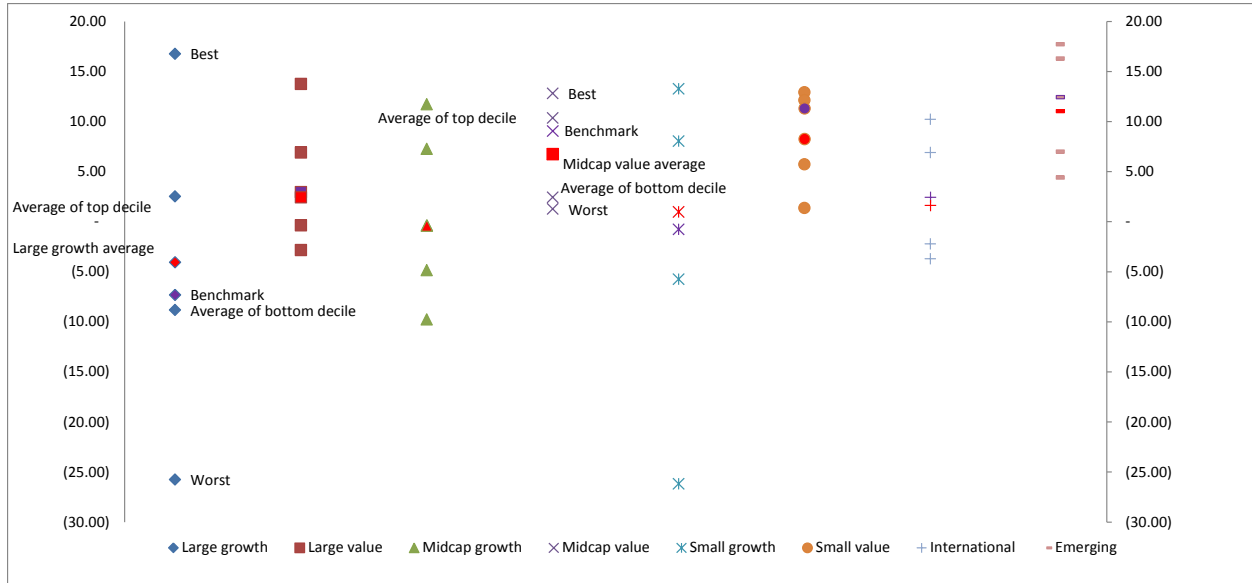
Active Manager Performance Deciles (annualized performance) vs. Passive Benchmarks
2000-2010

Manager Style			Return
Small growth	Best	Bridgeway Ultra-Small Company	13.25
	Average of top decile		8.02
	Small growth average		0.98
	Benchmark	Morningstar Small Growth TR USD	(0.76)
	Average of bottom decile		(5.76)
	Worst	Embarcadero Absolute Return	(26.20)
Small value	Best	Hotchkis and Wiley Small Cap Value I	12.93
	Average of top decile		12.13
	Benchmark	Morningstar Small Value TR USD	11.31
	Small value average		8.25
	Average of bottom decile		5.72
	Worst	Robeco WPG Small Cap Value	1.37
International	Best	Fidelity Canada	10.21
	Average of top decile		6.88
	Benchmark	MSCI EAFE NR USD	2.44
	International average		1.62
	Average of bottom decile		(2.24)
	Worst	Eaton Vance Tx-Mgd Intl Equity B	(3.73)
Emerging	Best	DFA Emerging Markets Value I	17.73
	Average of top decile		16.31
	Benchmark	MSCI EM NR USD	12.44
	Emerging markets average		11.04
	Average of bottom decile		7.00
	Worst	ING Emerging Countries C	4.42

The results are interesting. Only in two categories was the average of the actively managed funds greater than the benchmark: large growth and small growth. We are not surprised by the small cap outperformance, because, all things equal, this category is seen to be relatively less efficient, opening the door to more potential gains from security selection and risk management.

And large cap growth? It outperformed, in part, because it wasn't that hard to do: the benchmark annualized at -7.31% over this period.

The other thing to notice from the data is that there is much more dispersion among growth managers than value managers. The following chart, a visual representation of the above data, helps to make that more clear.



What does this mean? We might be able to say that among a data set with wide dispersion, and negative skew, it is easier for an average active manager to do better than a passive benchmark. Why the dispersion in large growth vs. other sectors? That is harder to say. One potential explanation is that large growth managers are making larger security selection bets than managers in some other sectors.

Takeaways

Active management tends to be better in declining markets due to the simple reason that you can be less than fully invested. Going partially to cash is a useful tool in a down market. But in an up market, or a strong bull market? The evidence for active management in those circumstances is not so clear.

LGL believes there are advantages to both active *and* passive management. We are not rigid with allocations, but do endeavor to identify managers who add value independent of the benchmark. In sectors, or in market regimes where this is hard to find, low cost, passive investment options can be compelling.



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