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The long view

Triumph of common sense over benchmarks

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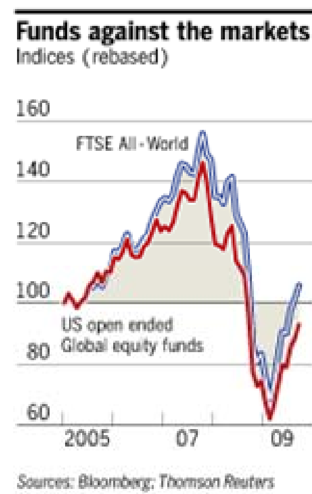
The Financial Times is a week into an ambitious series on **The Future of Investing**. It is yet to come to any firm conclusions but, if I had to boil down the contributions after the first week, they would come to the following.



First, professional investors found out last year that the most important assumptions on which they had based their careers were wrong.

Second, virtually nothing has changed yet. The March market rebound came just in time to stop the wholesale clear-out for professional investors that many had expected.

Third, nobody yet has a sense of what the future holds. There are plenty of attempts to adjust our understanding of markets and investments to take account of what has happened but nothing is yet coherent.

It is also a little too easy to attack the old verities. The apparatus of the efficient markets hypothesis and modern portfolio theory generated many false certainties leading up to last year's crash, but large chunks of it were quite useful. A key assumption – that it is difficult to beat the market consistently over time – regrettably stood up well to last year's shock.

But I do believe that one shift in investing's future is more or less assured. We are going to change the way we judge fund managers. This applies both to big institutions and to retail savers.

Over the past decades, portfolio managers have been subject to ever more precise benchmarking. First, they were compared to the big indices, such as the S&P 500 or the FTSE 100. The boom in passive index investing in the 1990s came as it grew more widely known that most funds fail to match the market.

This is a fair benchmark. But in some situations it creates the soft tyranny of low expectations.

At present, the average active fund manager has done rather better than the index for the year. In the US, according to Lipper, diversified equity funds are up 20.4 per cent, compared with a 16.1 per cent gain for funds tracking the S&P.

The problem is that this benchmark encourages conservatism. The priority is to ensure staying ahead of the index at the year's end. That means sticking to a portfolio that is close to the range of stocks in the index itself (making the fund much more like an index fund, which can be bought more cheaply).

It is a disincentive to making a big move either into or out of the market, even if a fund manager has a strong view that we are poised for a rally or a fall. This behaviour may yet allow the current stock rally to persist in spite of the disappointing economic data set by **Friday's US jobs report**.

So benchmarking can lead to herding behaviour and to "closet indexing" – where funds appear to be actively managed but in fact hug close to an index making only a few real bets against the market.

But benchmarking also has subtler effects. There was a sensible recognition of the fact that different managers have different skills and specialisms. Some are best at digging for bargains in small stocks, while others look at big, liquid companies; some follow the “value” style, looking for stocks that look cheap compared with the values on their balance sheets, while others follow the “growth” style, locking on to companies whose earnings are growing.

This led to the notion of the “style box”. Fund managers would be asked to invest in the mid-cap value style, for example. Rather than move into other types of stocks if their view of the market suggested it, they were expected to maintain “style discipline” and compete against their own index.

This helped justify the existence of retail brokers and pension consultants, who guided clients through elaborate allocations between different styles. It did not encourage skilful investing.

We are seeing a concerted attempt to understand what makes some investors more skilful than others. A paper from the Yale School of Management two years ago identified the “active share”, or the proportion of a portfolio that does not overlap with its benchmark index. Those with the highest active share did significantly better and beat their benchmarks.

Inalytics, a London-based firm, analyses managers by looking at the outcome of all of their decisions, rather than overall performance. This exercise suggests that skilful managers can be identified; they are the investors who can best overcome our deepest psychological tendencies. For example, we have an innate reluctance to sell losers as this implicitly admits that we made a mistake to buy them. Those with the self-discipline to do so and move on can prosper.

All of this is taking us encouragingly in the direction of common sense. Rather than watch everyone herd towards benchmarks, while charging fees for active management, in future perhaps a lot of money will be managed passively and the rest will be allocated to investors who can show they have skill, and who have the freedom to go wherever they believe they can profit.

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