New Evidence Threatens Active Management

by Larry Swedroe, 2/25/22

The academic evidence against active management is mounting. New research shows that information is incorporated into security pricing far too quickly for investors to profit from it.

In our book, *The Incredible Shrinking Alpha*, Andrew Berkin and I presented the evidence demonstrating that not only is active management a loser's game (while possible to win, the odds of doing so are so poor it is not prudent to try), but it is a game that is increasingly difficult to win. We also described the major themes behind this trend toward the ever-increasing difficulty in generating alpha:

- Academic research is converting what once was alpha into beta (exposure to factors in which you can systematically invest, such as value, size, momentum and profitability/quality). And investors can access those new betas through low-cost vehicles such as index mutual funds and ETFs.

- In the zero-sum game that is active investing (it is negative sum after expenses), you need victims who can be exploited to be successful. Unfortunately, that pool of victims is persistently shrinking. Retail investors' share of the market has fallen from about 90% in 1945 to about 20% today.
- The amount of money chasing alpha has dramatically increased. Twenty years ago, hedge funds managed about $300 billion; today it is about $4 trillion. And while there were only about 100 actively managed mutual funds in the U.S. 60 years ago, that figure is now about 8,000.
- For patient traders who don't need to demand liquidity, bid-offer spreads and commissions have fallen, making it easier to arbitrage away anomalies.
- The absolute level of skill among fund managers has increased – the competition is getting tougher and tougher.

Another hurdle for active managers is the increasing market share of indexing (and passive, or systematic, investing in general Markets have become less liquid, resulting in an increase in the market impact costs for active managers who demand liquidity when they trade. For example, the authors of the 2021 study, “In Search of the Origins of Financial Fluctuations: The Inelastic Markets Hypothesis,” estimated that investing $1 in the stock market today increases the market’s aggregate value by about $5.

Further evidence

Thibault Jaisson, Laurent Nguyen, Reda Messikh and Gabriele Susinno, authors of the July 2021 study, “The Predictive Power of Analysts and Their Impact on Prices,” provided yet another explanation for the increasing inability of active managers to generate alpha. They examined whether sell-side analysts’ forecasts were predictive and how quickly the market incorporates those recommendations into pricing. Before reviewing their findings, we’ll review the findings of the similar study, “Can Investors Profit from the Prophets? Security Analyst Recommendations and Stock Returns,” published in the November 2001 issue of *The Journal of Finance*. The authors found that while there was a significant performance difference in returns between the most highly rated and the

least favorably rated stocks. Unfortunately, after accounting for transaction costs, a strategy of buying the most highly rated and selling the least favorably rated stocks failed to produce a net risk-adjusted excess return greater than zero – there was no alpha.

Returning to the July 2021 study, the authors reviewed sell-side analysts' forecasts over the period 1994-2020. They found that the speed with which the market incorporated the information contained in the forecasts has been persistently increasing – markets were becoming more efficient as investors learned that analysts' recommendations provided valuable information. This makes systematic strategies taking advantage of those recommendations barely profitable after costs. And that is before even considering the expense ratios of the funds. The result is that there is less room for drift (momentum) in prices (the documented anomaly was shrinking).

Investor takeaway

In 1998 Charles Ellis wrote, *Winning the Loser's Game*, in which he presented evidence that while it is possible to generate alpha and win the game of active management, the odds of doing so are so poor it is not prudent for investors to try. The book is now in its eighth edition. In it, Ellis demonstrated and explained why it is harder than ever to produce investment results that overcome operating costs and fees. Thus, while active investing might be exciting and does provide the possibility of outperformance, the far greater likelihood is that it will lead to underperformance. Therefore, the prudent strategy is to invest in low-cost funds that invest systematically (eschewing stock selection and market timing strategies) and that target unique sources of risk (factors), and have the discipline to stay the course. That will provide you with the greatest odds of achieving financial goals.

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