EQUITIES

Does Active Management Pay? New International Evidence

August 11, 2015

One of the most important decisions for an equity investor is whether to manage investments actively or passively. The current dominant view is that active management is costly and does not pay, even for sophisticated investors. Thus, the advice given by academics to investors has been to avoid active equity management. How robust is this conclusion?

The authors analyze institutional investors' net returns to active relative to passive management across equity markets that vary in their levels of efficiency. In line with economic theory, the authors' baseline regressions suggest the benefits from active management are the highest in the least-efficient markets — that is, those where potential deviations from fundamental values are likely to be the largest, and where potential competition from other sophisticated investors is likely to be the lowest. The authors find that active management in emerging market equity outperforms passive strategies by more than 180 bps per year, and that this outperformance generally remains significant when controlling for risk through a variety of mechanisms. In EAFE equities (developed markets of Europe, Australasia and the Far East), active management also outperforms, but only by about 50 bps per year, consistent with these markets being relatively more competitive and efficient, with the outperformance becoming insignificant with some risk corrections.

These non-U.S. results are new to the literature and indicate that active management can indeed be valuable in the right setting. In line with these findings, the authors investigate allocations to active management and show that pension plans are more active in areas where being active pays: primarily in emerging equity markets, followed by EAFE equities. They also provide suggestive evidence that one driver of the active outperformance in non-U.S. markets is institutional constraints.

The authors show that small plans and public-entity plans, which they argue are more likely to have constraints on allocations, invest less in non-U.S. markets even though the returns they earn are similar to those of large and corporate plans. Taken together, the results suggest that the dominant view that active management does not pay should be reconsidered as a conditional statement, dependent on the efficiency of the underlying market and the sophistication of the investor. Also, the fact that these institutional investors achieve neutral to positive returns from their use of active management outside the U.S. opens up the possibility that they can play a role, suggested by models such as Grossman and Stiglitz (1980), in improving efficiency in these markets.

These results do not, however, suggest that retail investors using actively managed funds can perform a similar role. In EAFE equities, the before cost difference between active and passive returns (based on summary statistics) averages 78 bps per year. The authors conjecture that retail investors, and perhaps some institutional investors, may not be able to find quality active management at such a price.

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