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The Futility of Active Management

Throughout the life of this firm, we have as a part of our investment policy discussions, cautioned our clients about the futility of attempting to time the market. There are a number of compelling arguments against the idea of market timing including: the lack of evidence that anyone can do it consistently and regularly, the need to make two decisions in a row correctly (when to buy/sell and when to sell/buy), increased tax drag and trading costs, and the fact that being out of the market on the good days will be devastating to long term returns. There are many more, but we tend to emphasize this last one since it is objective and verifiable and gets to the heart of the matter. The risk of being out of the market on the good days is compounded by the fact that gains in the market do not happen evenly day after day, but show up in surges that happen over very short periods.

Not only do gains not happen evenly over time, the distribution of gains (and losses) over time is not a normal symmetrical distribution; the distribution is skewed. A few periods of outsized returns dominate the average, and without those periods the results quickly and materially fall below average. Skewness is a statistical term used to describe asymmetry from the normal distribution in a set of statistical data. We've never heretofore used the term "skewness" to describe this phenomena with respect to the timing of returns, but it seems, intuitively, to apply. Read on.

Market timing is but one leg of the two-legged stool of active management of investment portfolios. The other leg is security selection. It appears that this same dynamic applies to the security selection leg as well as the market timing leg.

A recent article, Lopsided Stocks and the Math Explaining Active Manager Futility by Oliver Renick on Bloomberg.com teases out some of the history of compelling research explaining the effect of skewness in the securities selection space.

It is well known that most fund managers substantially lag their benchmark. The general sense, backed up by evidence, is that only about 20% of managers outperform their benchmark in any given year. A large part of this underperformance is easily explained by the drag of management fees. Quite simply, the greater the fees charged against a portfolio, the more the manager needs to overperform the benchmark just to break even.

While the drag from management fees goes a long way toward explaining the persistence of manager underperformance, it does not, according to the cited researchers, explain the entire gap. The distribution of returns across companies is positively skewed, and a small number of companies are almost always responsible for the bulk of the returns in the average, and if many or most of those companies are absent or underweight in the portfolio, the performance against benchmark suffers significantly. Renick illustrates this difficulty with a bag of poker chips.

> *"Say you have five poker chips, four worth $10 and one worth $100. The five chips have an average value of $28, but what if you reach into the bag and pull out two chips over and over? That's roughly how mutual funds approach stocks, with managers picking portfolios that are subsets of the broader group. The problem is, the majority of selections will fail to snag the $100 chip. Mathematically, there is an average value of $56 across the 10 two-chip combinations—the problem is, 6 of 10 times you'll grab a pair with a sum of $20. The same thing happens with stocks chosen from a benchmark. Only a few managers will own the biggies, relegating the rest of the industry to mediocrity—or worse."*

All of this just directs another arrow at the heart of active management. Nonetheless, active managers will continue to proclaim that it is a "stock pickers market" and of course they are the wise pickers, or that "markets are due for a correction or worse" and that they have the secret sauce formula to step around the problem. Truth is, they are not and do not. Meanwhile the flow of money from active management to evidence-based investing continues. Just like the value of a fiduciary relationship becoming more commonly known, the futility and expense of active management is becoming more well known. For an entertaining recitation of this phenomenon, read Warren Buffet's letter to Berkshire Hathaway shareholders this year, pages 21-25.

The urge to get "active" in the management of your portfolio can get pretty strong. If you grab the wheel, odds are high you will wish you hadn't. We have established a globally diversified and low cost strategy for you that is intended to absorb market shocks. We will continue to do what we have done for the past twenty-plus years: attend to the fundamentals, rebalance, control costs, manage taxes, and avoid doing anything impulsive.

We will see the unsettling downside of the market again. We just don't know when and how much. It will be uncomfortable. We've been there before.

Don't mistake the urgency of your fears for investment wisdom. I've said it numerous times before and I'll say it again: Fear may be the worst possible basis for investment decision making.

We are always here to talk about this or any other financial matters that are on your mind.

The table below shows the returns through March 31, 2017 for selected investment asset classes. In most cases, the results below are appropriate benchmarks for the related mutual funds in your investment portfolio.

Asset Class	Data Series	YTD	1 Yr.	3 Yrs.	5 Yrs.
Ultrashort Bonds	BofA Merrill Lynch 6-Month US Treasury Bill Index	0.13	0.58	0.37	0.30
Short Term Municipal Bonds	BofA Merrill Lynch 1-3 Year US Municipal Securities Index	0.82	0.64	0.79	0.86
Short Term Corporate Bonds	BofA Merrill Lynch 1-5 Year US Corporate and Government Index	0.56	0.56	1.43	1.38
Short Term Global Bonds	Citi World Government Bond Index 1-2 Years (hedged to USD)	0.23	0.85	0.73	0.74
Intermediate Term Municipal Bonds	Bloomberg Barclays Municipal Bond Index 7 Years	1.95	-0.06	2.89	2.72
Intermediate Corporate Bonds	Bloomberg Barclays U.S. Credit Index	1.30	2.96	3.52	3.70
Intermediate Global Bonds	Citi World Government Bond Index 1-5 Years (hedged to USD)	0.29	0.64	1.38	1.38
US Marketwide Core 1 & 2; Vector	Russell 3000 Index	5.74	18.07	9.76	13.18
US Large Cap Market	S&P 500 Index	6.07	17.17	10.37	13.30
US Large Cap Value	Russell 1000 Value Index	3.27	19.22	8.67	13.13
US Small Cap Market	Russell 2000 Index	2.47	26.22	7.22	12.35
US Small Cap Value	Russell 2000 Value Index	-0.13	29.37	7.62	12.54
Real Estate Investment Trusts	Dow Jones US Select REIT Index	-0.27	1.21	9.96	9.45
International Marketwide Core & Vector	MSCI World ex USA Index (net div.)	6.81	11.93	0.35	5.38
International Large Cap Market International Large Cap Value	MSCI World ex USA Value Index (net div.)	5.67	16.46	-0.67	5.19
International Small Cap Market	MSCI World ex USA Small Cap Index (net div.)	7.61	11.58	2.70	7.78
International Small Cap Value Emerging Markets	MSCI Emerging Markets Index (net div.)	11.44	17.21	1.18	0.81
Ultrashort Bonds	BofA Merrill Lynch 6-Month US Treasury Bill Index	0.13	0.58	0.37	0.30

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