

ACTIVE MANAGEMENT AND PERFORMANCE MEASUREMENT

In the first parts of this book, we presented the concept of asset pricing under a portfolio theory approach that led to the notion of efficient markets. This demonstrated why assets should be efficiently priced and why the market portfolio represents the appropriate equity investment choice. The theory implies that a passive strategy of holding the market portfolio of equities, in conjunction with investments in bonds and cash, is optimal. Chapter 9 on market efficiency summarized this conclusion. Subsequently, we investigated techniques for evaluating stocks, bonds and derivatives; the result of this valuation process should be the prices that these assets would command in the efficient market. Were the results of these analyses to produce values that differed from observed market prices, we would have to reject either our analysis or the notion of rigid market efficiency; in the latter case, this would give rise to active rather than passive management.

Despite the efficient market hypothesis, there are reasons to believe that active management can have effective results, but these need to be verified after the fact. It is possible to evaluate the performance of a portfolio manager, but it is not a simple matter; what the manager is trying to do as an investment strategy, and how this relates to individual investors, will cause different measures of performance to apply. Although the subject may seem technical, a close and accurate



appraisal of performance is needed to cut through the arbitrary or nonspecific claims of success made by many professional managers.

We begin with a discussion of what one might expect from active management but illustrate how active management causes problems in evaluation. We then review the conventional approaches to risk adjustment for performance evaluation. We show the problems inherent in these approaches, even though they involve the use of specific theoretical measures, when they are applied in a complex world. We also present some newer alternatives to performance appraisal. Next we deal specifically with the issue of market timing, in which asset allocations between the three components are modified in response to macroeconomic factors. We conclude with some results and a discussion regarding the evaluation of actual performance. The appendices to this chapter present some technical details of measuring investment returns and an advanced analysis for assessing timing ability as an option.



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THE OBJECTIVE OF ACTIVE MANAGEMENT

How can a theory of active portfolio management be reconciled with the notion that markets are in equilibrium? Market efficiency prevails when many investors are willing to depart from maximum diversification, or a passive strategy, by adding mispriced securities to their portfolios in the hope of realizing abnormal returns. The competition for such returns ensures that prices will be near their “true” values. Most managers will not beat the passive strategy on a risk-adjusted basis. However, in the competition for rewards to investing, exceptional managers might beat the average forecasts built into market prices.

There is both economic logic and some empirical evidence to indicate that exceptional portfolio managers can beat the average forecast. Let us discuss economic logic first. We must assume that, if no analyst can beat the passive strategy, investors will be smart enough to divert their funds from strategies entailing expensive analysis to less expensive passive strategies. With less capital under active management and less research being produced, prices will no longer reflect sophisticated forecasts. The potential profit resulting from research will then increase and active managers using this research will again have superior performance.¹

As for empirical evidence, consider the following: (1) some portfolio managers have produced streaks of abnormal returns that are hard to label as lucky outcomes; (2) the “noise” in realized rates is enough to prevent us from rejecting outright the hypothesis that some money managers have beaten the passive strategy by a statistically small, yet economically significant, margin; and (3) some anomalies in realized returns have been sufficiently persistent to suggest that portfolio managers who identified them in a timely fashion could have beaten the passive strategy over prolonged periods.

These conclusions persuade us that there is a role for a theory of active portfolio management. Active management has an inevitable lure even if investors agree that security markets are nearly efficient.

¹This point is worked out fully in Sanford J. Grossman and Joseph E. Stiglitz, “On the Impossibility of Informationally Efficient Markets,” *American Economic Review* 70 (June 1980).