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An active headache for fund managers

John Authers Author alerts

2014 has been bad thanks to lower volatility and dispersion

Active equity fund managers are used t[...] been a biblically bad year for almost anyon[...] questions now are whether there are any reas[...] 2015 — and whether there are ways for the rest of [...]

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The raw numbers are astonishing. Different databases come up with different figures but all agree that active managers have been whipped by their benchmarks. According to Goldman Sachs, just 14 per cent of large-cap core mutual funds have beaten the S&P 500 so far this year while equity long-short hedge funds, whose performance is all about stockpicking, have managed to return 1 per cent so far this year.

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A database maintained by Denys Glushkov at the Wharton Research Data Service produces similarly dispiriting reading for active managers, finding some 90 per cent of large-cap managers underperformed.

Active managers usually underperform once their fees have been taken into account. But performance this bad is truly unusual — Mr Glushkov estimates that they are on course for their worst year since the database began in 1989. Why?

The biggest problem is the lack of dispersion of returns. Research by Standard & Poor's has demonstrated that when stocks' returns do not vary much, there is less to be gained by choosing the best stocks. High dispersion tends to accompany high volatility — and this was generally a year of low volatility.

It also had an unusual negative size premium — smaller companies underperformed large, while the biggest "mega-caps", like Apple, did best of all. Active managers have a "small-cap" bias — even large-cap managers underweight the very largest, to distinguish themselves from the index. And Morgan Stanley's Adam Parker says small-caps have lagged behind mega-caps over the past 12 months by the most in 15 years.

And indeed, Mr Glushkov finds that the years of small-cap underperformance have tended to show particularly bad performance for active managers.

The bond market this year came as an almost universal surprise. With the Federal Reserve tapering off QE bond purchases, 10-year yields were supposed to rise from the 3 per cent they had reached at the turn of the year, causing volatility and dispersion in the process. The opposite occurred. This meant many made the wrong sector bets. With yields low, utility stocks did far better than expected; and the falling oil price embarrassed those loaded with energy stocks.

Is there any reason to hope for better next year? Tom Lee of Fundstrat in New York suggests that there is. The small-cap underperformance is dramatic and likely to be reversed. Most importantly, he points out that dispersion itself is likely to reverse. In all the 14 previous periods when dispersion has dropped so far below its historic mean, it has snapped back over the following six months — generally to a level of dispersion that is consistent with fully half of active managers succeeding in beating the index.

Others are less optimistic. Neil Leeson, ETF strategist at Ned Davis Research in Florida, shows that, since 1979, dispersion has been

lower when the Fed is tightening — which is expected for next year. Active managers already missed their great opportunity.

Whether or not active managers have reasons to hope for 2015 — and it is hard to see how they could have another year as bad as 2014 — what should they do now? The odds strongly favour a "beta chase" as managers lagging their benchmarks pile into the stocks that are most sensitive to the market.

Mr Lee finds that 48 per cent of US mutual funds now lag their respective benchmarks by 2.5 percentage points or more. That makes this the second worst year on record, after 1998. Previous years where so many managers entered the quarter lagging this badly have tended to end in big year-end rallies. The crisis year of 2008 is the only significant exception.

This then sounds like a plausible justification for a "Santa Claus rally". If active managers pile into the stocks most heavily represented in the index, the index will rise, and active managers' tendency to shadow the index will intensify. In the very short term, it may be best to join them for the ride.

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