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Saving Active Managers from the Market

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Saving Active Managers from the Market

Abstract

Assets are leaving actively managed mutual funds at an unprecedented rate as investors have come to perceive that active management does not deliver value. Investor disappointment is generally attributed to the high fees and poor relative performance of the class, yet there is a deeper systemic issue at work. In the first part of this paper I argue that portfolio managers are unable to deliver value to investors because they generally do not consider the alpha-diluting opportunity costs of diversification (defined later) when constructing and managing their portfolios. In the second part of the paper I propose the introduction of a fund of concentrated fund (FoCF) structure that would allow investors to minimize the costs of diversification and capture significantly more alpha without compromising their ability to manage risk.

Keywords

Active asset management, active portfolio management, Performance management, Alpha, Fund of concentrated fund

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I. The Opportunity Costs of Diversification

The U.S. active portfolio management industry is in crisis. Mutual funds are seeing assets leave for passively managed vehicles on a scale and at a pace that is alarming. According to Morningstar data (McDevitt and Watson 2020), over the last decade passive funds have taken in over \$3.8 trillion while active funds have seen outflows of \$185 billion. The share of assets being managed actively has declined from 78% to 59% of total assets under management.

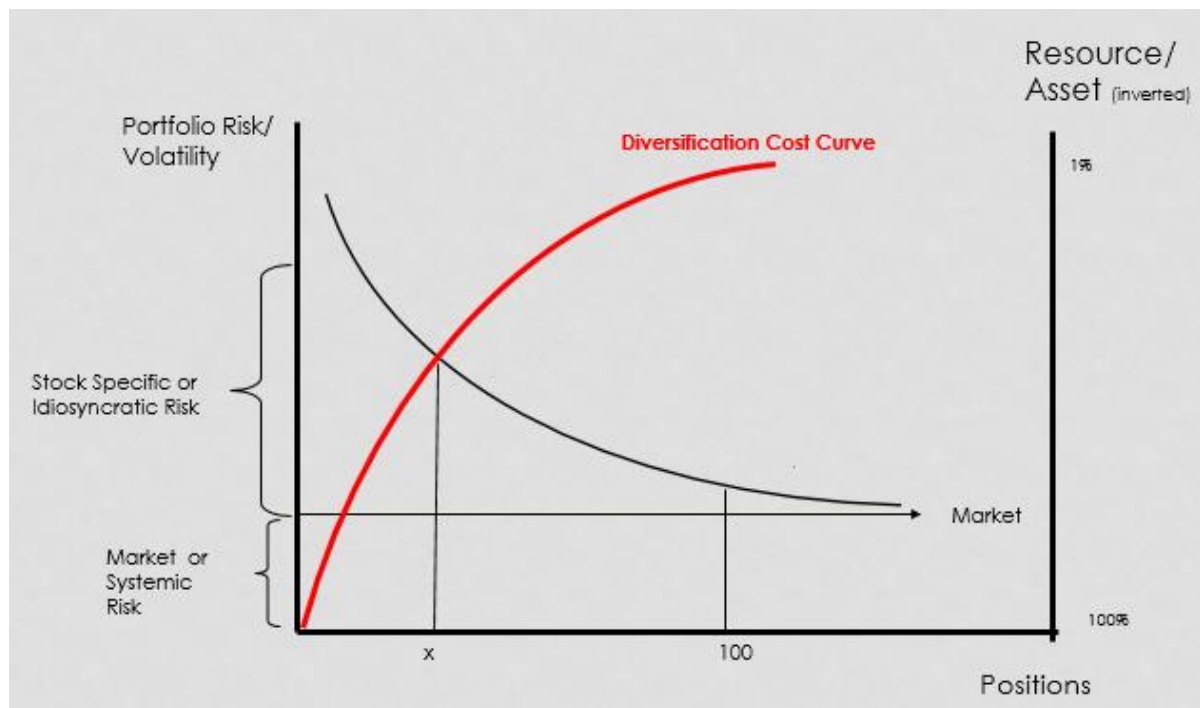
The exodus of assets from actively managed funds is mostly explained by the poor relative performance of the class. According to an analysis by S&P Global (Soe Aye, 2015), somewhere between 80-90 percent of all US actively managed equity funds underperformed the S&P Composite 1500 over the last five and ten year periods. Yet investors are not leaving actively managed funds simply because the class of products is underdelivering. They are leaving because they have come to realize that active management is generally incapable of delivering value. The distinction is subtle but important. Returns from actively managed products have become so closely tied to those of benchmarks that investors and advisors have concluded that underperformance is almost systematically assured (after considering fees).

But active management is not the problem. Ironically, it is a lack of active management that lies at the heart of the controversy. Specifically, managers are burdened with hidden costs that impede their ability to manage actively and produce alpha. These costs are not the management fees or sales charges which are so often cited as a drag on active management returns. Rather, they are the far more important opportunity costs of diversification. Ironically, the pursuit of mutual funds with low expense ratios often leads to the selection of funds with high opportunity costs of diversification.

Diversification carries costs in the context of actively managed portfolios. As a portfolio becomes more diversified, the potential for alpha generation declines. The more alpha

that is sacrificed in the name of diversification, the higher the opportunity cost. This simple idea has intuitive appeal, can be proven with logic and data, and yet has been largely ignored by the investing public and their advisors, who have forfeited the realization of alpha as a result.

The logic behind the concept is straightforward. We start with the basic assumption that active management has the potential to add value. We also assume that capital markets are highly efficient, implying that detecting inefficiencies is a difficult, time-consuming job. Given that a manager's time and mental bandwidth are fixed quantities, the more positions the manager adds to the portfolio, the less time the manager can devote to each. Due to the relative efficiency of public markets, the less time devoted to detecting and monitoring inefficiencies in a portfolio, the lower the probability of finding inefficiencies and producing alpha. Thus, the more positions in the portfolio, the less likely the manager will produce alpha across the entire portfolio, and the higher the opportunity cost.



Graphically, we can demonstrate the costs of diversification by modifying a chart commonly used to explain some of the benefits of diversification according to the Capital Asset

Pricing Model (CAPM). That graph demonstrates that as more assets are added to a portfolio, stock specific risk is gradually diminished so that the portfolio is left with only market risk as it approaches a market basket of securities. The chart helps illustrate the argument that portfolios should embrace wide diversification—eliminating stock-specific or idiosyncratic risk, because doing so is costless. Portfolio theory also teaches us that combining less than perfectly correlated assets allows an investor to enjoy the average of the assets' expected returns while experiencing a variance that is less than the average. This is commonly referred to as portfolio theory's "free lunch."

But the lunch is hardly free from the perspective of active management; in fact, it is very costly. We show this by representing the cost of diversification as the red line in the CAPM chart. This line describes the relationship between portfolio positions and the time and other resources available per position, which is shown on the inverted y-axis scale on the right. This line is sloped upward and to the right to show that, as more positions are added to the portfolio, the time available per position diminishes. As time per position diminishes, the probability of finding inefficiencies and capturing alpha declines, reflecting the increasing costs of diversification.

The takeaway from this graph is that while diversification can lower the amount of volatility in the portfolio, it should be employed only to the point where the marginal cost of adding a position is equal to the marginal benefit in terms of volatility reduction. Applying this logic results in portfolios that are generally more concentrated than the average active mutual fund portfolio today. Widely diversified portfolios incur high costs of diversification, greatly diminishing their alpha-generating potential.

This depiction isn't perfect because, as we will discuss later, volatility is not necessarily something that portfolio managers should try to regulate through diversification. Not only does volatility not reflect risk accurately, but volatility can be reduced without employing

diversification at the portfolio level. Also, because the CAPM graph relies on certain assumptions in its foundation that do not apply in the real world of active management, there is a mismatch. Nonetheless, the graph gives a good representation of the concept introduced in this section; it should help investors understand how the benefits of diversification need to be balanced against costs.

Alpha capture through active management turns portfolio theory on its head. To be active means taking stock-specific risk – indeed, this is the mechanism by which active managers add value. In fact, some will argue that an active manager should avoid market risk to the extent possible while preferring stock-specific risk, as the former is more difficult to discount than the latter. A skilled portfolio manager should be able to forecast a company's new product or service rollout and understand its risks better than the market – if that is his or her key focus, and if he or she has detected an opportunity. Yet there is little evidence that managers who focus on discounting market risk have persistently added value. A number of studies (CXO Advisory Group 2014, Ferri 2014, Hulbert 2013a, Hulbert 2013b) have found that professional market forecasters are incorrect more than half the time.

Ironically, a concentrated portfolio may offer investors the active management equivalent of portfolio theory's "free lunch." In pursuing a concentrated strategy, a manager typically risks more than his or her investors. In addition to often investing a higher proportion of his or her net worth in the product than most investors, he or she is also assuming significant career and reputational risk in pursuing a concentrated strategy rather than hugging an index. If the manager has shown talent in the past, and feels strongly enough about the inefficiencies detected that he or she is willing to accept important risks, which the investor does not bear in owning the same assets, investors are underpaying for their stake and dining at the active management free lunch buffet.

This is not to downplay the issues that result from accepting idiosyncratic risk. A good portfolio manager may be highly skilled at pricing the risks surrounding a particular company, but that portfolio manager cannot hope to understand all the stock-specific risk which attends that investment. There are unknown unknowns, and diversification protects investors from those risks by averaging them across large numbers of securities, leaving investors with market risk. For instance, a portfolio manager couldn't hope to predict that the CEO of one of his portfolio companies would be hit by a bus, or that the head of R&D might secretly sell valuable corporate trade secrets to a competitor.

Yet market risk represents an unknown unknown too, and whether or not that risk is preferable to asset-specific unknown unknowns is subject to debate. In any case, minimizing idiosyncratic risk can be a counterproductive goal for active managers. Managers earn their fees by discounting asset-specific risks better than the market, and effectively pricing this risk creates the potential for alpha.

The implications of the idea that diversification carries costs are profound. Incorporating this concept into our financial system could compel dramatic change across capital markets. Our focus here, however, is the mutual fund industry, which must adapt if it is going to retain appeal to active investors in light of the high opportunity costs of diversification which the average fund incurs. The top 20 percent of most diversified funds own an average 228 positions, while the average mutual fund holds somewhere between 90-100 positions (Sapp, Yan, 2008) and turns over its assets approximately 130 percent per year¹—meaning that the average portfolio manager may hold well over 100 different securities in a given year. According to the popular Active Share measure, approximately 50 percent of all funds are closet indexers (Petajisto (2013)). A large proportion of funds have diversified well past the

¹ According to author's estimates using: <https://www.investopedia.com/articles/mutualfund/09/mutual-fund-turnover-rate.asp>

point where the costs of diversification exceed the benefits, pointing to the need for dramatic change. Proof that diversification costs are too high is seen in the relatively low tracking errors and return dispersions for the class, the lack of meaningful persistent alpha creation, and the flow of money away from actively managed funds.

The costs of diversification create a direct conflict of interests between investors and the active fund operators managing their money. While it provides scale economies, risk minimization, and more earnings to fund companies, wide diversification deprives investors of the ability to realize alpha. The investing public and its advisors, however, are generally unaware of this conflict. They have been taught to view investment decisions through the lens of portfolio theory, which recommends wide diversification in pursuit of efficient portfolios, and which views diversification as costless.

Most fund companies view wide diversification as necessary to their business. Many individual mutual funds have become so large, that they require wide diversification to source the liquidity needed to operate. Investing in a select group of securities is impractical at such a scale, because moving in and out of positions is too time consuming and would compromise returns by influencing security prices. Fund managers also use wide diversification to limit downside risk relative to the benchmark index – preventing disastrous relative performance. This is a protective mechanism that helps the fund manager keep his/her job and the fund company retain its fee-paying assets. A manager who consistently underperforms the index by a small margin is less likely to be fired than a manager who outperforms heroically for several years and then underperforms dramatically.

While some will argue that increased mutual fund scale and downside risk mitigation are goals that benefit investors as well as fund companies, this is only true to the extent that these objectives don't interfere with alpha production. After all, if low fees and managing

downside risk relative to a benchmark are the primary focus of investors, those investors have no business buying actively managed funds.

Fund platforms will not change to accommodate the costs of diversification, sacrificing their profitability, until investors give them a reason to do so. When investors and their advisors recognize that portfolio-level diversification can work against their financial interests, they will begin to assess portfolio diversification more critically. They will demand that portfolio managers prove that they have balanced the costs and benefits of diversification properly—such that a manager can demonstrate alpha generating potential across the entire portfolio. These investors will respond to concentrated fund offerings, driving demand for more of these products, and creating a force for change in the mutual fund industry.

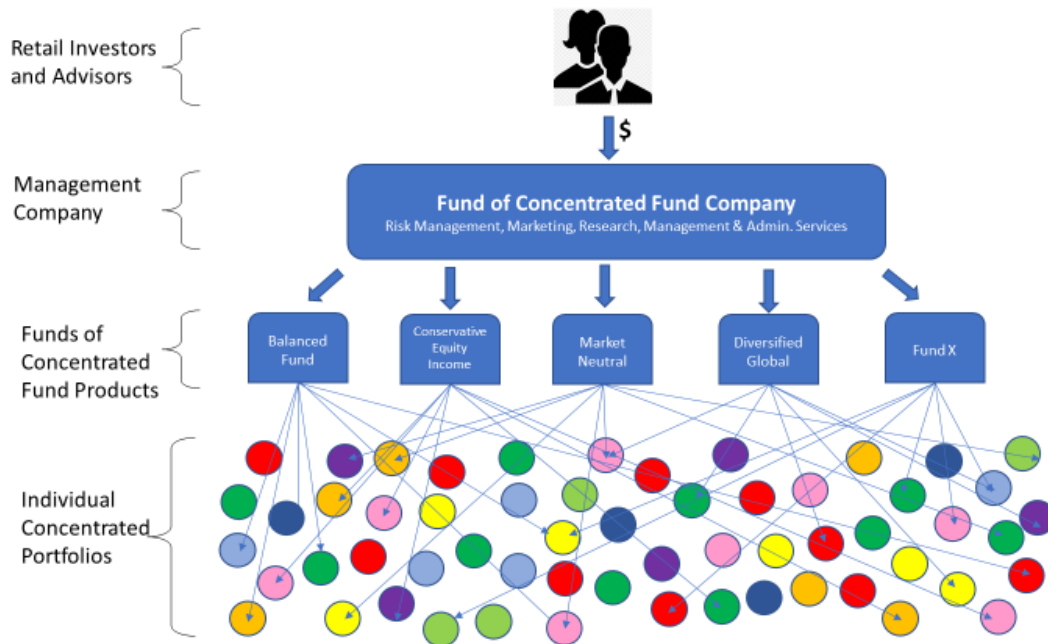
As noted in the beginning of this paper, the concepts in this section have been presented as if the issues are black and white for the sake of clarity. In practice, there are endless shades of gray. Some portfolios claim high Active Share even though they are relatively diversified. Some portfolios hold many positions, while in fact the portfolio's value is concentrated in a few names – creating fairly concentrated exposures. Macro strategies might hold hundreds of positions based on a single thesis or “bet.” Thus, the opportunity costs of diversification may need to be adjusted based on different circumstances. Nonetheless, the relevant point is that diversification costs will always be present for fundamental, bottoms-up active managers, and investors need to be educated as to the existence of these costs and how they may be avoided.

II. Decoupling Alpha Creation from Risk Management in Theory and Practice

Regardless of the shortcomings of portfolio theory, some level of diversification is advisable for most investors, and this may not be provided by a single concentrated portfolio. Fortunately, investors can enjoy the benefits of diversification while avoiding alpha-diluting costs by decoupling the responsibilities of asset selection from those of diversification or risk management. Practically speaking, this means combining concentrated portfolios strategically, in order to achieve diversification goals. This arrangement allows portfolio managers to focus all of their resources on producing alpha, spending little or no resources in pursuit of diversification. It also allows Investors and their advisors to evaluate even the most concentrated of managers based solely on their capacity to generate alpha.

Since it is generally impractical for retail investors to create and monitor a portfolio of concentrated funds on their own, a fund of concentrated fund (FoCF) structure should be implemented. That system would be defined by the selection of managers who practice high conviction, high concentration investing at the portfolio level. A professional FoCF manager would represent retail investors' interests at the FoCF level, selecting and firing managers, allocating between funds, measuring and monitoring risk exposures, and (depending on the strategy), making top-down allocation decisions between asset classes or factors. Under this system, retail investors would get the best of both worlds. They would enjoy the benefits of high conviction professional asset management and alpha generating capacity, in a strategically diversified portfolio customized to their preference.

Fund of Concentrated Fund System Structure



Decoupling alpha generation from diversification allows for more efficient delivery of both, in contrast to highly diversified mutual fund products, which tie the two functions together. We've already discussed how eschewing diversification at the portfolio level can help managers deliver more alpha by giving them greater opportunities to detect market inefficiencies. Moving diversification responsibilities out of the portfolio and into the hands of a FoCF manager allows diversification strategies to be productized and customized to the preferences of investors, so that investors have more control over their exposures. Managing risk over a number of relatively concentrated portfolios will also bring focus to investors' comprehensive exposures and will help insure that investors are accepting exposures that align with their objectives.

As an example, consider an investor who owns three or four highly diversified mutual funds. Not only does that investor have little chance of sourcing alpha, but he or she is not likely to benefit from efficient diversification. A fund manager's style may drift, creating voids and duplicate exposures. Even without style drift, over time exposures between funds may

overlap, affecting the investor's risk management strategy. Due to the professional FoCF manager's greater focus, resources, expertise, and information, he or she is far more likely to detect and adjust for these changing exposures than a retail investor or his advisor.

Decoupling asset selection from risk management allows retail investors to better discern between top-down and bottoms-up strategies. When an investor purchases a fund that holds over one-hundred positions, he or she is getting what is often a top-down strategy, even if it is marketed as a stock picking fund. By contrast, under the proposed system, an investor could purchase a FoCF product with a fixed, top-down strategy per his or her preference, and allow the FoCF manager to invest with concentrated portfolio managers who generate alpha within that framework. Alternatively, the investor might want top-down management discretion and allow the FoCF manager wide latitude in setting exposures. The investor would benefit from knowing what he or she was buying and having more choice.

The fund-of-funds structure allows for other efficiencies as well. By concentrating retail money in the hands of an institutional FoCF manager, retail investors gain additional leverage which can bring more flexibility. For instance, the FoCF manager could access detailed and updated information about exposures in the portfolio, and therefore could monitor exposures more tactically than retail investors are typically able.

Similarly, a structure that offers concentrated portfolios may make it easier for investors and FoCF managers to understand which funds are worthy of an investment. A FoCF manager should be better able to probe the validity of the investment thesis behind each position in a concentrated book versus a highly diversified portfolio. The more concentrated form of management could make it easier to detect a manager's style as portfolios would not contain decoys – positions added simply because they are in the benchmark. Also, the signal that managers produce over time will be much stronger in concentrated rather than diversified portfolios.

The idea of decoupling asset selection and risk management through a fund-of-funds structure offers the retail investor much to gain and little to lose. Diversification and asset allocation strategies can be implemented to the same or better effect in this system – as contrasted with traditional mutual funds – while the opportunity to capture alpha should be greatly enhanced. Since the potential for alpha generation is the single most important reason investors place money in actively managed funds, the benefits of the proposed system are substantial.

Adopting the changes suggested in this paper may not allow active managers as a class to beat the market, but it will help skilled managers to beat it by a larger margin while demonstrating evidence of persistence, a marker for the influence of active management. Return dispersions will widen, and skill will exhibit a more pronounced signal, distinguishing itself from market noise. Skilled managers and their investors will be rewarded, and active investors will no longer feel that the system has been rigged against them. Investors will receive the active management for which they are paying.

II.1 How Much Diversification is too Much?

When a portfolio manager is asked for his or her top ideas, he or she will typically recite a compelling investment case for two or three securities. It is often clear from the manager's description that he or she has a very well-defined opinion about the risk and likely business outcomes associated with these assets, and how these assessments differ from the market's view. That differential creates the investment opportunities fund managers seek. The correct identification of that differential is responsible for generating alpha, and the information behind it is commonly referred to as a manager's "edge."

As we would expect, taking into account the costs of diversification, a manager's edge typically diminishes as he or she describes assets that make up a smaller and smaller proportion

of the portfolio. The level of conviction and “edge” displayed by the manager in describing the fifth favorite name in the portfolio is typically not as robust as for the top name. By the time the portfolio manager reaches the 50th or 75th name in the book, he or she often sounds more like a top-down manager than a stock picker. Very little or no edge is evident in the manager’s description of the opportunity. He or she cannot make a convincing case that he or she can discount risk and cashflows associated with the name better than the market.

Active management’s hierarchy of conviction logically compels investors to hold a portfolio of concentrated portfolios. To the extent that we believe active management adds value, we should also believe that the higher the conviction a portfolio manager shows for a security, the more alpha generating potential that security possesses (assuming the portfolio manager is skilled). Given this, it doesn’t make sense that a rational investor should invest in all 60 positions of one manager if that investor has the option of investing instead in four other portfolios, each containing 15 names – assuming equal skill levels among all the managers. Why accept the opportunity costs associated with assets 15-60 in the diversified portfolio if these can be avoided?

Academic studies and empirical data demonstrate the link between alpha creation and manager conviction. Data from (Silli, Cohen, and Polk, 2008) argues that manager conviction is directly linked to alpha generation. The study cites data suggesting that managers’ “Best Ideas” outperform the market, as well as other stocks in their portfolios, by 1.2 to 2.6 percent per quarter – a significant margin.²

² “Our results suggest that while the typical manager has a small number of good investment ideas that provide positive alpha in expectation, the remaining ideas in the typical managed portfolio add little or no alpha. Managers have clear incentives to include zero-alpha positions. Without them, the portfolio would contain only a few names, leading to increased volatility, price impact, illiquidity, and regulatory/litigation risk. Adding additional stocks to the portfolio can not only reduce volatility but also increase portfolio Sharpe ratio. Perhaps most importantly, adding names enables the manager to take in more assets, and thus draw greater management fees. But while the manager gains from diversifying the portfolio, it is likely that typical investors are made worse off. Based on these observations, we examine optimal decentralized investment when managerial skill is consistent with our “best ideas” evidence. We show that under realistic assumptions (e.g., investors put only a modest fraction of their assets into a particular managed fund), investors can gain substantially if managers choose less diversified portfolios that tilt more towards their best ideas” (Silli, Cohen, and Polk, 2008).

Other studies have come to similar conclusions about the evidence supporting the potential for added value through concentration. These studies would include those from: Wermers (2000), Ivković and Jegadeesh (2004), Kacperczyk, Sialm, and Zheng (2005), Busse, Green, and Baks (2006), Ivković, Sialm, and Weisbenner (2008), and two papers from Martijn Cremers and Antti Petajisto (2009, 2013), though this list is not exhaustive.

Academic studies need to be taken with a grain of salt because they are subject to biases. A list of studies that find no evidence of added value through investment concentration exists as well. Regardless of what the latest academic research says, however, the logic behind the potential for superior alpha creation in more concentrated portfolios is most important, and that logic will endure.

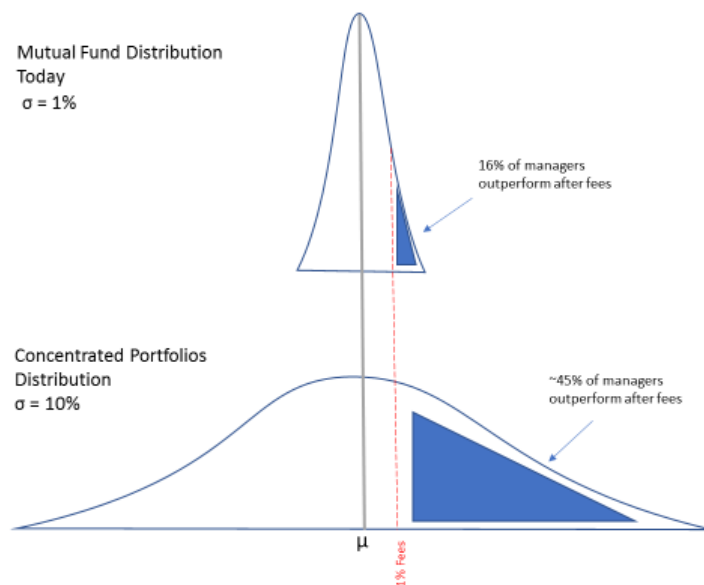
Though investors should favor concentrated portfolios for their alpha generating potential, there is no need to set a specific number of positions, a percentage of concentration in top names, or an Active Share level that qualifies a fund as sufficiently concentrated. The proper level of concentration will depend on a variety of factors, including the style and the resources applied to the management of the portfolio, and the level of inefficiencies present in the particular market the manager seeks to exploit. Regardless, a skilled FoCF manager should be able to judge effectively whether a portfolio manager can add sufficient value across all of the positions in a portfolio. The important point is that the FoCF manager casts a critical eye to the level of diversification within specific portfolios in an effort to ensure that the costs associated with that diversification are not too high, and that the investor is receiving the active management he or she is purchasing, across the entire portfolio.

II.2 Assessing the Results

What this paper proposes is institutionalizing a system to make active management genuinely active for retail investors. In a technical sense, there is no doubt that it will work. It

will allow managers to invest more actively. Concentrated portfolio returns will be more widely dispersed and more volatile – a result that is neither good nor bad, but nonetheless is a signal that managers are incrementally more active. Remember that this additional volatility at the portfolio level will be managed by FoCF managers who would likely invest in several portfolios, thereby reducing as much of the volatility as is consistent with their particular strategy.

Return Distributions Relative to Benchmark



(Above) The top diagram assumes active returns tightly clustered around the market mean (μ), reflecting the low tracking errors and high diversification of today's average fund. With a one percent standard deviation (σ) and one percent fees, only 16 percent of managers will outperform after fees (approximately 84 percent of the distribution falls to the left of one σ). The bottom chart illustrates relative return distribution in a concentrated fund structure with 10 percent σ , which results in approximately 45 percent of managers outperforming after fees. Please note that these diagrams are conceptual in nature and the quantities shown are approximations.

Moving from an industry of widely diversified funds to a group of concentrated portfolios will cause return distributions to migrate from something approximating the top diagram to the diagram on the bottom. Two important things are accomplished by creating

greater dispersions of returns. First, a far larger proportion of managers outperform the market after fees. Second, because the larger dispersions are created through the generation of alpha (and negative alpha), skill is being rewarded and investors can capture a larger portion of that reward if they pick skilled managers.

Some will question whether a wider dispersion of relative returns benefits investors. They will argue that the average investor is no better off, as the expected return has not changed, and some investors will do much worse relative to the benchmark. This is all true. Active management is not a panacea. It rewards the efforts of the skilled investor.

While it is possible that concentrated managers as a group may shift the mean return to the right if they comprise a small enough part of the market, the argument for concentrated fund structures doesn't depend on this outcome. If the wider dispersion results from the creation of alpha, then returns are not random. We expect that portfolio managers who make superior decisions will capture volatility as positive alpha over time, and that managers who are less adept will produce inferior returns.

The presence of alpha means that a skilled FoCF manager could use past performance, historical correlation information, and investment acumen to create portfolios of alpha producing managers, which reduce the area under the left-hand side of the distribution. Concentrated funds and FoCF offer retail investors an opportunity set that largely does not exist in today's world of low tracking error, highly diversified mutual funds.

Understanding how to detect whether active management is adding value within the proposed system is important. Previously cited studies assessed performance data from concentrated portfolios and indicated alpha creation for this group. We also have performance data from endowments and other institutional pools of capital, who have made use of relatively concentrated private vehicles, such as venture capital, private equity, and hedge funds, that

demonstrate a level of alpha generation. Conversely, there are studies which demonstrate little or no alpha creation from these groups.

The reality is that we should not rely on any of these studies to form a judgment on the success or lack thereof for active management. Each relies on alpha to assess performance, and alpha is a flawed measurement. Not only are alpha measures tainted by invalidating assumptions, but they are systemically biased against managers who practice concentrated investment strategies to the extent that their performance is more volatile than that of the relevant benchmarks.

Yet, even if we had a perfect measure of risk, we shouldn't expect alpha from active managers as a class. Performance for this large group will trend toward market averages due to the influence of the law of large numbers. Active managers may outperform or underperform indexes over a given time frame, but the differential will never be great as long as active assets under management make up a substantial portion of the market. Average performance results, however, do not imply a lack of alpha. Those results may mean that excess returns are being produced by some managers while other managers are destroying value.

The most appropriate marker to determine whether active managers are adding value is persistence in performance. If managers within a class, or in general, demonstrate a tendency toward continued outperformance or underperformance, it indicates that returns are not randomly distributed around the mean. A lack of randomness implies a less than perfectly efficient market, and it leaves the door open for active management value creation. It means that a manager who has outperformed over a period of time has a better than even chance of outperforming over time going forward, assuming that other portfolio factors remain constant (no change in strategy, manager, assets under management, etc.). Likewise, managers who are underperforming are more likely to underperform. In other words, past performance will be a relevant factor in predicting future performance.

II.3 Practical Issues

Creating a new FoCF infrastructure raises a host of practical questions. This section addresses some of the more important of these at a high-level. It does not present an exhaustive list of issues.

One important consideration is whether retail investors would adopt a system that requires investing in concentrated funds, many of which will exhibit returns that are more volatile than highly diversified mutual funds and indexes. Some investors will never be convinced of the benefits and the risk mitigating features of the system, but most will appreciate the logic behind the FoCF structure and its promise of greater value relative to today's actively managed mutual funds.

Retail investors will also understand that while the new system is a substantial departure from the mutual fund industry's structure today, it is not a radical change. In fact, it has been practiced in certain segments of the investment community for a long time. Large institutional pools of capital, including endowments, pensions, and family offices, have actively allocated to relatively concentrated managers for decades in an effort to achieve superior, low-correlated returns. Most of those allocations have funded privately available vehicles such as hedge funds, private equity, and venture capital, as well as direct investments in projects and real estate. In addition, fund of funds has also served these investors, primarily offering access to private vehicles.

Some retail investors have already seen the wisdom in allocating to FoCF strategies. Litman Gregory has offered a FoCF to retail investors for over a decade. In addition, more concentrated, high Active Share mutual fund portfolios are being introduced as fund companies begin to understand that there is a sizable market for this product.

While these developments are promising, they are small in scale, and wholesale change is far from assured. Conventional mutual fund companies control most of the investment talent needed to create concentrated funds, and they are certain to resist because FoCF represent a significant threat to their economic interests. A FoCF system demands substantially more, and smaller mutual funds, all run by well-qualified active managers. The implied loss of scale would hurt mutual fund platform profit margins in a transition.

The threat to mutual fund companies extends beyond the loss of scale. Under the proposed system, mutual funds would see their retail clients replaced by the institutional FoCF manager, cutting off their direct relationship with the retail investor. The institutional manager would be more likely than individual investors to pressure fund companies for lower fees, and to withdraw all of the fund's assets if he or she felt the fund manager were not performing to expectations.

Mutual fund company resistance will represent a significant hurdle, but one that can be overcome. FoCF companies targeting retail investors will need to be creative and pioneering, but they should be rewarded for their work given the level of opportunity. Because of the appeal of FoCF to retail investors, a FoCF platform may be able to attract independent retail distribution partners. With the backing of those partners and the assets and clout they bring to the table, the FoCF is much more likely to convince fund companies that it is in their best interest to create concentrated products. Yet even without the help of mutual fund platforms, FoCF companies may be able to source enough independent managers to seed a variety of different products. They may target emerging managers, independent managers, or large platform mutual fund managers eager to break out of current institutional constraints and prove their skills as asset-pickers.

Costs to the retail investor are an important consideration. The proposed strategy creates a new layer of costs in the investment management process which will give investors

and their advisors pause. In addition, the loss of scale economies may translate into higher expense ratios for mutual funds. Nonetheless, overall costs to the retail investor do not have to increase as much as some might think.

This strategy shifts some responsibility and costs from the portfolio manager/fund company to the FoCF manager. Because FoCF companies would assume the role of interfacing with retail investors, fund manager marketing, sales, investor communication, and education costs would essentially be transferred to FoCF companies. The retail investor would not have to absorb incremental administrative costs except to the extent that scale is sacrificed, which may or may not be the case depending on the size of the FoCF.

Mutual fund management fee reductions could be negotiated. As an institutional investor, the FoCF manager could exercise a degree of leverage that individual retail investors cannot, and attempt to negotiate management fee concessions from fund managers. Fees paid to FoCF managers could then be partly offset by reductions in mutual fund management fees. In addition, both mutual fund managers and FoCF managers may be willing to accept a reduction in management fees in return for the institution of performance incentive fees (or the modification of management fees to include performance incentives), as the new system will create the potential for more alpha production, and thus greater incentive pay. Though retail investors may pay more under the FoCF structure, most will find this alternative preferable to paying less for something they generally don't receive.

Another practical consideration concerns the fact that managing a portfolio of concentrated portfolios is similar to managing a single portfolio; thus, the same costs of diversification will apply. Top-down risk management and strategic allocation work requires constant monitoring and evaluation of portfolios and markets, skill in manager selection, and expert knowledge in risk management. The costs of diversifying portfolios can dilute a top-down manager's ability to monitor exposures and to understand which portfolio managers and

markets are likely to outperform (amongst other considerations). Thus, these costs need to be weighed against the benefits of adding more portfolios. The practical impact is that the total number of portfolios within a given FoCF product should be limited such that the costs do not exceed the benefits. This will limit the scalability of the concentrated FoCF business.

There may also be legal considerations with which to contend. Fiduciary standards, including the Uniform Prudent Investor Act as well as ERISA law, specify that diversification is a key responsibility of fiduciaries. Fund companies could face legal liabilities if they manage highly concentrated funds. The legal ramifications would have to be sorted out by lawyers, but the common-sense approach suggests that under the proposed system, the FoCF manager has assumed risk management responsibilities, and fiduciary responsibilities should reside with the FoCF rather than the concentrated fund manager. A broader question that may be asked in the future is whether legal liability arises for placing client assets in highly diversified funds whose tracking errors suggest that they have little possibility of earning the alpha required to pay for their various active management fees and charges.

There are several types of companies positioned to create products to take advantage of this opportunity. Existing fund of fund companies have some of the infrastructure in place to accomplish the work, but they deal mostly with private investment vehicles and would have to adapt their businesses to reach retail investors. Mutual fund companies are well-positioned to offer these products, but they generally have too much to lose. Brokerage firms are also a natural provider of top-level risk management services, and they have enough clout to affect the creation of concentrated funds. Many brokerages, however, also offer profitable proprietary products that could suffer if this strategy is successful. It may be that independent providers would have to emerge to harvest this opportunity.

There are endless varieties of strategies that FoCF managers could employ, depending on investor preference. Strategies could allow FoCF managers wide latitude in how they invest,

or they might be highly restrictive. Strategies could be traditional style-box oriented, market directional, retirement date focused, or market neutral – there are no limits to potential configurations. Regardless of strategy, the funds would allocate to managers who take idiosyncratic risk and do not manage to a specific index. If part of their strategy included investments in a class of assets where alpha is difficult to source, the FoCF might include the use of passive vehicles. Index references would exist at the FoCF, or super-portfolio level, but would be much less important to individual portfolio managers than in the current system.

III. Conclusions

Saving active managers from the market means decoupling asset selection from diversification and risk management responsibilities at the portfolio level. It means institutionalizing a system that allows active managers to make investments based on conviction rather than on benchmark weighting. It means recognizing that wide diversification at the portfolio level is costly to investors and is to be discouraged. It means offering investors the benefits of diversification independent of portfolio-level concentration.

The opportunity costs of diversification are of critical importance to investors. These costs have a direct influence on a portfolio manager's potential to create alpha, and the production of alpha is the principal reason that investors place money with active managers. Despite their profound importance, however, the costs of diversification are mostly overlooked by an investment community, which has been blinded to the simple logic behind these costs by the bright lights of portfolio theory and scale economies.

Opportunity costs of diversification are a reality, and their presence demands that investors rethink their approach to risk management and portfolio optimization. When these costs are given proper weight, the result will be a substantial shift in mentality by investors. Rather than viewing wide diversification at the portfolio level as a marker of an efficient

portfolio, investors will view it with appropriate skepticism. Investors' newly critical approach to diversification will compel portfolio managers to pare their holdings. The logic behind the costs of diversification will invariably lead investors to consider combining concentrated portfolios.

The gap between active and passive investment strategies will widen and become more noticeably bifurcated when costs of diversification are given full consideration. Low-cost, high-scale, passive and quasi-passive solutions will reside on one end of the spectrum. On the other end investors will find relatively high cost, concentrated, boutique-like, actively managed products. Active investors who remain in the middle, pursuing low-cost active management, are likely to be disappointed with performance outcomes. Low-cost active funds that rely on scale to keep expense ratios low often sacrifice alpha and ignore the costs of diversification.

Whether the system proposed in this paper is adopted is an open question. The inertia of reluctant fund companies who are unwilling to cannibalize their high return business means that a transition, if it happens, is not likely to happen quickly. Yet if active fund platforms cannot systemically divorce their funds from the market, and make their managers dramatically more active, they will continue to lose relevance even as they lower their fees. If today's fund platforms are unwilling to adapt, they may find that outflows accelerate as investors discover innovative new active management companies who are willing to prioritize the creation of alpha over the creation of profits.

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