

# Why Do Investors Favor Active Management ... To the Extent They Do?

Ron Bird, Jack Gray, and Massimo Scotti

Ron Bird, Jack Gray, and Massimo Scotti are with the Paul Woolley Centre for the Study of Capital Market Dysfunctionalities, University of Technology, Sydney (Australia).

*Half a century of analysis has yet to fully answer why investors place such a large proportion of their funds with active equity managers, given the discouraging evidence on the latter's ability to add net value. From the voluminous literature on manager performance we conclude that there is some, but limited, evidence that can rationally justify hiring active managers. The weakness of the evidence leads us to ask, Why do investors favor active equity management to the extent they do? To help answer this question, we conducted two online surveys, one of Chief Investment Officers of predominantly large Australian superannuation (i.e., pension) funds and another of asset consultants. The results confirmed that the industry is captive to a pervasive prior towards active management. The prior is reinforced by a competitive environment and supported by a complex mix of behavioral, agency, organizational, and cultural factors.*

*Keywords: Active Management, Agency Costs, Behavioral Finance, Pension Fund, Retirement Savings*

## The Active Management Question

A much-discussed question is, Do active managers add sufficiently to market returns to justify their fees? Do they provide value for money? Although active strategies dominate passive strategies by a wide margin, and in a noisy environment there is evidence both for and against active management, the evidence suggests that this dominance is unwarranted. Perhaps investors are becoming more critical of active management: globally, passive<sup>1</sup> exposures are increasing, though it is too early to tell whether this is a cyclical response to the financial crisis or part of a deeper trend (Johnson 2010).<sup>2</sup> The Chair of the UK Asset Management and Investors' Council sees a "long-term trend to indexation" in the UK and Europe (Robert Parker, qtd. in Skypala 2010), while one consultant we surveyed claimed that "the financial crisis has driven a re-think of ... active/passive ... Outperformance through active management is now really being questioned."

Notwithstanding the evidence, the ineluctable arithmetic of a zero-sum game still leaves scope for a given active manager to outperform the index net of fees over a given period, either because she is more skillful than the median investor, because she takes higher risks than the benchmark portfolio, or because she is just plain lucky. Even after controlling for risk and luck, there may still be some managers that outperform net of fees, so not all active investors necessarily lose. The most sanguine

results are those of Jones and Wermers (2011, 1541), who from an extensive literature review conclude that "the average active manager does not outperform but that a significant minority ... do add value ... [and] investors may be able to identify superior managers in advance by using public information."

On balance, the evidence provides *the beginnings* of rational evidence-based support for active management, but makes it difficult to justify the *extent* to which funds and their staff, trustees, and advisers favor active management as being in the best economic interests of the principals.

To gain further insight, we conducted two online surveys, one of Chief Investment Officers (CIOs) of predominantly large Australian superannuation (i.e., pension) funds and another of asset consultants. Our broad conclusion from these surveys is that, in general, CIOs and consultants do attempt to make decisions in a rational evidence-based framework, but their attempts are undermined by a quartet of interconnected forces:

1. The influence of *agents*, especially consultants but also including the fund's fiduciaries and investment staff. Agents determine the *realpolitik* of decision making that underlies formal governance structures.
2. Well-known *behavioral* impediments, such as overconfidence and the illusion of control, push decision makers toward excessive levels of activity.

3. Society strongly favors activity in all areas and sees passivity as unacceptable. Funds and their managers must be seen to be *doing* something. This is exacerbated in Australia by competition in retirement savings, which encourages funds to try to outperform each other through a search for alpha.<sup>3</sup>
4. Because many respondents are probably aware of the weak rational support for active management, they play a “blame game” that further hinders objective decision making.

In the next section we draw on the finance and behavioral literature to hypothesize some possible answers to the question in our title.

## Why Do Investors So Favor Active Management?

French (2008, 108), who asked, “Why do active investors continue to play a negative sum game?” represents one of the few attempts to reconcile the evidence on the difficulty of identifying value-adding managers *ex ante* with investors’ propensity to play the active game. Malkiel (2013, 106) exposes the depth of that difficulty in the context of American mutual funds; his conclusion that “it is hard to think of any other service that is priced at such a high proportion of value” captures the spirit of our investigation. Drawing on the finance and behavioral literature, we hypothesize five interrelated possible answers to the “Why?” question. We then link these hypothesized reasons to the survey inferences.

### 1. Imperfect Knowledge and Bounded Rationality

Investors and their agents may be unaware of the true cost (brokerage, custody, transactions) of active management or of the probabilities of net outperformance and successful manager selection. They may not know how to adjust for data biases such as survivorship and for human biases such as saliency, which make us vulnerable to fads (Shiller 2000) and manipulation (Daniel et al. 2002). They may lack the ability or knowledge to interpret noisy data or to use probabilistic reasoning correctly. Even sophisticated people systematically over-value sample evidence (the “lore of small numbers”) while under-valuing *a priori* probabilities (Kahneman 2011). We all suffer from limited cognition and bounded rationality. We make errors and mistakes and reason imperfectly. Our knowledge and ability to understand are limited. Explanations of causality are often weak, especially in a noisy environment with powerful feedback loops.

Knowledge imperfections are magnified by advertising and the media. Mullainathan and Schleifer (2005) develop a strong case for the negative impact of advertising on both retail

and institutional investors. For instance, manager promotions often emphasize the informational inefficiency of markets, subliminally suggesting that this necessary condition for beating the market is also sufficient, a message reinforced by eternal stories of undervalued stocks and successful investors. Notwithstanding “health warnings” about the dangers of relying on past performance, Haslem (2011) shows how influential it is. Yet typically only time-weighted returns are shown, even though much outperformance dissipates when measured by asset-weighted returns or IRR, the returns investors actually receive. According to Swensen (2003), from 1993 to 2003 the average manager’s time-weighted return relative to the S&P 500 was +280bps, while the average asset-weighted relative return was –210bps.

### 2. Other Investment Benefits

Even if active managers underperform, they might be able to reconfigure return distributions to provide some valuable downside protection. Bird and Gallagher (2002) demonstrate that in almost all markets, across several asset classes and countries, active managers do typically outperform in down markets (but underperform in up markets). Whether active management is as beneficial under more extreme market dynamics remains a matter for debate. Kosowski et al. (2006) show that active management provides some benefit in periods of financial turmoil; however, a post-crisis Mercer (2009) survey of large institutional investors found no consensus as to whether or not active management is a benefit in market distressed conditions. An extension of this belief in downside protection is that alpha and beta tend to have low correlations, which, in a rationalist framework, can justify some active management as a partial market hedge.<sup>4</sup>

Another investment benefit that active managers might provide is information and knowledge that CIOs can use to improve their decision making, enhance their status, and build and retain an internal investment team, as reported in Mercer (2009).

### 3. Agent Influences

Most institutional investors rely on a collection of external agents, consultants, lawyers, custodians, and managers whose revenue is tied to activity. It would therefore be surprising if their advice did not favor active management (Lakonishok et al. 1992). One consultant we surveyed was explicit about this: “The case for passive is strong. I would like to use it more but am not empowered to by our business model.” One of us, when practicing as a consultant, was bluntly told by senior management that recommending passive management was not good for business.

Agency theory suggests that outperformance by even the few skillful managers will fail to flow through to clients because in a competitive environment in equilibrium, managers will

charge fully for their skill (Berk and Green 2004). In fact, Biais et al. (2010) conclude that managers will charge *more* than they deliver, resulting in negative relative returns. Internal staff will also be biased toward activity, because much of their work involves selecting and monitoring active strategies. Active managers capitalize on this bias by “servicing” clients, something that index funds, which necessarily compete on costs and execution, can ill afford to do.

#### 4. Non-standard Utility

Some investors are prepared to trade off returns for perceived other benefits. At least informally, they augment their “standard” utility function, which is based solely on expected return and risks, with factors that allow assets and managers to be assessed as consumption (if not luxury) goods that provide expression and status. Fama and French (2007) assess the effect on asset prices of “tastes” such as social responsibility, loyalty to certain corporations, and a preference for staying close to home. Barberis and Xiong (2012) allow for utility from the realization of gains. Statman (2004, 2010) offers further examples of non-standard utilities that, for instance, value “bragging rights.”

Being primarily psychological, these perceived benefits flow to agents, not necessarily to principals. For instance, relative outperformance can generate industry-wide prestige and influence for a CIO, which can be traded for higher status and greater compensation. Active management can be justified by CIOs whose utility includes (non-standard) career and business risk factors, as they will likely see their responsibility as “beating” competing funds. Utility that weights asymmetric payoffs will favor the positively skewed active manager returns not available from indexing. For some, the utility of infrequent large excess returns might dominate the disutility of consistent benchmark performance, a hypothesis supported by the convexity of the performance–flow relationship (Goriaev et al. 2008).

Kritzman (2009, 5; emphasis added) hints at the role of non-standard utility in claiming that it is very hard, “if not impossible[,] to justify active management for most individual, taxable investors *if their goal is to grow wealth.*” In the opposite direction, Sharpe (2002) sees non-standard utility as a justification for passive management: “in the long run this boring approach can give you more time for more interesting activities such as music, art, literature, and sports ... and it may very well leave you with more money as well.”

#### 5. Behavioral Factors

A quarter-century of research in behavioral finance has forced even economic rationalists to accept that we are less than perfectly objective and rational. For one of our surveyed consultants, the key issue is to “create incentives

to get more of the aggregate asset pool invested passively; [or] at least to get the decision made more *objectively*” (emphasis added).

Behavioral traits, a dominant one being a *confirmation bias*, help explain many justifications for favoring active management. The affective cost of recognizing when we are wrong encourages us to actively seek confirmation of our assumptions (Rabin and Schrag 1999). A related trait, *overconfidence*, is manifested in a belief in selection ability – for example, investors’ belief that they can identify future outperforming managers. Gort (2009, 1) highlights overconfidence by Swiss pension fund decision makers, which “sheds some light on why active management is still so popular.” Despite knowing the evidence on average ability, decision makers may believe their own odds to be better than average. Given the ample evidence that we overestimate our abilities in most areas (Kahneman 2011), it would be surprising to find that manager selection is not one of them. However, Foster and Warren (2010) demonstrate that investors with the option of firing managers need only believe they have a small edge to justify active management. This conclusion finds support in Dahlquist et al.’s (2011) study of Swedish retail investors, which observed a causal effect of fund changes on performance.

Another relevant behavioral trait – one that has evident links to gambling, but is difficult to uncover in a simple survey – is that decision makers may be exhilarated by the asymmetry of payoffs in the active “game,” which at least provides a consumption benefit if not a wealth benefit. One survey respondent was brutally frank on that score: “I enjoy punting on the share-market. I know I would be much better off being passive! It’s a bit like eating McDonalds – I know it’s bad for me, but still I eat it.”

As a broad sociological observation, favoring activity over passivity is deeply embedded in society. All players (boards, internal staff, managers, lawyers, custodians, brokers, consultants, academics) are predisposed to activity, which is the norm in every other sphere of life and is strongly encouraged across society. In no other field of human or organizational endeavor does it pay to be passive. Indeed, because passivity is commonly seen as the epitome of indolence and irresponsibility, boards may adopt the “common-sense” imperative that passive managers don’t do any work for the fund. Keynes (1964, 162–63), at his eloquent best, warned that “it is our innate urge to activity which makes the wheels go round, our rational selves choosing between the alternatives as best we are able, calculating where we can, but often falling back for our motive on whim or sentiment or chance.”

## Surveys of Fund CIOs and Asset Consultants

To assess whether the reasons discussed above explain the extent of active management, in late 2009 we conducted online surveys<sup>5</sup> of fund<sup>6</sup> CIOs and of asset consultants.<sup>7</sup> For psychological and organizational reasons, the true answers to the question in our title lie hidden; we all explain our decisions as the outworking of an objective rational process (Altman 2006), which makes it pointless, for instance, to ask CIOs, “To what extent are your active/passive decisions (a) rational and evidence-based, and (b) made largely in your own self-interest?” Instead, we must infer the actual decision-making process and agency influences from less explicit and threatening questions.

Questions focused on respondents’ attitudes, and their beliefs about the attitudes of their Investment Committee and their asset consultant, to the active/passive equities decision. We received 48 completed CIO responses, a 60% response rate, and 40 completed responses from 10 consulting firms, a 74% response rate.

Table 1 breaks down CIO respondents by type of fund within funds regulated by the Australian Prudential Regulation Authority (APRA)<sup>8</sup> and with funds under management (FUM) in excess of \$50M. Six other funds were not regulated by APRA, including some public-sector funds and a sovereign wealth fund. FUM ranged from \$0.4B to \$55B, with a median of \$2.6B and an average of \$8.5B. Aggregate FUM was \$399B, of which 83% (\$330B) were superannuation fund assets.<sup>9</sup> The average size of consultants’ funds under advice (FUA) was \$32B.<sup>10</sup>

**Table 1: Surveyed Funds vs. All APRA Funds >\$50M**

	By Number (%)	By FUM (%)
All funds (n = 42)	14	73
Industry (n = 26)	62	75
Public (n = 10)	23	90
Corporate (n = 6)	14	25

CIOs were asked to specify, within ranges, their active weights (enhanced passive was deemed active), from which we estimated the average active weights of both Australian and international equities<sup>11</sup> to be 85% (with a correlation of 0.7). Evidence of a belief in diseconomies of scale is reflected in summary responses in Table 2 for Australian equities, the data for international equities being broadly similar.

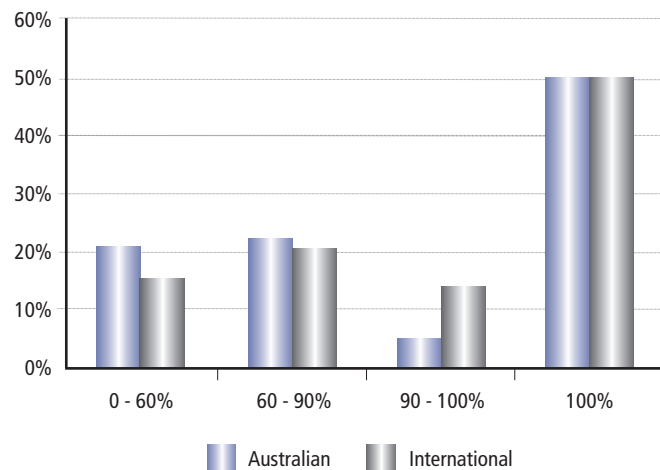
**Table 2: Active Weights vs. Fund Size**

	Average Estimated* Active Weight (%)
Small funds <sup>†</sup> (n = 18)	86
Medium funds <sup>†</sup> (n = 16)	82
Large funds <sup>†</sup> (n = 14)	77

\* Midpoints of active ranges were used for estimates  
 † Small: <\$2B; medium: \$2–10B; large: >\$10B

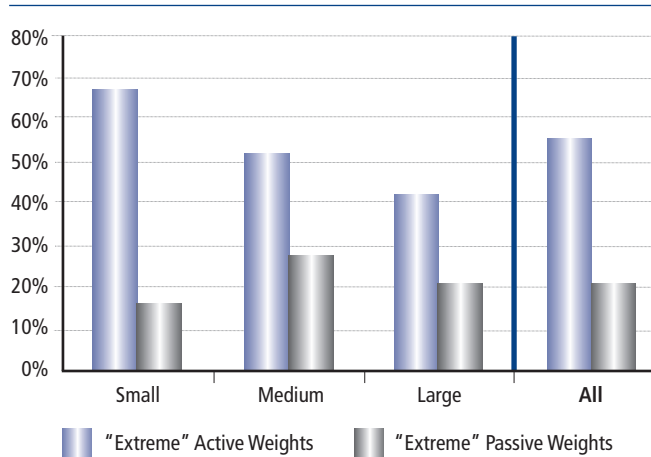
The distribution of active weights shown in Figure 1 does not support the claim that funds are more active in Australian than in international equities. This is somewhat surprising, given the common belief and supporting evidence that the domestic market is less efficient and that outperforming is easier in the former than in the latter.<sup>12</sup>

**Figure 1: Active Weights**

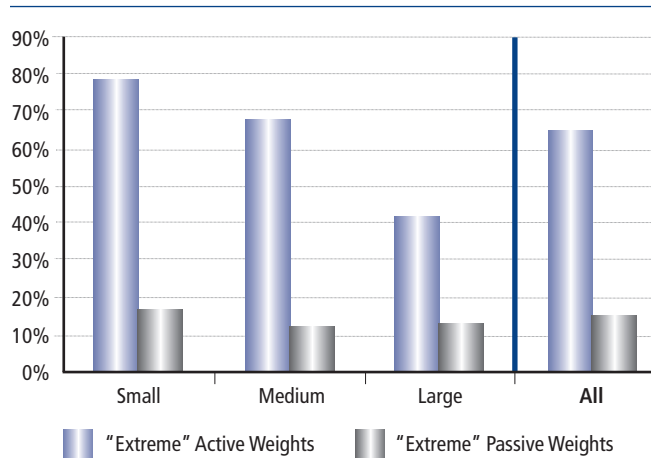


The intensity of respondents’ views can be inferred from the fraction of funds with “extreme” active or passive weights. An “extreme” weight for active was taken to be 90% or more; as only 21% of funds had passive exposures above 40%, “extreme” for passive was taken to be 40% or more. Figures 2a and 2b show that extreme active weights decrease with size, a decrease not matched by a corresponding increase in extreme passive weights. Larger funds appear to be more balanced in their passive / active exposures.

**Figure 2a: “Extreme” Active / Passive Weights vs. Fund Size – Australia**



**Figure 2b: “Extreme” Active / Passive Weights vs. Fund Size – International**



CIOs were asked whether their funds had (a) formal investment beliefs and (b) explicit constraints on active exposures. Those with formal beliefs were more likely to have lower active exposures, consistent with Bauer et al.’s (2010) conclusion that investment beliefs impose a “measurable” discipline on decision making and generate greater consistency between “preferred” and “actual” exposures, although size may be a further explanatory variable, as those with formal beliefs were also more likely to be large. Thirty-five percent of surveyed funds have explicit active constraints. The contrast between the wide variety of constraints shown in Table 3 and the relative homogeneity of funds’ objectives raises questions: How do funds justify their active / passive exposures? Does each fund believe their own active / passive allocation to be optimal?

**Table 3: Variety of Constraints on Active Equity Exposures**

100% active
≥75% active
≥70% active
66% active Australian equities / 33% active international equities
50% Australian / 50% international
≥50% Australian / ≥50% international

Active weights were effectively uncorrelated with the five-year FUM growth rate (an average of 14.4%), the size of the Investment Committee, and the number of investment staff.<sup>13</sup> The latter two findings are slightly at odds with evidence of agent influences explored in the next section. CIOs were asked for their broad view on active/passive: “Do you (a) generally prefer active, or (b) generally prefer passive, or prefer passive in some sectors and/or at some times?” Their stated preferences were broadly in line with actual weightings. CIOs were also asked what they believe are the broad views of both the Investment Committee and their consultants.

**Figure 3: Funds’ Preferences for Active (as Reported by CIOs)**

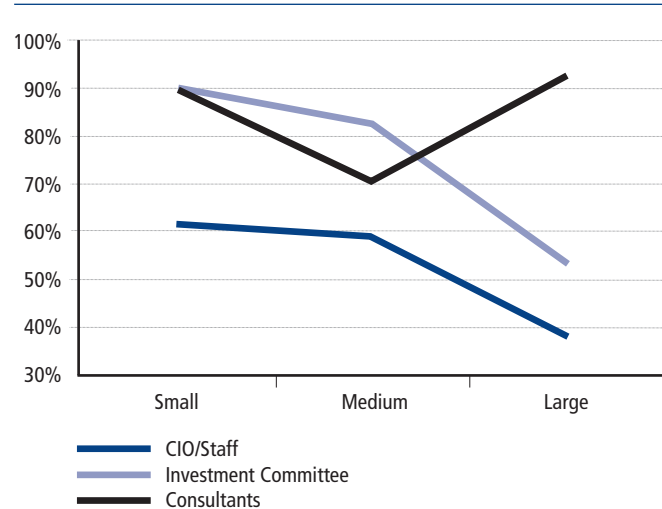


Figure 3 plots the percentage of CIO / staff, Investment Committee, and consultants that “generally prefer active” versus fund size. The reported CIO preference for active by CIO/Staff and by Investment Committee decreases with fund size, in



contrast to their consultants' preferences. The data on large funds suggest an agency friction between CIO, staff, and Investment Committee and consultants, which will be discussed later. The three very large funds (>\$15B) are even less disposed toward active; they are less likely to be concerned about competition and less likely to have a regular asset consultant, both of which, for agency reasons, nudge funds toward more active management. Indeed, funds with regular asset consultants are less likely to have "seriously considered the active/passive issue over the past five years." Agency costs can probably be inferred from Table 4.

**Table 4: Consultants and Active/Passive Weights**

	Average Active Weight (%)	Extreme Active* (%)	Extreme Passive† (%)
Fund <i>does</i> have a regular asset consultant	83	51	18
Fund <i>does not</i> have a regular asset consultant	78	44	33

\* Defined as ≥90% active  
 † Defined as ≥40% passive

Before the survey, we asked a senior asset consultant the question in our title. His instant response that "all consultants here are indexed," while not to be taken literally, does highlight a serious principal / agency friction. In the opposite direction, Table 5 hints at a degree of consistency between consultants' personal and advisory beliefs: 40% of consultants reported some passive in their personal retirement accounts, and that cohort also has greater passive weights in their FUA.

**Table 5: Consultants' FUA Weights (Self-Reported)**

	FUA Average Active Weight (%)	FUA Extreme Active (%)	FUA Extreme Passive (%)
Some passive in personal account	71	29	41
No passive in personal account	88	61	10

## Reasons for the Active / Passive Decision

Previously we proposed five reasons why decision makers favor active management to *the extent they do*:

1. imperfect knowledge and bounded rationality;
2. other investment benefits;
3. agent influences;
4. non-standard utility; and
5. behavioral factors.

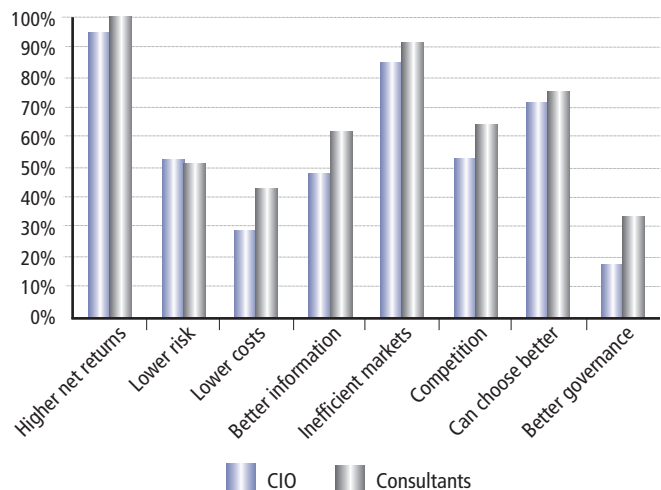
The subjective psychological nature of the reasons meant that respondents would be loath to admit to them (there were exceptions) or might be unaware of their influence. Because it would be unproductive and perhaps inappropriate to ask direct questions about the reasons, we asked more objective questions, from which we hoped to draw inferences.

One such question was to rank on a four-point scale (0 = unimportant, 3 = very important) the relative importance of eight putative rationales "for favouring active management to the extent you do":

1. Higher expected net returns
2. Lower expected risk
3. Lower cost
4. Inefficient markets
5. Better-quality information
6. To be competitive relative to peers
7. The fund/consulting firm can choose better managers
8. Greater governance influence over companies

Figure 4 shows the percentage of CIOs and consultants who consider each of these rationales to be "very important" or "somewhat important," from which we draw inferences and try to relate them to our posited five reasons.

**Figure 4: Reported Reasons for Active Decisions**



Both CIOs and consultants report higher net returns and a belief in market inefficiency as the dominant rationales for favoring active management. As discussed earlier, seeking abnormal returns is an ambitious but far from impossible goal. Because more than 70% consider *their own* ability to select outperformers a very to somewhat important rationale for favoring active management to the extent they do, we infer that respondents do appreciate that market inefficiency is a necessary but not sufficient condition for achieving that goal.

Responses to rationales 1, 4, and 7 point to decision making grounded in attempts to be rational. But given the likelihood of success, with which institutional investors are probably familiar, the *extent* of active management demands explanation. The most immediate hypothesis is that behavioral factors, especially overconfidence, have a substantive influence on decision making. An intriguing alternative hypothesis from Baks et al. (2001) is that Bayesian (rational) investors who, based on standard statistical arguments, are skeptical of active management would nonetheless rationally make economically significant allocations to active managers. A simple online survey is too crude a tool to distinguish between these alternatives.

More than half the respondents see being competitive as an important rationale for active management, which again suggests excessive conviction in their ability to select better managers. That larger funds are less disposed toward active management, as Table 2 shows, is consistent with their being less concerned about competition.

### **1. Higher Expected Net Returns**

Both CIOs and consultants report higher expected net returns as the dominant rationale for their decision, consistent with a belief in market inefficiency (see rationale 4 below). The slight surprise is that CIOs' rankings were not even closer to the 100% reported by consultants (see Figure 4). The *belief* that funds can generate higher returns through active management is probably justified by three of the reasons we posited earlier – imperfect knowledge and bounded rationality, agent influences, and behavioral factors – all subsumed within one CIO's declaration that “our job is to make money for members so it is incumbent on us to be active.”

### **2. Lower Expected Risk**

Public-sector CIOs rated lower expected risk above average at over 60%, in keeping with a common perception of their greater risk aversion. Large funds, too, were more likely to cite this rationale. Risk was interpreted as relative and/or absolute. For example, the comment “through periods of strongly trending markets a tilt to passive may be justified” implies a belief that active will underperform passive in rising markets and a concern for benchmark risk. On the other hand, a concern for absolute risk is revealed in this comment: “the Board has a strategy to

protect returns on the downside ... active management assists in this.” Lower risk was also a concern for the CIO who saw “alpha [as], in general, lowly correlated with market returns ... [so] its impact on diversification can be large.” All five of our posited reasons likely underlie the belief in lower expected risk.

### **3. Costs**

Except for the 21% of funds with extreme passive exposure, the low ranking of this rationale is inconsistent with funds' belief that their active managers generate *net* outperformance (see item 7 below). Consultants believe funds to be more concerned about costs than they actually are.

### **4. Inefficient Markets**

The differences shown in Figure 4 between the scores for rationale 4 (inefficient markets) and rationale 1 (higher expected returns) suggest that some who justify their active decision through a belief in higher returns may also believe that markets are efficient. Bounded rationality and behavioral biases explain this disconnect.

### **5. Better-Quality Information**

The fact that only 48% of CIOs (and only 23% of those from public-sector funds) ranked better-quality information as a somewhat or very important rationale for active management is unexpected, given active managers' emphasis on knowledge transfer as a sales hook. For instance, active managers claim to have knowledge denied to indexers that allows them to better meet specific needs and objectives. According to one CIO, “Only active managers have the capacity to consider tax-aware mandates.” Another's response was challengingly contrarian: “Active managers can be a source of very expensive advice ... sometimes the best research comes from underperforming managers.” Consultants value this benefit more than CIOs, a finding consistent with, but not fully explained by, their role as agents to CIOs. Three of our reasons – other investment benefits, agent influences, and non-standard utility – explain the (limited) reliance on rationale 5 as support for choosing active management.

### **6. To Be Competitive Relative to Peers**

Large funds are less concerned with competition, consistent with Figure 3, while public-sector funds are far less concerned with competition than corporate and industry funds. Again, consultants see this as more important than do CIOs. Non-standard utility, reflected in an emphasis on relative returns, likely contributes to this rationale.

### **7. The Fund / Consulting Firm Can Choose Better Managers**

Both CIOs and consultants firmly believe in their ability to choose the better managers; unsurprisingly, consultants believe

it even more firmly. Around 70% of each group report they can choose consistently top quartile performers. Some CIOs were explicit about their overconfidence: “We prefer active as we have the skill set to identify top quartile managers”; “We must have a comparative advantage in selection in order to engage in that activity.” Confirmation bias is blatant in some comments: “Passive is the default unless we have an opinion. We have a few opinions hence there’s little passive.”

The *endowment* and *disposition* effects (Altman 2006) likely underlie this reasoning: anecdotal evidence not drawn from our survey hints at CIOs’ and consultants’ showing greater tolerance for the underperforming managers they themselves selected. Factors underlying this stated rationale likely include overconfidence and agent influences, as consultants’ business depends on believing in their ability to choose the better managers.

**8. Greater Governance Influence over Companies**

Of the CIOs surveyed, only 20% consider greater governance influence over companies to be of some importance. Somewhat surprisingly, public-sector funds rank it even lower, at 10%. Again consultants value this justification more highly than those they advise. Imperfect knowledge and non-standard utility probably underlie the low ranking of this rationale.

**Decision Makers’ Influences**

Table 5 suggests a positive correlation between active exposure and having a regular asset consultant. Survey voices further suggest causality and its direction: “I know the evidence but if I suggested passive to my Board they’d fire me”; “Many boards are driven by consultants who have a vested interest in maintaining the status quo ... funds need research that can challenge the current conventional thinking that active management outperforms.” A similar view was expressed somewhat differently: “Consultants obviously believe in active management ... which over-rides their thoughts on costs ... so it is hard for funds to have other than an active bias” (emphasis added).

Tables 6a and 6b hint at a “blame game” that will put upward pressure on active weights. Only 52% of CIOs “generally prefer,” active but they believe that 83% of consultants do. Of consultants, 73% “generally prefer” active but, reversing the blame, believe that 85% of CIOs do. Tables 6a and 6b show that CIOs and consultants see all decision makers as equally influential, but more specific survey questions reveal that 60% of consultants see the CIO / staff as having a “very strong” influence, compared to a mere 52% for the Investment Committee and 50% for consultants themselves.

The blame game smacks of a nuanced, variable, and often unclear distribution of power within funds’ decision-making framework, one that reflects a *realpolitik* underlying formal governance structures. *Realpolitik* probably best explains one CIO’s *cri du coeur*: “I really don’t know why I have so much [active management] when over 12 years they’ve added nothing.” Three years hence, and that CIO still had “so much” active management. Of course, CIOs are not without power and influence, and Figure 3 shows that the CIOs of large funds, at least, do impose their views over those of their consultants.

**Table 6a: CIOs’ Views of Decision Makers’ Preferences and Influence**

	Generally Prefer Active (%)	Influence (1–3)
CIO / Staff	52	2.3
Investment Committee	72*	2.4
Consultants	83	2.2

\* Only 50% for public-sector funds

**Table 6b: Consultants’ Views of Decision Makers’ Preferences and Influence**

	Generally Prefer Active (%)	Influence (1–3)
CIO / Staff	85	2.6
Investment Committee	80	2.4
Consultants	73	2.5

Consultants’ passive recommendations tend to increase with experience, though almost none “use it copiously.” Those who have never worked in investment management are also slightly more likely to recommend passive management. Of the consultants, 63% reported that their advice varies across clients, and most said it varies across asset classes. Beyond listed equities, 73% of consultants “would recommend a lesser use of active” in asset classes such as REITs and global fixed income, while 55% “would recommend a greater use” in other asset classes such as small companies – again, rationally supported by evidence.



## Defined Contribution Plans versus Defined Benefit or Hybrid Plans

Comparing DC and DB / hybrid plans reveals some interesting attitudinal differences. Table 7 shows the differences in number and size; Table 8 shows that DCs are more likely to prefer active management and roughly half as likely to have extreme passive exposures in either domestic or global equities, in broad agreement with EnnisKnupp (qtd. in “Falling Short” 2008).

**Table 7: DC vs. DB / Hybrid Funds**

	DC	DB / Hybrid
Number of funds	28	14
Average members	427,000	149,000
Average FUM	\$5.4B	\$11.8B

**Table 8: Active/Passive Weights**

	Estimated Average Active Weight (%)	Extreme Active* (%)	Extreme Passive† (%)
DC	86	57	14
DB / Hybrid	76	36	29

\* Defined as ≥90% active

† Defined as ≥40% passive

DB and hybrid funds are also 40% more likely to have explicit “limits or guidelines” on active / passive and roughly three times as likely to have an Investment Committee, CIO, or consultant who “generally prefers passive.” They are also 30% less likely to have a regular asset consultant (probably because of their greater size and larger internal staff, consistent with Table 2 and Figure 3), and 70% less likely to use “competition relative to peers” as a rationale for their decisions. Probable explanations for the differences include minimal concern for competition, a sharper focus on liabilities, and concern for the sponsoring organization’s balance sheet, all of which are likely reflected in different objectives, investment approaches, and governance structures.<sup>14</sup>

## More Independent, Knowledgeable Trustees Needed

The relatively weak evidence and theory in support of managers’ ability to outperform their benchmarks net of costs and investors’ ability to select them suggest that institutional funds over-allocate to active managers. The causes are a complex of cultural, behavioral, and organizational influences, prime among which are the many principal/agent relationships. Although in principle formal governance structures clarify roles and responsibilities, in practice decisions are made in ways that support the psychological and financial interests of the agents, including trustees, internal investment staff, asset consultants, and managers.

The complexity and interconnections of the reasons for favoring active management are unlikely to yield to simple solutions. Most fundamentally, funds do need more technically adept and independent trustees with the time, temperament, skill, and commitment to understand and act on the active / passive decision in the best economic interests of the principals.

## Endnotes

1. Throughout we ignore “smart beta” and its concomitant interpretations of the concept of “passive.”
2. The share of assets invested in American equity index funds relative to all equity mutual fund assets increased to over 17% by 2012, from 1.1% in 1985 (ICI 2013, fig. 2.11). These data do not include ETFs.
3. By construction, indexing commits money to overpriced stocks, which serves to increase momentum, a prime source of mispricing. Thus some active management is necessary for efficient price discovery and to provide liquidity. So, in making markets more efficient in the informational and, therefore, in the allocative sense, *some* active management appears to be a public good, although Malkiel (2013) argues that active management fails on that score, too: that it *fails* to increase pricing efficiency.
4. The assumed low correlations are central to “ $\alpha$ - $\beta$  separation,” in which the cheap and easy passive search for market returns is separated from the expensive and difficult active search for abnormal returns.
5. Mercer (2009) conducted a survey of large funds on the same topic on behalf of the Norwegian Ministry of Finance.
6. Of the 48 funds, 40 contained only superannuation assets; 5 contained superannuation, treasury, and insurance assets; and there was 1 each of endowment, family office, and sovereign wealth fund assets.
7. Survey questions are available from the authors. Conducting the survey online meant sacrificing some detail and nuance for higher completion rates, though “other comments” provided some nuances.
8. APRA regulates institutional and retail superannuation funds.
9. Based on a reported average of 3.6 superannuation funds per member, in aggregate respondents’ funds represented approximately 3.7M members with an average account balance of \$32K.
10. Unless otherwise indicated, amounts are given in Australian dollars. Converting to US\$ via an exchange rate of 1 will do little violence.
11. The average benchmark allocations to Australian and (developed) international/global equities were 34% and 24% respectively.
12. As one of many pieces of supporting data, Standard and Poor’s (2012) shows five-year gross outperformance of benchmarks to end 2011 of all Australian (retail) equity funds with comparable American data, both adjusted for survivorship bias. The usual explanation for the apparent superior performance of the Australian funds is the presence of 60% of “dumb” money. Domestic managers account for approximately 40% of the local equity market, with the balance split 20% / 40% between retail investors and offshore managers. The latter are believed to use Australia simply as a resource play, so their interest lies in timing the entire market, not in stock-picking or even in outperforming. An added explanation is the mispricing of IPOs and their inclusion in funds before they are included in indices.
13. Correlations ranged from  $-0.1$  to  $0.2$ . Although only ranges of active exposures were reported, correlations were quite insensitive to point estimates within these ranges.
14. These likely explanations are somewhat undermined by some corresponding figures from the CEM database of large global funds (Ambachtsheer 2012), according to which DC funds have an average active weight of 67% (excluding company stock) compared to DB funds’ 80%.

---

## References

- Altman, M., ed. 2006. *Handbook of Contemporary Behavioural Economics: Foundations and Developments*. New York: M.E. Sharpe.
- Ambachtsheer, K. 2012. Private communication.
- Baks, K., A. Metrick, and J. Wachter. 2001. "Should Investors Avoid All Actively Managed Mutual Funds? A Study of Bayesian Performance Evaluation." *Journal of Finance* 56 (1): 45–85. <http://dx.doi.org/10.1111/0022-1082.00319>
- Barberis, N., and W. Xiong. 2012. "Realization Utility." *Journal of Financial Economics* 104 (2): 251–71. <http://dx.doi.org/10.1016/j.jfineco.2011.10.005>
- Bauer, R., M. Cremers, and R. Frehen. 2010. "Pension Fund Performance and Costs: Small Is Beautiful." Working Paper. <http://dx.doi.org/10.2139/ssrn.965388>
- Berk, J., and T. Green. 2004. "Mutual Fund Flows and Performance in Rational Markets." *Journal of Political Economy* 112 (6): 1269–95. <http://dx.doi.org/10.1086/424739>
- Biais, B., J.-C. Rochet, and P. Woolley. 2010. "Innovations, Rents and Risk." Working Papers 644, Institut d'Économie Industrielle (IDEI), Toulouse.
- Bird, R., and D. Gallagher. 2002. "The Evaluation of Active Manager Returns in a Non-symmetrical Environment." *Journal of Asset Management* 2 (4): 303–24. <http://dx.doi.org/10.1057/palgrave.jam.2240055>
- Dahlquist, M., J. Martinez and P. Söderlind. 2011. "Individual Investor Activity and Performance." <http://dx.doi.org/10.2139/ssrn.2018816>
- Daniel, K., D. Hirshleifer, and S. Teoh. 2002. "Investor Psychology in Capital Markets: Evidence and Policy Implications." *Journal of Monetary Economics* 49 (1): 139–209. [http://dx.doi.org/10.1016/S0304-3932\(01\)00091-5](http://dx.doi.org/10.1016/S0304-3932(01)00091-5)
- "Falling Short – The Trouble with Pensions." 2008. *The Economist* (June 14): 93–96.
- Fama, E., and K. French. 2007. "Disagreement, Tastes, and Asset Pricing." *Journal of Financial Economics* 83 (3): 667–89. <http://dx.doi.org/10.1016/j.jfineco.2006.01.003>
- Foster, F., and G. Warren. 2010. "Why Might Investors Choose Active Management?" Working paper, Australian National University.
- French, K. 2008. "The Cost of Active Investing." *Journal of Finance* 63 (4): 1537–73. <http://dx.doi.org/10.1111/j.1540-6261.2008.01368.x>
- Goriaev, A., T. Nijman, and B. Werker. 2008. "Performance Information Dissemination in the Mutual Fund Industry." *Journal of Financial Markets* 11 (2): 144–59. <http://dx.doi.org/10.1016/j.finmar.2007.10.003>
- Gort, C. 2009. "Overconfidence and Active Management: An Empirical Study across Swiss Pension Plans." *Journal of Behavioral Finance* 10 (2): 69–80. <http://dx.doi.org/10.1080/15427560902905369>
- Haslem, J. 2011. "Mutual Funds: Advertising, Behavioral Models, and Investor Choice." *Journal of Index Investing* 1 (4): 7–12.
- Investment Company Institute [ICI]. 2013. "Recent Mutual Fund Trends." In *2013 Investment Company Fact Book: A Review of Trends and Activities in the U.S. Investment Company Industry*, ch. 2. ICI, 2013. [http://www.icifactbook.org/pdf/2013\\_factbook.pdf](http://www.icifactbook.org/pdf/2013_factbook.pdf)
- Johnson, S. 2010. "Investment Industry Set for Big Shift into Passive Management." *Financial Times*, June 27. <http://www.ft.com/cms/s/0/80350de0-8091-11df-be5a-00144feabdc0.html>
- Jones, R., and R. Wermers. 2011. "Active Management in Mostly Efficient Markets." *Financial Analysts Journal* 67 (6): 29–45. <http://dx.doi.org/10.2469/faj.v67.n6.5>
- Kahneman, D. 2011. *Thinking, Fast and Slow*. New York: Farrar, Straus and Giroux.
- Keynes, J.M. 1964. *The General Theory of Employment, Interest and Money*, 1st Harbinger ed. New York: Harvest / Harcourt Brace Jovanovich.
- Kosowski, R., A. Timmerman, R. Wermers, and H. White. 2006. "Can Mutual Fund "Stars" Really Pick Stocks? New Evidence from a Bootstrap Analysis." *Journal of Finance* 61 (6): 2551–95. <http://dx.doi.org/10.1111/j.1540-6261.2006.01015.x>
- Kritzman, M. 2009. "Rules of Prudence for Individual Investors." *Windham Investment Review* (Winter), 5. <http://www.mebanefaber.com/wp-content/uploads/2009/02/wir-winter-2009-february.pdf>
- Lakonishok, J., A. Shleifer, and R. Vishny. 1992. "The Structure and Performance of the Money Management Industry." *Brookings Papers: Microeconomics* 1992:339–91. [http://www.brookings.edu/~media/projects/bpea/1992%20micro/1992\\_bpeamicro\\_lakonishok.pdf](http://www.brookings.edu/~media/projects/bpea/1992%20micro/1992_bpeamicro_lakonishok.pdf)

---

## References (cont'd)

Malkiel, B. 2013. "Asset Management Fees and the Growth of finance." *Journal of Economic Perspectives* 27 (2): 97–108. <http://dx.doi.org/10.1257/jep.27.2.97>

Mercer. 2009. "Norwegian Ministry of Finance Survey on Active Management: Final Report." <http://www.regjeringen.no/upload/FIN/Statens%20pensjonsfond/rapporter/Mercer%20-%20Active%20management%20survey.pdf>

Mullainathan, S., and A. Schleifer. 2005. "Persuasion in Finance." NBER Working Papers 11838.

Rabin, M., and J. Schrag. 1999. "First Impressions Matter: A Model of Confirmatory Bias." *Quarterly Journal of Economics* 114 (1): 37–82. <http://dx.doi.org/10.1162/003355399555945>

Sharpe, W.F. 2002. "Indexed Investing: A Prosaic Way to Beat the Average Investor." Presentation given at the Spring President's Forum, Monterey Institute of International Studies. [http://www.stanford.edu/~wfsharpe/art/talks/indexed\\_investing.htm](http://www.stanford.edu/~wfsharpe/art/talks/indexed_investing.htm)

Shiller, R. 2000. *Irrational Exuberance*. Princeton, NJ: Princeton University Press.

Skypala, P. 2010. "Tracing a Decline of Active Managers." *Financial Times*, FTfm, June 6. <http://www.ft.com/cms/s/0/0360cf88-7002-11df-8698-00144feabdc0.html>

Standard and Poor's. 2012. S&P Indices. <http://www.spindices.com/spivaresearch>

Statman, M. 2004. "The Diversification Puzzle." *Financial Analysts Journal* 60 (4): 44–53. <http://dx.doi.org/10.2469/faj.v60.n4.2636>

Statman, M. 2010. "What Investors Really Want." *Financial Analysts Journal* 66 (2): 8–10. <http://dx.doi.org/10.2469/faj.v66.n2.5>

Swensen, D. 2003. "The Interplay between Asset Allocation and Security Selection in a Well-Managed Portfolio." CMS Investment Seminar, New York, November.