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FOR QUANTITATIVE FINANCIAL RESEARCH

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***Asset Manager Funds***

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# Asset Manger Funds

## Key insights from an analysis of an unnamed consultant database

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This paper:

1. Documents the size of the institutional asset management sector
2. Documents the aggregate fees paid by institutional investors
3. Documents the extent of active management in active funds
4. Documents average performance of active funds relative to indexes
5. Documents performance relative to a strategy benchmark
6. Infers the factor exposures driving active manager performance
7. Finds that active managers do earn their fees today by choosing factor exposures, but are threatened by lower cost ETF's which allow investors to bypass higher active management fees

# Documents Active Management Universe

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## 1. Documents the size of the institutional asset management sector

- Institutional assets \$23 trillion in 2000, \$48 trillion in 2012
- Investible assets \$79 trillion in 2000, \$175 trillion in 2012

## 2. Documents the aggregate fees paid by institutional investors

- Based on current fee schedule
- Assumes average \$ pays the median fee from the schedule
- Average delegated dollar pays a fee of 47 basis points
- Institutional investors pay \$172 billion per year in fees

## 3. Documents the extent of active management in active funds

- Tracking error 7.87% relative to broad asset class benchmarks (“global equity” uses MSCI World ex U.S.)
- Tracking error 5.92% relative to strategy benchmarks ( “Asia ASEAN equity” uses MSCI South East Asia)
- Tracking error seems a bit high (financial crisis related?)

# Finds Outperformance Relative to Asset Class Indexes

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## 4. Documents average performance of active funds relative to indexes

- Active managers outperform indexes by 119 bps, of which 37 bps is timing (fees of 47 bps imply net outperformance of 72 bps)
- “Timing” refers to changes in valuation and flows, vs fixed asset class weights, not active management
- Paper calls this outperformance “gross alpha”
- 119 bps implies \$432 billion of which \$172 billion is fees
- Implies other investors average 49 bps below the market
- Outperformance could result from market beta  $> 1$  or to tilts toward other priced risk factors

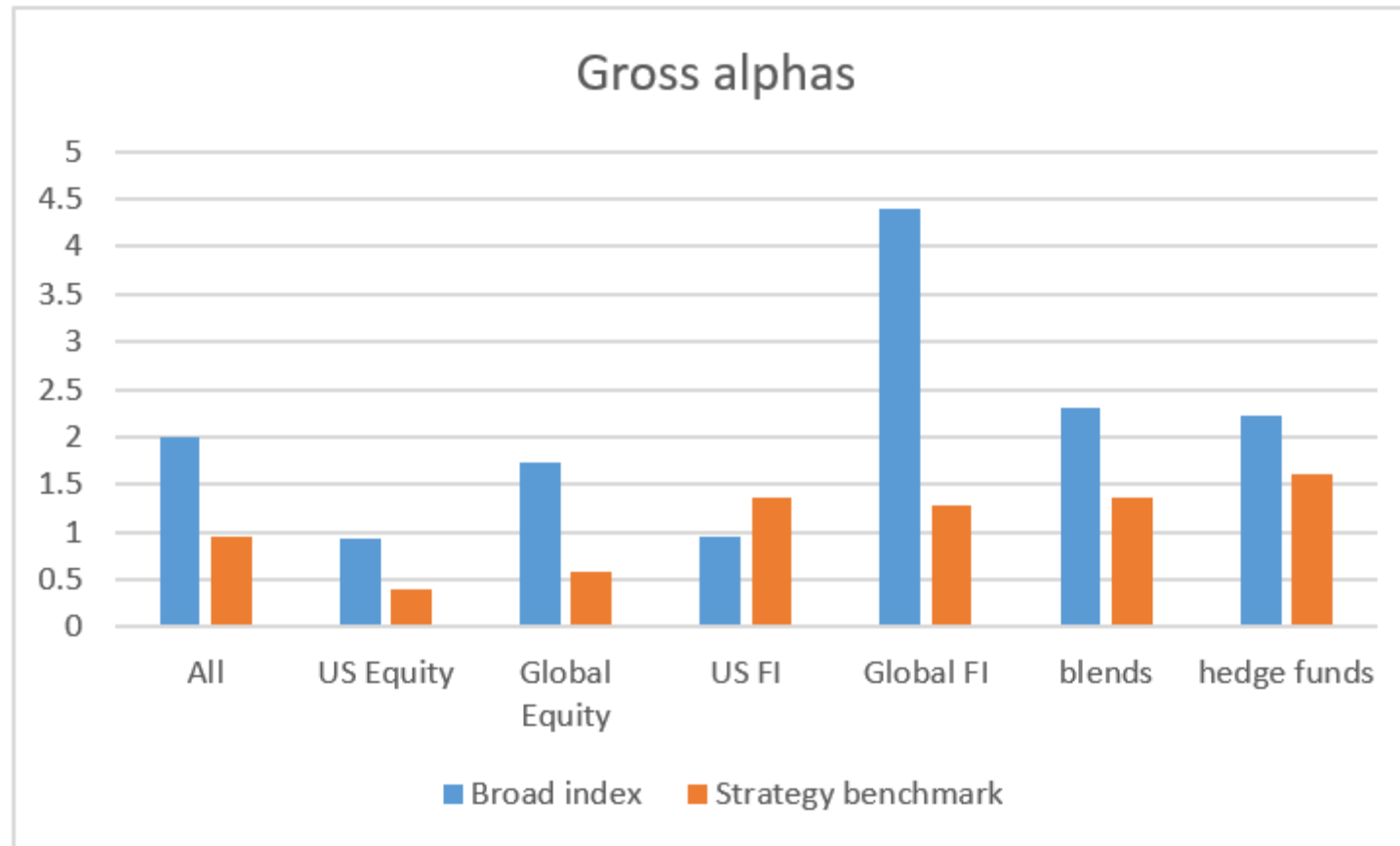
# Finds Outperformance Relative to Strategy Benchmarks

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## 5. Documents performance relative to a strategy benchmark

- **Asset class benchmarks**
  - beta averages .88
  - Eliminates the beta  $> 1$  possibility
  - Outperformance of 119 bps relative to asset class benchmark, correcting for beta  $< 1$  implies gross alpha increases to 199 bps
- **Strategy benchmarks**
  - beta also averages .88 relative to strategy benchmarks
  - Strategy benchmarks tie funds more closely to priced risk factors such as the “value” factor in equities
  - gross alpha decreases to 96 bps

# Finds Outperformance Relative to Strategy Benchmarks



During the period 2000 – 2012, active managers in this consultant database outperformed

# Loadings on Tradable Factors

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6. Infers the factor exposures driving active manager performance
  - Mimicking portfolios are constructed using regressions
  - Mimicking portfolios explain all the positive performance
  - The terms “timing,” “dynamic,” and “tactical” should be reserved for active time-varying exposures
  - Fees positively correlate with style exposure returns and residual returns
    - 1-std higher mimicking portfolio return implies a 2.61 bps higher fee
    - 1-std higher residual return implies a 1.99 bps higher fee
    - As is to be expected

# Loadings on Tradable Factors

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## 7. Finds that active managers do earn their fees

- Authors implement “mean-variance efficient” portfolios of factor indices for each asset class; Sharpe ratio .142
- Using “historical data” and “the standard algorithm” ?
- Then use two modifications to generate “more stable” and “simpler-to-implement” portfolios that avoid extreme short or long positions
  - Diagonal covariance matrix and sets negative risk premiums to zero; Sharpe ratio .359
  - Add no short-sale constraint; Sharpe ratio .331
- No use of Black-Litterman? ☹️



# What Costs Would Lead to Disintermediation?

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7. Finds that active managers do earn their fees (cont.)

- **Sharpe ratios of MV portfolios match active manager Sharpe ratios if fees are as follows:**

• Standard MV portfolio --	-205.2 bps
• MV portfolio with diagonal cov matrix	73.1 bps
• MV portfolio with short-sale constraints	43.3 bps

- **Actual fees are:**

• Institutional Mutual funds	
• Quartile 1	65.1 bps
• Median	86.5 bps
• Quartile 3	109.6 bps
• End-of-sample ETF's	25.4 bps

# Conclusion

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- “The introduction of liquid, low cost ETF’s is likely eroding the comparative advantage of asset managers.”
  - Indeed!
- A few caveats:
  - Disintermediation requires adequate liquidity is available for replication based on ETF’s, index funds, and institutional mutual funds.
  - Disintermediation assumes institutions would be able to find and implement factor tilts on their own
  - Less sophisticated institutions, or those who receive other benefits, may choose delegation over in-house management.

# The Bottom Line

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- The analysis of active manager's performance in an unnamed consultant database seems consistent with trends that will lead to the disintermediation over time of active managers.
- We should expect increases in:
  - passive indexing
  - outsourced CIO management
  - smart beta and factor based investing strategies
  - style ETF's