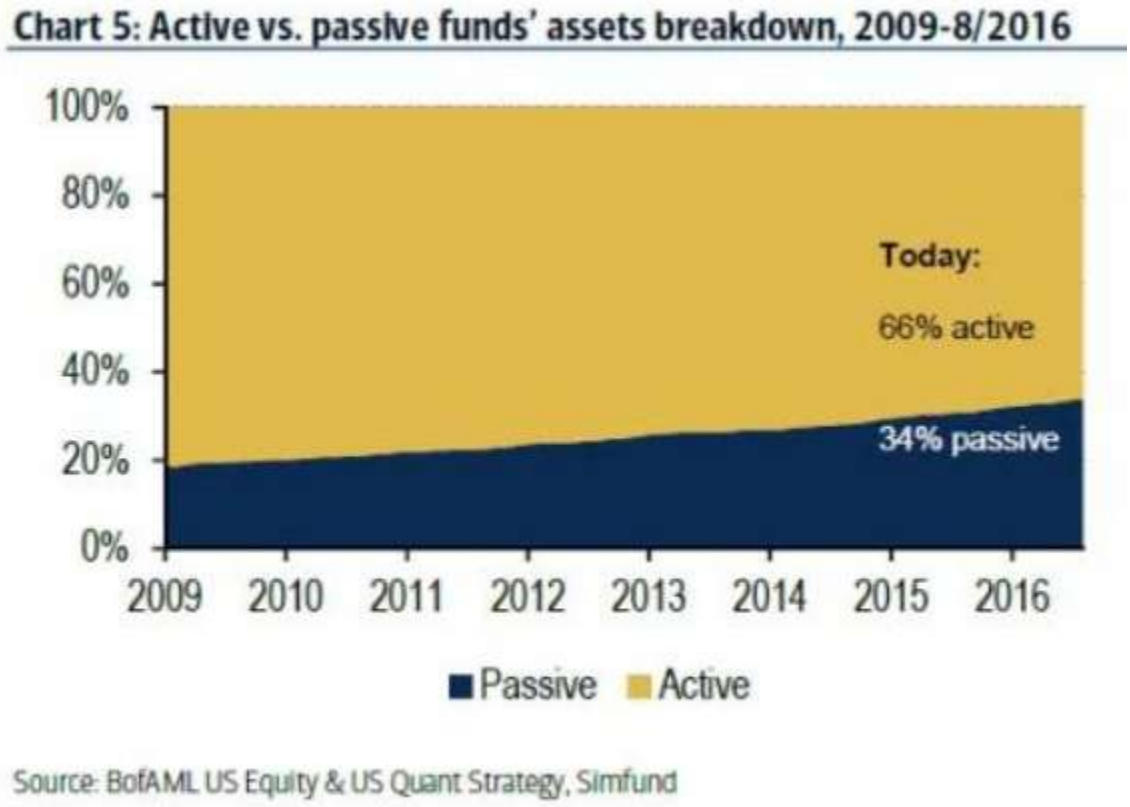
The Rewards for Saving Active Investment Management

Three things cannot be long hidden: the sun, the moon, and the truth. Buddha

- Active investment management is fading away, losing hundreds of $billions every year.
- Advisors can be heroes who save active investment management.
- Those who choose to be heroes will be rewarded with competitive advantages, but maybe not the gratitude of some active managers.

Disappointed investors have withdrawn $500 billion from active managers. Thankfully advisors can save active management. Coming to the rescue has its rewards.



Don't Blame Investment Managers

Numerous studies by S&P, Vanguard, Morningstar, and others conclude that the vast majority of active managers fail to outperform passive, frequently reporting that more than 80% underperform. Because it is so competitive, investment management is more about marketing than investment returns, so blaming managers for your investment failures is like blaming the foxes for eating your chickens when it's your watchdog who has failed. The simple truth is that there are way too many incompetent active managers who get business because intermediaries – consultants and fund-of-fund managers – can't tell the difference between good and bad managers.

Why Losers Get Hired: Laziness

Few would claim that all active managers are dolts, that none add value. But candid advisors acknowledge that finding skill is a challenge, especially when it comes to complicated strategies, like some hedge funds. This challenge could be overcome by contemporary due diligence, although hardly anyone is willing to do the hard work that this requires. The search for skill continues to be conducted with the same old lazy tools that have never worked and never will. It's like the allegory of the drunk and the streetlamp: The drunk loses his keys at night in a park across the street but he looks for them under a nearby streetlamp because it's easier to see.

Useless Tools

The old performance evaluation tools are indexes and peer groups. These are awful barometers of success or failure. Indexes don't work because many skillful managers don't live in style boxes, nor do they hug indexes. Peer groups don't work because they are loaded with biases, especially Loser Bias that evaluates active management performance versus a bunch of losers, since as many as 80% have underperformed their benchmark. Peer groups of hedge funds are exceptionally silly because hedge funds are unique so they can't be grouped together by definition: "unique" means without peers. Because the members don't belong together, hedge fund peer groups epitomize another peer group bias called classification bias. For further details, see "The Compelling Case for Changing Hedge Fund Due Diligence."

The Rewards

Investment advisors can save active management, and in the process gain a big competitive advantage. Investment manager consulting is a fungible credence good, i.e. a service that is difficult if not impossible to properly assess before or even after consumption. Credence good markets emerge when sellers are much more knowledgeable than buyers. This fact has propelled so-called "Robo advisors" into the limelight because if you can't tell the difference, you might as well buy the cheapest. Clients are wising up, and figuring out that they've been had. There's a good reason that active managers selected by consultants fail to deliver value added: **consultants aren't trying hard enough because they don't have to**. Therein lie the rewards.

Advisors can set themselves apart by replacing useless performance evaluation tools with high tech breakthroughs that actually work.

Replacing Antiquated Useless Tools

New and improved custom benchmarks and scientific peer groups accurately identify good active managers. Custom benchmarks address the make or buy decision. We can replicate (i.e. make) most managers inexpensively with blends of ETFs long and short, as determined through custom benchmarking approaches like style analysis or factor exposures.

Scientific peer groups, or universes, use high tech hypothesis testing to determine if performance in excess of a custom benchmark is statistically significant. The hypothesis "performance is good" is tested by comparing the manager's actual return to the returns on all the portfolios the manager might have held, following his portfolio construction rules and using his eligible stocks; it's a sophisticated portfolio simulation.

In its Benchmark Subcommittee Report, the CFA Institute recommends custom benchmarks and cautions against the use of peer groups. Custom benchmarks are a good suggestion, but they come with a problem: it takes many decades to establish statistically significant alphas with custom benchmarks. Scientific universes solve this waiting problem by testing the hypothesis "performance is good" in the cross-section of all possibilities, whereas alpha tests this hypothesis across time using regression analysis.

Active Investment Management Can be Saved: Halleluiah

Investment advisors can save active management by taking away the "Losers Welcome" doormat, abandoning the old ways**.**

The old ways continue on because of momentum, laziness and self interests. We're all hardwired to resist change. Despite the fact that change could save them, active

investment managers prefer the *status quo* because savvy salespeople can always find an index and/or peer group that they have outperformed. Have you ever met a manager who ranks below median? Advisors like the old ways because they have told their clients that these ways are the right ways, and have invested in them. Also, pay-to-play is a way of life in the investment business that engenders old ways.

The recommendations in this article replace the old approaches that have failed with new tools that work. Clients deserve better, and giving it to them brings big rewards. Destructive innovation is good

Please see our Active Manager Infograph and our Power Point presentation.

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