

Capital Idea #4

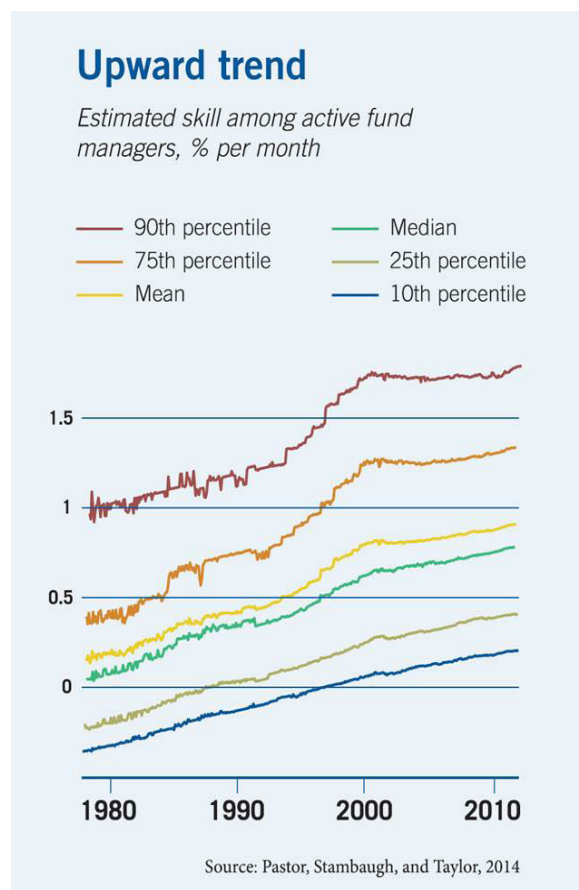
Why active fund managers' improving skills don't translate into better performance

Increasing competition makes it harder to beat benchmarks

- Active fund managers' ability to beat benchmarks declines as the industry grows, and improvements in managers' skills don't overcome this effect, according to research by Chicago Booth's **Lubos Pastor**, with Robert F. Stambaugh and Lucian A. Taylor of the Wharton School.
- The researchers measured the impact of both industry size and fund size on an active fund's returns. They controlled for skill, which affects both fund size and performance.
- A \$100 million increase in the size of a fund depresses annual returns by two basis points. A percentage point increase in industry size, measured as a fraction of total stock market capitalization, leads to a performance decline of 40 basis points per year for a typical fund.
- Active fund managers have become more skillful in recent decades, especially those in the top percentiles (see chart). However, this has not boosted fund returns because the industry has grown as well.
- The researchers define skill as a fund's average benchmark-adjusted return, or alpha, on the first dollar invested. This measures a manager's stock-picking ability before erosion due to the effects of size.
- Younger funds, armed with the latest strategies, are more likely than older funds to beat the market. But their advantage declines as they get older, due to the continued arrival of new competitors.
- The researchers examined data from 3,126 active funds in the United States between 1979 and 2011, a period that saw dramatic growth in the industry.

Lubos Pastor, Robert F. Stambaugh, and Lucian A. Taylor, "Scale and Skill in Active Management," NBER working paper, February 2014.

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