
Rekenthaler Report

Are Younger Managers Better--Or Younger Strategies?

By [John Rekenthaler](#) | 03-11-14 | 11:30 AM | [Email Article](#)

Getting Better All the Time

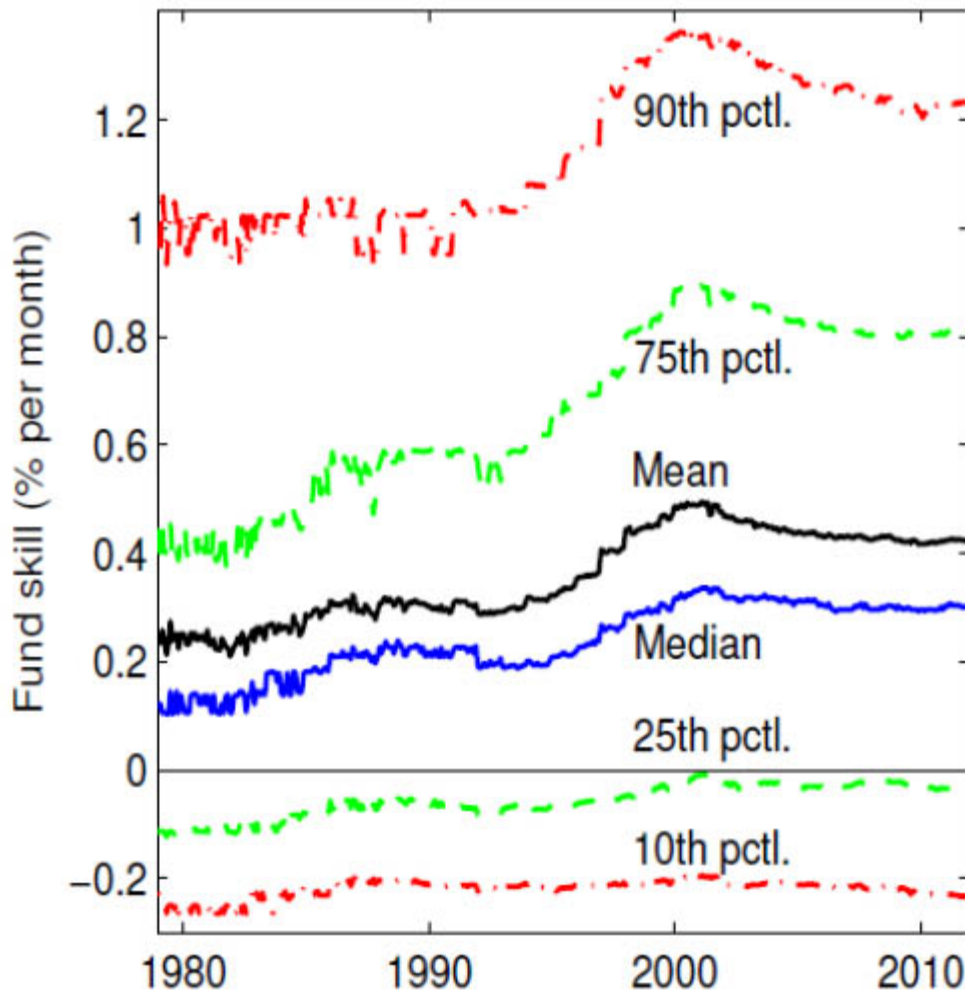
[Friday's column](#) advanced the thesis that today's fund managers are more skilled than those of the past. Because professional investment managers control an increasingly large percentage of the stock market, it's tougher than ever to beat the averages. Trades that once would have remained profitable over a long time period now quickly are discovered by the herd of professional managers. That today's stock mutual funds perform as well as those of 30 years ago, as defined by gross returns versus their benchmarks, testifies to the overall improvement. If managers had not become more skilled, their results would have declined.

Such is the thesis of "[Scale and Skill in Active Management](#)" by Pastor, Stambaugh, and Taylor. The argument makes sense. Despite the growth in indexed investing, active professional managers have grown their market share over the past several decades, as investors have migrated from holding stocks directly to investing through funds. One generally thinks of asset bloat as applying to individual funds, which can become too bulky to maneuver successfully, but it certainly can affect the overall activity of investment management as well. More-intelligent, trained people controlling more assets makes for more accurately priced securities.

Determining the amount of the change caused by the increase in professional management is a tricky task. After all, there is no control group. The authors can't drop today's fund managers into the 1985 market, measure the difference between those results and what managers currently accomplish, and publish the difference. Instead, they take an indirect approach. Effectively, the authors can measure the speed of the runner but not the speed of the headwind. So they estimate the headwind, then use this figure to calculate the true speed of the runner--that is, the speed of the runner had there been no headwind.

The chart below gives their results. The numbers represent the authors' estimate of managers' true skill, meaning the results that managers would achieve if there were *no* other professional fund managers eroding the benefits that accrue to skill.

Estimates of Manager Skill (Constant-Skill Assumption)

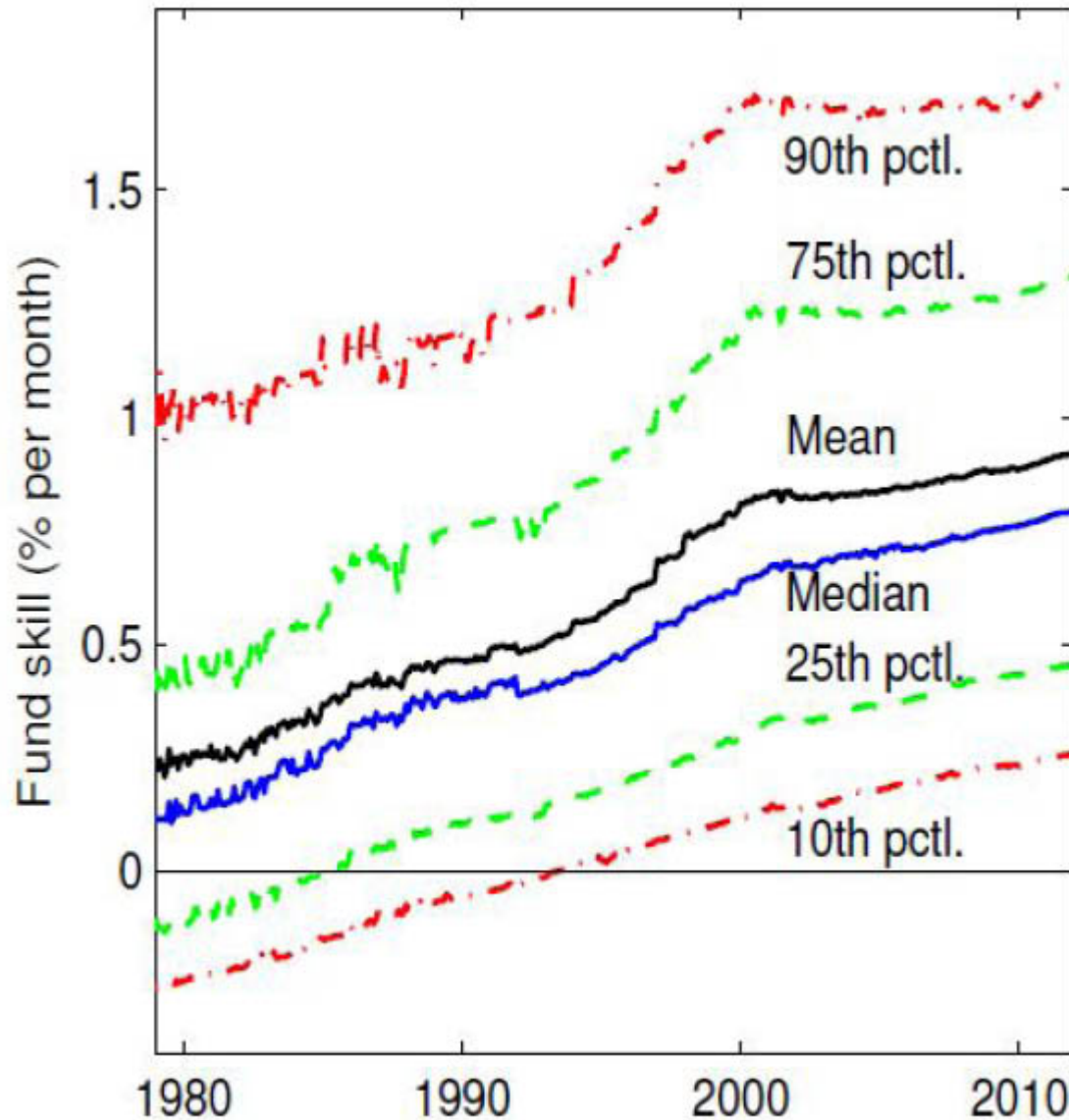


My first thought was that the numbers are absurdly high. More than 1.2 percentage points of skill per month for the top managers? Even the median manager shows a healthy 3 percentage points per annum. Upon second thought, though, who knows? It's hard to imagine a stock market that features no competition among professional management. There might well be 15 points per year of opportunity waiting to be plucked. Indeed, from that perspective, it's surprising that one fourth of fund managers have negative skill. Remove the headwind and they still run backward!

Perhaps the bigger takeaway than the level of the numbers is the enormity of the gap between the most- and least-skilled managers. That's far removed from the popular-press view of academic literature, which is that fund performance is a random walk because no fund managers have true skill. The end result of both views is largely similar, that buying funds with strong gross past performance will not necessarily lead to better results, but the paths to that conclusion are very different. As we will see at this column's end, they also can lead to different investment conclusions.

In the chart above, the authors assumed that fund managers have constant skill over time. They become neither better nor worse with experience. In a second series of calculations, the authors relax that assumption.

Estimates of Manager Skill (Age-Varying-Skill Assumption)



There are two effects wrapped into this second picture. First, as with the initial chart, new funds entering the industry tend to perform better than existing funds. It is for that reason that funds are able to maintain the same relative performance against benchmarks, despite the steeper competition. Second, fund managers improve with experience. They learn on the job. Because of these two effects--better-managed funds entering the industry, and existing managers improving--all the lines increase over time.

Unfortunately, though, existing managers are not improving fast enough. Although they enhance their skills, this improvement cannot keep pace with the industry's increased competition. To return to the runner metaphor, each year fund managers learn to run a little bit faster--but their overall observed speed declines because the headwind grows at an even faster pace. The result: Funds come out of the gate blazing, but their relative performance slowly subsides over time.

To summarize:

- 1) New funds are far better than older funds.
- 2) The managers of older funds are improving their skills.
- 3) However, managers of older funds do not in general improve their skills fast enough to keep pace with the demands of stiffer competition.

Which finally brings us to the thesis advanced at the beginning of this four-part series: Younger managers are better than veteran managers. Younger managers are equipped with the latest training; they have been taught cutting-edge investment concepts, which come easily to them because they are in the learning stage. The old dogs, on the other hand, can only partially learn new tricks.

That is how the story has been reported, and while it's not necessarily wrong, it requires some further explanation. As we have seen, the authors didn't measure manager ages. (No such database exists, to my knowledge.) Rather, they measured *fund* ages. It is an assumption that newer funds are run by younger managers. I asked Morningstar's fund research team about that assumption. The response was mildly skeptical. It's probably true as a very general rule, the analysts said, but often an experienced manager is given another fund to run. Also, a young investment manager may be named as a comanager on an older fund. The relationship between fund age and manager age is murky.

An alternative explanation offered by the fund researchers, which I prefer, is that new strategies are superior to existing strategies. By this logic, funds are launched because fund companies devise innovative strategies that use fresh investment concepts. These strategies are successful when a fund is first launched because they are relatively fresh. However, as word gets out and competitors begin to emulate that fund's trades, the edge erodes. Meanwhile, the fund's manager is learning on the job, adding to his/her skill set, and doing a better job of selecting securities. However, the strategy's erosion is occurring too rapidly to full prevent, and the new fund gradually slides toward the mean.

Or perhaps both are true. At any rate, the distinction is more than academic. If manager ages are the key, investors will do well to find freshly minted MBAs at strong fund companies, regardless of whether they run newer or older funds. If new strategies are what matter most, however, then manager biographies are less important than the novelty of the fund.

Well, that can be studied. Not this week, though. For those who have followed along in this four-part series, whether fully or only partially, thanks for your support. These columns won't be my most popular, not by a long shot. But sometimes it's good for

the brain--mine for certain, and I hope yours as well--to work through an academic paper, rather than merely accept its findings.

John Rekenhale has been researching the fund industry since 1988. He is now a columnist for Morningstar.com and a member of Morningstar's investment research department. John is quick to point out that while Morningstar typically agrees with the views of the Rekenhale Report, his views are his own.

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