*Baseball, Active Management and the Willingness to be Wrong*

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For what seems to be twenty years now, we've heard this steady mantra that active equity management, especially in the domestic large cap space, has not added value when compared to passive alternatives. I understand the frustration. As one who has spent the better part of the last thirty years attempting to build a case for active management (and earning ample gray hair in the process), the fact is, it's true. Most managers have not earned their keep once you factor in expenses and other opportunity costs. You hear of companies not earning their cost of capital. The same is true of many managers. Most don't earn their relative cost of capital either.

You're probably wondering what this has to do with baseball. I have season tickets to the *California* Angels (I refuse to call them the Los Angeles Angels of Anaheim, but that's another story). We sit just behind the visitors' dugout. I love baseball. Always have. When I can, I'm the guy who gets there hours early to take in batting practice (those are the games my wife doesn't attend). You pay attention to the pre-game activities, the ground crew, the perfectly manicured field, the interaction between the players and fans, and the coaches.

Baseball is one of the few major sports with an elaborate minor league system. Getting drafted by a major league ball club is one thing. Getting to the major leagues, let alone staying for any reasonable period of time, is something entirely different. (Believe me, I know.) Many a fresh faced 18-year-old high school phenom turns into a not so fresh faced 28-year-old journeyman after spending ten years of his life toiling away in locales such as Peoria, Quad Cities and Bakersfield. Hundreds of minor league ballplayers lose their jobs every year. Most assimilate into society, but some, a lucky few who are well liked by the right people but not quite considered major league player material, are kept on board as coaches to spend the next ten (or twenty) years of their lives working in small Midwestern towns, giving instruction to the next generation of fresh faced 18-year-olds. If they're fortunate enough, some day they may have a crack at coaching at the major league level. Next time you're at a big league game, take a look at the coaches. They're the ones with skin that has seen way too much sun and wearing uniforms designed to fit athletes decades younger (which begs the question, what other sport has coaches dressed the same as the players?)

What does life in baseball have to do with investment management? More than you think. Investment manager selection reminds me of baseball manager selection in decades past. In baseball, a middle-aged career guy is fired as manager of the Cubs because he isn't getting the job done. (Sorry Chicago, but no one seems to be able to get the job done. Then again, everyone has a bad century now and then.) Weeks later he's recycled by someone else because he has new, fresh ideas and what it takes to lead his next employer to the World Series. He's the same guy, for cryin' out loud. Same managerial experience, same decision-making process, and ultimately, same result.

No different with investment managers. For years you couldn't open an industry publication without reading of a particular manager being fired from some fund for performance-related issues, and then in the next column read of the same manager being hired elsewhere to manage the same strategy for someone else. It's uncanny. Nothing has changed. It's the same people managing the same strategy for what is now expected to be a different result. It's a big zero-sum game. In baseball, as with investment management, the same managerial experience, the same decision-making process along with the same staff will lead, ultimately, to the same result. The manager is the same. The process is the same. Only the uniform is different.

Manager selection, whether in baseball or investment management, is not an easy task. With investment management, although there are large, established firms out there who consistently do a good job, they are the minority. I have always believed that, with many if not most firms, once you reach some level of success, whether that is determined by assets under management, revenues or the amount of money the key people are making, whether intentional or not, something changes. That something is that many previously successful firms cease to play the game to win. They now play the game to not lose. The name of the game is not to do what's in the client's best interest (provide alpha) but do what's in *your* best interest. Namely, protect the revenue stream of the business. Don't get fired. How do you do that? Don't take chances. Don't make mistakes. Play defense. Not offense. Gravitate to the mean.

Most investment firms work in an institutional environment where they're typically one of several managers employed. Let's take a situation where a manager is one of five working with a large pension fund. While the implied goal is to rank among the top of your peers, the unstated or unintended goal (depending on your level of cynicism) of too many managers in this business is to finish...third. Why third? Because it's unlikely you'll be fired. You would love to be number one or two, but that implies somehow sticking your neck out and taking on what may be perceived as additional risk. Managers need to do something different to add value. You can't look like everyone else. If you differ from everyone else and you're right, great! What if you're wrong? That's the problem. You could be that fourth or fifth manager. Can't go there. That flies in the face of rule number one—don't get fired. If you linger among the cellar dwellers for some uncomfortable period of time, you could lose the relationship and its accompanying revenue stream. Plan sponsors may consider replacing one manager out of five. Maybe two. But three? Unlikely. Hence, the unwritten incentive is to finish in the middle of the pack. You've bought yourself some time. You've protected the revenue stream for the time being. Most importantly, you've protected your paycheck. Is the client happy? No. Are they unhappy enough to fire you? Probably not. At least not now.

Need some evidence? In 2006, K.J. Martijn Cremers and Antti Petajisto of the Yale School of Management introduced the concept of "Active Share." Professors Cremers and Petajisto studied a large cross section of mutual funds over time and asked the simple question: Which ones added value, which ones didn't and why? The findings were quite telling. Newer, younger, more entrepreneurial funds, those with no other choice but to succeed or perish, had a higher component of something called Active Share. Active Share can be loosely defined as that portion of your portfolio that deviates from the underlying index with which it's being compared. An interesting trend began to emerge. Along with performance success came a growth of assets under management. The more successful the fund became, the more assets under management grew, the more revenues increased, the more of a franchise the manager had to protect. As assets, revenues and incomes grew, that portion of the portfolio attributed as Active Share did not. In fact, it shrank.

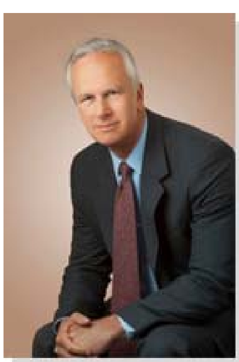
Those same portfolio managers who added meaningful value early on were now playing defense. Not offense. They too were not playing the game to win. Rather not to lose. As they succeeded there was an inverse relationship to assets under management and a high Active Share. Portfolios they managed began to look more and more like the index they were compared to. Intentionally or not, they became a closet index fund.

Is this entirely the fault of self-interested portfolio managers? Not necessarily. There's plenty of blame to go around. The plan sponsor and *some* in the consultant community play a role here too. Countless times have I been in prospect presentations or consultant meetings where you're repeatedly asked why you don't look like everyone else. How can you own a particular security your peers don't own? Why don't you have industry or sector allocations that look like everyone else's? If a plan sponsor or consultant is hostile to a manager who doesn't look like everyone else, that would imply they're favorably predisposed to managers who do. It's a vicious cycle. Success begets success. Unfortunately, so does failure. Hence, the tendency is to retain managers who are predisposed for mediocrity. The inclination is to retain managers who, ultimately, perform like the index. Managers who look like everyone else perform like everyone else.

Investment managers need to think outside of the box to add value. So do plan sponsors. So do consultants. There are active managers who add consistent value in a transparent, liquid and cost-effective manner. You just need to look a little harder to find them. Loading up on alternatives is not the answer to all your problems.

In portfolio management, as in baseball, it is helpful to think for yourself and be different. You can't be fearful of criticism and, occasionally, failure. Many times you need to be willing to be wrong in order to be right.

As of this writing, the Angels are off to one of their worst starts in team history. But the grass is just as green, the uniforms are just as crisp, and the hot dogs are just as good.



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