Can Active Portfolio Managers Generate Excess Returns in Today's Markets?

Warren Buffett is arguably one of the best investors of all time. An investment of $10,000 in his partnership at the inception of his career would be worth well over $250 million today. Mr. Buffett is currently Chief Executive Officer of Berkshire Hathaway (NYSE symbol: BRKA).

Charles Munger, Vice-Chair of Berkshire Hathaway and long time Buffett partner in the investment world, was also an incredibly talented investor. An attorney by trade Munger began investing in real estate, then founded a small investment partnership which was structured and regulated in a manner comparable to the LSGI Fund partnership. Mr. Munger actively managed this investment partnership from 1962 to 1975.

Mr. Buffett also managed a private investment partnership. He actively managed these investment partnerships from 1957 until roughly 1969.[1] When he shut down the partnerships investors could either 'cash out' or roll over their investment into Berkshire Hathaway. Those who cashed out did very well. Those that rolled their investment over to Berkshire Hathaway did incredibly well.

- **Passive & Active Portfolio Management: In Search of Alpha**

There is a growing consensus among investment advisors and professionals that 'active' portfolio managers – that is managers who pick and choose stocks for their portfolio like Buffett and Munger – tend to under-perform the major market averages. There is some statistical validation of this claim.[2]

A measurement of a money manager's excess returns is referred to as 'alpha'. It is defined as the added returns over and above the returns you would expect from the market. Bill Donoghue, Editor of The Proactive Fund Investor, recently reviewed 3,226 actively managed mutual funds and found the average alpha was –0.74. Donoghue's results indicate that active portfolio managers are delivering returns below what you would expect from the market – that is investors were penalized from a return standpoint by investing in these funds. The finding was not unique.

Studies like Donoghue's are why many investment advisors recommend individuals consider low cost exchange traded funds that track the major market averages. Statistically, the advisors argue this low cost 'passive' method of investing generally outperforms many strategies that rely on actively managed portfolios.

As an investor, and active portfolio manager seeking to add value for our investors, we have more than a passing interest in the 'passive' versus 'active' argument. If we cannot add significant excess returns as an active manager our business concept – attempting to deliver excess returns over and above the major market averages – is flawed.

Academically the issue is also appealing to us: Is the market so efficient that active portfolio managers are unable to add value? With eight years worth of data from the Buffett, Munger, and LSGI partnerships we might be able to draw some conclusions with regard to this issue.

The table below represents the performance of each entity benchmarked against the Dow Jones Industrial Index during the first eight years of operations of each partnership.

	Average Annual Return (Gross)	Excess Annual Return Over DJIA Benchmark	CAPM Alpha	CAPM Beta	CAPM r square
Buffett Partnerships	27.7%	16.7%	20.6%	0.62	0.731
Munger Partnership	35.6%	30.9%	31.9%	0.93	0.461
LSGI Partnership	27.5%	24.9%	28.3%	1.87	0.226

Several interesting points can be drawn from this chart:

- During the time period involved it appears that each partnership delivered significant excess returns over and above the benchmark index. The Dow Jones Industrial Index was used by Buffett and Munger as a benchmark for the

[1] The information on the Munger and Buffett Partnerships, and performance data, come from Robert Hagstrom's book entitled "The Warren Buffett Portfolio" and Andrew Kilpatrick's book entitled "Of Permanent Value". Gross performance data, before the allocation of incentive fees, was reported annually.

[2] See: "The Little Book of Common Sense Investing: The Only Way to Guarantee Your Fair Share of Stock Market Returns", (Wiley Publishing 2007) by John C. Bogle.

market, so for this comparison we utilized this index as a benchmark for LSGI to maintain consistency. At least in this case, over the time periods involved, active portfolio managers seem to have added significant value.

- Using the Capital Asset Pricing Model (‘CAPM’), a linear regression of historical performance data, we find that each manager delivered significant excess returns over and above what would be expected from the market. This measure of excess returns is known as ‘alpha’. The Munger partnership generated the highest alpha, excess returns of 35.6% per year. Most actively managed public mutual funds have an alpha near zero (hence the argument investors should buy index funds).

- Using the Capital Asset Pricing Model (‘CAPM’) we find the ‘beta’ – or volatility of the partnership versus the benchmark – varies considerably. Both Buffett and Munger’s beta was well below 1.0, meaning their portfolio was less volatile than the Dow Jones Industrial Index for the period in question.

  The LSGI partnership has a beta well in excess of 1.0, meaning the LSGI partnership is much more volatile than the benchmark. Volatility is a measure of risk according to some, therefore the argument can be made the LSGI partnership carries much more risk than the Buffett or Munger vehicles. In theory, an argument can be made that the LSGI partnership is incurring more risk to deliver its’ excess returns.

  Note that beta changes over time. Since we have the historical data for the entire 14 year Munger partnership we find that beta on his partnership increases to well over 1.0 when additional historical data points are considered. Also, portfolios that move to cash during market downturns will have a lower beta than the model indicates. Cash has a beta of zero (the value of cash does not vary with the benchmark index).

  Over the last 12 months the LSGI partnership has had periods when cash levels well over 25% and periods where cash levels well below 5%. For this reason the short term beta of the LSGI partnership will change, but the longer term beta in the CAPM model might not reflect these short term variations.

- The coefficient of determination, also known as “r squared” also varies considerably between the partnerships. What is quite surprising is the fact the Buffett partnership had an r squared of 0.731. This means that during the time period examined 73.1% of the return of that partnership was statistically explained by movements in the benchmark index.

  Munger had an r square of 0.461 and LSGI had an r square of 0.226. Both partnerships correlated poorly with the benchmark index. This is positive since the lack of correlation with the market reduces the overall risk in an individual’s total stock portfolio.

  Because of the low correlation, an argument can also be made that for the Munger and LSGI partnerships stock selection and portfolio management activities had a greater impact on the investment returns than movements in the market index.

- When reviewing any historical performance data we seek to study a period substantial enough to validate any trends we might uncover. Short term variations, both positive and negative, will tend to cancel each other out over longer periods. We consider an eight year period sufficient enough to be considered ‘long term’, however the results noted above might not be ‘significant’ from a statistical standpoint.

Regardless of the statistical significance (or lack thereof) of the data noted above, and the tendency for actively managed portfolios to lag the major market indexes, it appears that these active managers outperformed a passive management strategy for the periods involved. The question becomes why did they outperform?

➢ **Return Attribution Analysis**

We think the excess returns delivered by the above partnerships can be explained from both an academic as well as practical standpoint by the following factors:

1. During the time periods involved all the managers noted above invested partnership funds in small company stocks. Statistically, over time, small and micro-cap firms have significantly outperformed the major market indexes. This part of the market is extremely inefficient.

2. The cost, in time and effort, to research and conduct due diligence on small companies is significant. For economic reasons most firms and managers ignore many of the firms in this sector. As a result many excellent companies are not followed by analysts or managers and are inefficiently priced. The managers of all three partnerships enjoyed the exercise of evaluating these small firms, a task some would deem tedious.

3. All three partnerships used value-based criteria as a measure to evaluate potential investments. Growth potential was also important. Historical data indicates this value-based growth strategy in the small and micro-cap sector tends to outperform the market.

4. All three partnerships managed a limited amount of assets in their early years. The lack of assets was a major advantage as the partnerships could easily invest a significant part of their portfolio in undervalued small companies. The more assets

under management the more difficult it is to invest in this asset class, and hence the more difficult to deliver excess returns to investors.

5. All three partnerships ran relatively concentrated portfolios which contain the manager's best ideas. Munger was especially notorious for running extremely concentrated portfolios. If the risk/reward relationship is tilted heavily in favor of the investor this style of investing in theory should deliver substantial excess returns over time. Both Buffett and Munger have noted a key element to their success was to invest heavily in a company when the odds were strongly in their favor.

6. Due to the criteria noted above the managers tended to invest in companies with a unique market niche, with impressive margins, and with the ability to 'scale' their operations.

7. The partnership structure allows the manager to control the inflow of cash into the portfolio. Studies of historical data show that the less movement of cash into or out of an actively managed portfolio the easier it is for the manager to generate excess returns.

   A recent theory of the relationship of asset flows and returns in publicly traded mutual funds makes an analogy to the 'tragedy of commons' social theory. Substantial excess returns in a public fund generate a flood of new assets into that fund. The theory maintains the excess returns are diluted by the public cash inflows until they are reduced to 'market average' levels.

   When investing in a relatively inefficient and illiquid sector, such as the small company sector, major flows of assets into or out of the portfolio can create problems for the manager.

8. The partner structure of the investment vehicle, and the substantial amount of funds each manager held in their partnership, strongly aligned the interest of the investor with the manager. While some might criticize the fee structure of these partnerships (including, surprisingly, Mr. Buffett, who claims that most active managers don't generate enough excess returns these days to justify their performance incentive fee) it does tend to align the interest of all towards one goal - performance.

   From an economic standpoint the fee structure of actively managed public mutual funds and many other types of managed accounts reward the manager for the amount of assets under management, not performance. This conflict of interest, with the factors noted above, might go a long way at explaining the lack of 'alpha'.

While all three partnerships generated excess returns for their investors, in our opinion it has become much easier for an active manager to generate alpha due to the following recent developments:

- Online electronic databases of historical stock market data can be used by investors to 'screen' firms for attractive investment attributes. Buffett and Munger did not have access to these databases, or the personal computers to analyze them
- The population of public companies we can invest in is a multiple of those that traded three decades ago
- We know from studies of historical data what characteristics have been present in equities that have outperformed the market. Buffett and Munger did not have access to these studies.
- The Internet allows an investor to conduct due diligence in a fraction of time it took Munger and Buffett to examine a company
- The cost of trading equities has fallen dramatically in the last decade. Meanwhile the technology and sophistication of the trading platforms continues to evolve to the benefit of the active manager.

Even with these incredible advantages over Buffett and Munger, most actively managed portfolios in today's markets have not generated excess returns.

➢ **Conclusion**

Certain active portfolio managers have generated excess returns due to the investment strategy they employ, and the inefficiency of the small capitalization sector of the market. Modern tools are available today to assist active managers in ways that Buffett and Munger could only dream about – which makes their accomplishments as active portfolio managers all that more impressive.

Active portfolio management, at least in some circumstances, can generate excess investment returns.