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Active Management has a 'Genetic Defect'; New Research from Turing Technology Uncovers Cure

New York, NY. October 24, 2019 – The question of why the average active manager underperforms index funds appears to be finally answered. It is not (only) due to fees, and certainly not due to a lack of manager skill. Instead, based on new research from Turing Technology that evaluated years' worth of daily holdings from more than $2.25 trillion in actively managed fund assets, we now know that the answer lies in a 'genetic defect' in how active managers build their investment portfolios.

The two key findings from the research, and as first reported by the *CFA Institute*, include:

- Active managers typically add significant value from stock picking, but this skill is limited to their 'Best Ideas', (referred to by Turing as High Conviction Overweight positions, or "HCOs").
- However, the average fund only allocated 55% of its investment dollars to their High Conviction Overweights.

Thus, the problem. The average active fund only has one engine of stock selection alpha, and it's operating at only half its potential impact. Before fees. In practice, this under-allocation to HCOs sabotages the active fund's ability to outperform, and it has a larger negative impact on performance than fees.

This 'defect' has been inherent in portfolio design for decades, but now that it has been diagnosed, it can be addressed. According to Alexey Panchekha, President of Turing and the author of the study, "If you can measure it, you can manage it, and now we know exactly what to measure." He further explained, "Just like Billy Beane and *Moneyball* taught us On-Base-Percentage is a better metric to evaluate players than Batting Average, this research shows that HCO performance and its portfolio allocation is more informative than overall Fund performance."

The numbers from the study prove this theory out. Funds with the best performing HCOs <u>and with at least a 60% HCO allocation</u> delivered an average annual excess return of 455 basis points (4.55%) over rolling one year periods. Funds with top performing HCOs <u>but with an HCO allocation less than 40%</u>, only delivered 183 basis points (1.83%) in annual excess returns. Both groups succeeded (because their HCOs outperformed), but increasing the HCO allocation from under 40% to over 60% increased investor returns 2½ times.

According to Matthew Bell, CFA, President of Bell Family Interests, LLC, and a Turing Board member, "The active industry needs to change, or Vanguard, Fidelity and Blackrock will manage all of the world's assets. Some change is easy, like ensuring the portfolio weight of the HCOs is above 50%. Some change, such as getting the HCO allocation to 100%, will be harder. But we know how it can be done." His final thought was, "For the industry, the familiarity of status quo has a comforting allure. Too often though, to borrow an old quote, that false sense of everything going well is nothing more than the body heat at the center of the herd."

To learn more about Turing Technology or to download a copy of the study, please visit www.turingta.com. An edited version of the study was published by the CFA Institute, and can be found at https://blogs.cfainstitute.org/investor/2019/10/03/the-active-manager-paradox-high-conviction-overweight-positions/.

About Turing Technology:

Turing Technology Associates, Inc. ("Turing") is a technology company that licenses its technology and Intellectual Property to investment management, insurance, brokerage, RIA, and wealth firms to allow them to create and deliver superior investment solutions. Key to Turing's success are the Hercules Database, Ensemble Active Management (EAM) Portfolios, and Downside Volatility Management (DVM) Portfolios.

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