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# The value of active portfolio management

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## Abstract

We calculate the value of interim portfolio revision, an integral component of active management of mutual funds by comparing the returns on actively managed mutual fund portfolios with the returns the fund portfolios would have earned had there been no interim revision. The results show that, on an average, excess returns from interim portfolio revision do not cover the incremental trading costs, even over holding periods as long as 6 months. Across mutual funds, we find evidence of a positive relationship between the excess returns and mutual fund expense ratios suggesting that those managers who generate higher excess returns charge higher fees from the stockholders.

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## 1. Introduction

Actively managed mutual funds attempt to add value to their shareholders in two ways: (a) selecting a portfolio of securities expected to provide a superior risk-return trade-off; and (b) monitoring and revising their portfolios continuously in response to the market conditions. Mutual fund managers claim to have skills in both these departments that enable them to provide higher returns to their shareholders compared to other mutual funds or benchmarks such as the S&P 500 index. Active management is expensive and would benefit the shareholders only if the excess returns on actively managed portfolios are larger than the incremental cost incurred by the shareholders.

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Academic finance literature is full of studies that attempt to measure and analyze the performance of active portfolio management. Shukla and Trzcinka (1992) review the literature on performance evaluation and conclude that active management does not provide a net benefit to the investors. Recent research, however, has provided mixed evidence on this issue. Keim (1999) finds that the '9–10 Fund' from Dimensional Fund Advisors provided a 2.2% annual premium over the CRSP 9–10 Index on which the fund is based. He concludes that investment strategy and trading rules components of the fund's design contributed to this premium. Chen, Jegadeesh, and Wermers (2000) show that stocks purchased by mutual funds outperform the stocks sold by them, and that funds that have higher turnover also have better stock selection skills. Wermers (2000) compares the returns earned by the stocks in the mutual fund portfolios to the expense ratios and transaction costs and concludes that funds pick stocks well enough to cover their costs. Weigand, Belden, and Zvirlein (2003), on the other hand, find that stocks weighted heavily in mutual funds significantly underperform those weighted lightly. Furthermore, Day, Wang, and Xu (2001) conclude that the portfolio weights for stocks selected by the mutual fund managers are generally inefficient.

Conclusions of performance evaluation literature are based primarily on the risk-adjusted measures calculated using returns reported by mutual funds. Calculating risk-adjusted performance measures is subject to numerous pitfalls. As summarized in Grinblatt and Titman (1989b), these problems may be attributed to the inappropriateness of the benchmark and the managers' effort to time the market, which alters the linear relationship between the fund and the benchmark returns. Using simulation, Kothari and Warner (2001) conclude that traditional portfolio performance measures may not be able to detect abnormal performance. They argue that portfolio composition based measures have significantly higher power. Cornell (1979) proposed a performance evaluation methodology that is based solely on portfolio composition and is not subject to many of the pitfalls associated with benchmarks. Cornell's methodology assesses selectivity skills of fund managers by determining whether fund managers place high weights on securities that provide positive abnormal returns during the holding period relative to some "normal" period. Cornell's methodology found only a limited application because of the lack of availability of portfolio composition data. Mutual funds are required to report their portfolios twice a year though many mutual funds report their portfolio compositions on a quarterly basis. Only recently have these data been available in a machine-readable form.

Grinblatt and Titman, in a series of papers, have used portfolio-based measures of performance. In Grinblatt and Titman (1989a), they calculate a time series of hypothetical returns for mutual funds as the weighted average return on the CRSP-listed equity portion of the portfolio. Then they estimate the total transaction costs incurred by the mutual fund investors as the difference between the Jensen measures for the hypothetical portfolio returns and actual returns realized by the mutual fund shareholders. The total transaction costs consist of the expenses charged by the fund plus the trading costs associated with active portfolio management which are not explicitly charged but are reflected in the return of the actively managed mutual fund portfolio. In Grinblatt and Titman (1993), they propose a portfolio change measure for performance evaluation. This measure is based on the relationship between the portfolio weights and the ensuing returns on the securities: an informed manager will increase weights on securities that perform well subsequently and decrease weights on securities that perform poorly. Consequently, a positive covariance

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