**Don’t Get Caught in the Middle**

*By C. Thomas Howard, Ph.D., and Craig T. Callahan, D.B.A.*

One bane of modern investment management is the closet indexer. The last thing that either an advisor or client wants is to pay active management fees for what essentially is an index product. Are you an advisor who is able to avoid closet indexers and pick winning managers, or have you thrown in the towel and resorted to simply indexing client portfolios? As the debate about active management versus passive management continues, total assets managed by closet indexers within open-end U.S. equity funds has grown to almost 30 percent, according to a recent study by Yale professors Martijn Cremers and Antti Petajisto (2007). It seems that the avoidance of closet indexers is more challenging than ever.

In this article, we examine the cost of investing in closet indexers; we hypothesize why this phenomenon has come to be; we show why it is difficult to avoid closet indexers when using the style grid to allocate portfolios; and we show how strategy-based investing can be used to find winning active managers.

**What Is the Cost of Investing in Closet Indexers?**

Cremers and Petajisto (2007) provide evidence that bears directly on this question in a working paper based on a comprehensive study of open-end U.S. equity mutual funds for the period 1980 through 2003. They measured how active a manager is by comparing a fund’s holdings to the best-fit index holdings, then calculated the fund’s “active share,” which ranges from 0 percent (index fund) to 100 percent (fully active). By using the active share, Cremers and Petajisto (2007) are trying to measure how aggressive the manager is in attempting to beat the market, not how actively the portfolio is being traded.

Figure 1 shows the performance of each active share quintile from Cremers and Petajisto (2007). The top two quintiles, which include the most-active managers, have average alphas (net of fees and the market benchmark return) of 139 basis points and 39 basis points, respectively, while the lower three quintiles contain the closet indexers, which underperform the top active managers by nearly 300 basis points on average. Thus any methodology that drives advisors toward closet indexers—the managers that fall in the middle between active managers and true indexers in figure 1—will in turn underperform.

Cremers and Petajisto (2007) is one of several recent articles that conclude that market-capitalization/value-growth box investing (which we argue leads directly to closet indexing) produces poor investment performance. These recent articles include several of our own (Howard and Callahan 2006; Callahan and Howard 2006a; Callahan and Howard 2006b; Callahan and Howard 2007). We make the case that constraining investment managers to boxes, defined by market-cap and value-growth characteristics, costs about 300 basis points per year in underperformance. We also show that style boxes are not asset classes and that diversifying funds among those boxes provides minimal, if any, risk reduction beyond what can be obtained by randomly selecting funds.

Some of our studies and others are summarized in table 1. Each study focuses on the question of whether it is better for a manager to stay in a box (i.e., be a hugger) or drift around the U.S. equity universe (i.e., be a drifter). These studies use different methodologies, cover a 24-year period, and come to the same conclusion: It is better to be a drifter than a hugger. The annual risk-adjusted drifter-minus-hugger return differential ranges from a little under
200 basis points to more than 400 basis points.

Advisors can prove to themselves that drifting helps performance. The first study cited in Table 1 can be replicated by any investment professional with access to Zephyr by sorting fund returns by the Zephyr Style Drift measure and noting that those that drift the most generate the highest returns.

**Why Has Closet Indexing Increased?**

Over the past 20 years, the style grid has become more prominent as a diversification tool in portfolio construction. In this approach, an advisor seeks out small-cap value and large-cap growth managers, for example, in order to fill out the “box” allocations for a client portfolio. Managers are expected to stay within a box or to be “style pure,” an aspect of portfolio management that has been elevated to the highest level of importance. Consequently, boxes play a central role in categorizing, evaluating, and constructing equity portfolios.

How did this all get started? We recently met with several investment industry veterans who said they believe it started in 1984. At the time, they were meeting with a distinguished professor of finance about how their company might build its indexes. The professor went to the board in the conference room and began laying out a simple four-box system based on the evolving academic research in market-cap and price-to-earnings ratios. Thus was born the style grid, and the company began to build indexes based on this concept. Others in the industry began using these indexes to assess managers, and shortly thereafter the idea of “style purity” took root, much to the chagrin of these industry pioneers. The rest, as they say, is history because the industry has bought into the style grid concept lock, stock, and barrel.

How does “style purity” breed closet indexers? Using boxes to allocate portfolios and correspondingly setting the expectation that managers be style-pure is the same as asking active managers to provide products that look like the box indexes. Commonly used measurements such as low style drift, high R squared, and low tracking error all measure the degree to which an active manager matches a box index. As these have become standard over the years, the result has been a rise in closet indexing as active managers are pigeon-holed into the boxes by advisors, consultants, and the distribution system in general. To be fair, this growth also is the consequence of fund companies responding to the new box-driven demand. We refer to this fundamental industry shift as a leaderless stampede toward the style grid resulting in the commensurate rise of closet indexers.

Results from Cremers and Petajisto (2007) shown in Figure 2 confirm the emergence and growth of closet indexers. Cremers and Petajisto (2007) found that in the early 1980s essentially all open-end U.S. equity funds were active (i.e., had an active share of 60 percent or more) and that there were neither closet indexers nor any true indexers to speak of. When the industry began boxing managers in the mid-1980s, both closet indexers and true indexers began to grow as a percent of industry assets under management (AUM). By 2003, true indexers had grown to 13 percent of AUM while closet indexers had grown to nearly 30 percent or roughly $1.5 trillion.

We believe that the emergence of closet indexers is the direct result of

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**Table 1: Performance Advantage of Drifters Versus Box Huggers**

<table>
<thead>
<tr>
<th>Author</th>
<th>Date Published</th>
<th>Methodological Focus</th>
<th>Sample Period</th>
<th>Drifters–Huggers*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Kacperczyk et al. (2005)</td>
<td>2005</td>
<td>Industry concentration</td>
<td>1984–1999</td>
<td>1.84%</td>
</tr>
</tbody>
</table>

*Annual risk-adjusted return differences.
**Research based on the April 2007 Zephyr database, spreadsheet available upon request from C. Thomas Howard.
We believe that the emergence of closet indexers is the direct result of the industry moving toward boxing managers. We also believe that boxing managers contributed to the increase in true indexing, because investors had a difficult time identifying successful active managers due to boxing.

We believe that a better solution is to abandon the boxes and construct portfolios that use truly active managers. This can be done by focusing on the strategy the manager is pursuing, with the manager consistently pursuing this strategy over time. Consequently, the manager moves about the U.S. equity universe as dictated by the investment strategy. We refer to this approach as strategy-based investing or SBI (Callahan and Howard 2007).

In developing SBI, we’ve found that the following are useful in identifying superior active managers:

Buy drifters, not huggers. An increasing body of research shows that characteristic drifters outperform huggers (i.e., managers that hug an index or stay in a particular box). Thus characteristic drift is good for performance.

Assemble strategy-focused managers. Combine complementary, strategy-focused managers to obtain stable, high-performance client portfolios.

Hire specialists, not generalists. Strategy specialists perform better than generalists. Beyond a reasonable level, the more things a manager looks at the worse the performance. So hire a valuation specialist, a competitive position specialist, an opportunity specialist, and so forth, and let each focus on what each does best.

Demand strategy consistency. Beyond knowing the strategy of the manager, the next most important thing is strategy consistency. If managers aren’t consistent, get rid of them.

By using SBI, it is possible to identify the strategy a manager is pursuing and how consistently it is being pursued over time. Our continuing SBI research reveals that strategy optimization and manager consistency leads to superior performance in line with the various performance results reported in table 1. SBI is a way for an advisor to build better client portfolios and avoid being caught in the middle where the closet indexers reside.

C. Thomas Howard, Ph.D., is a professor of finance at the University of Denver and co-founder, chief executive officer, and director of research at AthenaInvest, Inc. He earned a B.S. in mechanical engineering from the University of Idaho, an M.S. in management science from Oregon State University, and a Ph.D. in finance from the University of Washington. Contact him at tom.howard@athenainvest.com.

Craig T. Callahan, D.B.A., is founder and president of ICON Advisers, Inc. and co-founder and director of AthenaInvest, Inc. He earned a B.S. from The Ohio State University and a D.B.A. in finance and statistics from Kent State University. Contact him at info@iconadvisers.com.

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