Editorial

Financial markets punish success. Successful investment strategies spawn imitators or grow organically until their very size ensures their own demise. Taken to its logical end, such reasoning argues exclusively for passive investing. Certainly, there is very little empirical evidence that individual investors can consistently outperform passive benchmarks after transactions costs. The real-life consequence of this has been consistent growth in indexing both within and across countries. Yet active investment management is far from dead. Indeed in its purest form — the hedge fund — active management is growing dramatically as institutions include alternative investments in their strategic asset allocations. We are therefore witnessing the simultaneous success of both pure passive and pure active investing. While at first glance this may seem strange — even contradictory — these trends are actually natural developments with the potential to reshape the entire asset management industry.

Even the most strident opponents of indexing would admit that investing in an active strategy requires some faith in the skill of the manager. While these investors retain faith in active management, it is by no means absolute. They want their managers to operate without the artificial, benchmark-related constraints which are inherent to long-only funds but detrimental to their active performance. They also insist on the managers' incentives being aligned with their funds' success. Skilled active

managers want the same things — many believe hedge funds provide the solution.

Furthermore, both active investors and active managers would agree that skill is rare and that even the most successful of investment strategies has only limited capacity to add value. They recognise that as a successful strategy grows its trading generates more and more 'market impact'. The active manager still retains the skill to identify opportunities, but in trying to capture them he moves prices in a way that reduces or eliminates alpha. Perhaps the most striking example of this occurred in the world of fixed income arbitrage. For a period of time, LTCM used its skill to earn returns from global bond markets. As it grew in size and competitors engaged in similar trades, however, a point was reached where the capacity to extract alpha from fixed income arbitrage was exceeded, at least temporarily. At the other end of the investment spectrum, Warren Buffet has often warned his shareholders that the very size of Berkshire Hathaway precludes it from earning the same magnitude of returns going forward that it has in the past.

As more investors explicitly accept this notion of capacity limits, they are budgeting their risk more accurately and forcing healthy changes on the industry. To the extent that they believe in the existence of skill, they want conditions to be conducive to its realisation: hence the growth in hedge funds. At the same time the mechanics of market impact place a limit on how big successful active strategies can ultimately be. Investors are

being careful to understand these limits and to spread their risks across a range of different active management styles. Underpinning all of this is the continued growth in passive investing as the core way of obtaining exposure to market and systematic risks.

As investors become more sophisticated so must the practitioners. They must improve their understanding of trading costs, particularly market impact, so that they can place a limit on their own capacity. The hurdle is no longer just to demonstrate good investment ideas. Managers also need robust methodologies for turning ideas into realised alpha and determining at what point this alpha will be wiped out by the cost of trading. The notion that big is beautiful has gone largely unchallenged in the industry over the past decade. Yet restricted capacity means that large active managers either need to be collections of boutiques or possess some skill in running low-turnover, high-capacity products. Lastly, as market pressures force the size of active strategies to be limited, managers will need to carefully ration and price capacity. If skill is indeed as rare as it appears this may mean an increase in price for those active strategies that do survive at high turnover but low capacity.

The good news for the readers and contributors to the *Journal of Asset Management* is that there are many avenues for research and investigation. An unconstrained hedge fund strategy

should be the best environment to capture investment skill. But does this hold in practice? While some important empirical work has begun to examine whether hedge fund managers do indeed possess persistent alpha, the jury is still out. More fundamentally, until we have a convincing theoretical framework that allows for the existence of skilled active managers, investing in any active strategy will remain partly an act of faith. The best models we have to date exclude the possibility of anything but transitory active management opportunities. Behavioural models allow for long-lived opportunities, but have yet to provide guidance on where capacity limits might be and how they could be reached.

The asset management industry is changing. It might ultimately polarise into a world of pure active and pure passive strategies. Pure, market-neutral, active strategies will be available at a range of turnovers, capacities and hence prices. This will clarify the price of both market exposure and active management, allowing investors to budget risk more precisely. For active managers, such a world at least, and at last, provides clarity. For those with skill there is an obvious way forward, for those without there is always indexing!

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