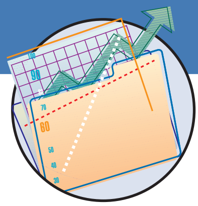

Cleaning Closets

In difficult times, ranks of closet indexers swell

BY CHRISTOPHER WRIGHT

KEY POINTS

- Closet indexers deny the client excess returns and cause the client's overall portfolio to underperform.
- *R* squared, tracking error, beta, and information ratios are among the tools used to detect suspected closet indexing.
- Clients can deal with closet indexing by explicitly indexing more of the portfolio, terminating managers, or offering incentive fees.

Terry Dennison's client was enormously frustrated. The client found that external money managers were using only half the tracking error assigned in the risk budget for a certain portion of the client's overall portfolio. It wanted incremental returns from active management and wasn't getting them. So, the client "got out the pitchfork and kept poking the managers—'Will you *please* increase the risk you're taking?'" recalls Dennison, who is U.S. director of consulting in Los Angeles for Mercer Investment Consulting, which serves pension, endowment, and other institutional needs in 35 countries.

The managers who were frustrating Dennison's client were "closet indexers," managers who hug the benchmark while professing an active strategy. Their numbers have waxed and waned over the past 30 years. But the problem, in Dennison's estimation, is currently growing.

Harold Bradley, who oversees external managers as chief investment officer for the Kauffman Foundation in Kansas City, Missouri, is also finding closet indexing more prevalent than it was two years ago. He attributes this increase in part to manager inexperience with tough market conditions. Younger managers lack the courage of their convictions and abandon their style at the bottom of their cycle. "During risky times, you break in a whole new generation who run to closet indexing because they become afraid," says Bradley.

Also, in Bradley's experience, closet indexing is more common at investment firms that are, in effect, run by marketing people, not investment professionals, or firms that are more focused on asset gathering instead of investment performance.

Other reasons can account for closet indexing. Some managers hug the benchmark to preserve their own profitability. They fear the client will fire them if their active strategies significantly underperform the benchmark. There is far less risk of being terminated if benchmark results are obtained.

Another factor is rising market efficiency. More financial information is available to anyone with an Internet connection today than investment professionals had at their disposal 30 years ago. "The game is getting harder to win," Dennison says. "Managers struggle to add value. If managers can't find high-conviction ideas, they have to invest in something. Closet indexing is an evolutionary adaptation to a changed environment."

Closet indexing can also be tactical. Some managers temporarily retreat to the index for a safe haven when nothing looks attractive in their space.

The problem is that clients don't get their money's worth. "If you believe that you gain from spending the time and money to find good active managers, then you want the excess return that comes from active management," Bradley says. "Closet indexers call themselves active and charge active fees but then run a product with low tracking error to the benchmark."

The high fees charged by closet indexers get most of the attention, but "more importantly, the client is spending part of their risk budget and not getting the full benefit of active management," Dennison says. In the low-return environment of the past few years, a gap between passive returns and client actuarial requirements often means that clients must receive an increment of alpha from a significant portion of their portfolio in order to meet their objectives. Managers that hew closely to the benchmark are denying the client excess returns and causing the client's overall portfolio to underperform. And that, says Dennison, is "a much bigger number than the fees."

There are many ways to detect closet indexing. One is R-squared, the percentage of a portfolio's variances that can be explained by fluctuations in the benchmark. Bradley favors changes in tracking error. "If I have a manager who historically ran top-quartile tracking error while he was putting up good numbers and he's suddenly running bottom-quartile tracking error, there's been a change in investment approach," he says. Similarly, if the manager was running a high or low beta vis-à-vis an index but the beta starts to trend toward 1 (market volatility), Bradley will suspect closet indexing. Another tip-off: "A high rate of change in new assets under management is always a warning flag," Bradley says. "If you hire a small-cap manager and they've been hot and suddenly they're running US$2.5 billion, the likelihood is they're not a small-cap manager anymore."

Bradley also uses returns-based analysis software from MPI (Markov Processes International in Summit, NJ) to identify suspected closet indexers. Returns-based analysis can be put to more than one use: (1) to detect possible closet indexing, (2) to inform the client whether the manager is actually adding value or merely providing expensive beta, and (3) to investigate whether the portfolio is providing the style exposure intended (e.g., U.S. large cap) or, because of security selection, is behaving like something else (e.g., a global portfolio because U.S. firms with substantial overseas operations were selected).

Like Bradley, Dennison uses tracking error to detect closet indexing because relatively high tracking error is part of the reason why the manager was chosen in the first place. Dennison also uses an information ratio (excess return over a benchmark divided by the standard deviation of the tracking error) but says it's important to assess trends over three-year rolling time periods with respect to both measures. A point-in-time snapshot can be misleading because there are occasions when a manager's performance will resemble the index for completely innocent reasons. Just looking for overlap between a manager's holdings and the securities in the index is a naive approach, in Dennison's view, because it's possible for managers to produce index-like returns and volatility with fewer or different holdings.

Several observers have commented that clients provoke closet indexing on the part of their external managers by imposing contract terms that limit the extent of permissible underperformance, specifying mandatory holdings, attempting to constrain tracking error, asking for beta near 1, or other self-defeating behaviors. In fact, Richard Ennis, CFA, goes so far as to say that the clients, not the managers, are the real closet indexers.

"Generally speaking, I fault the investors themselves, e.g., pension funds, for closet indexing, for they are the ones to control against it," says Ennis, who is chairman of Ennis Knupp and Associates (an investment consulting firm in Chicago) and editor of the *Financial Analysts Journal.* "Lots of clients know they've got managers that have R squareds with their benchmark of 95, 98 percent but say, 'Well yeah, that's what I bought.'"

The most common portfolio architecture in the pension and endowment world today is fatally flawed, Ennis asserts. It employs too many external style managers, who end up with too small a slice to contribute meaningfully to alpha. By his reckoning, such architecture underperforms by 1.34 percent after management fees and trading costs. Thus, clients might as well be indexing. Ennis advocates appointing a single manager internally (chief investment officer), explicitly indexing up to 80 percent of the portfolio, using talent scouts to identify a few external managers who are the most likely to produce alpha, and freeing those managers to apply their skill in more than one asset class or style box.

Harold Bradley has fired five external managers for closet indexing. Termination followed a conversation in which the manager could offer no satisfactory explanation for starting to behave like the index.

But contrary to common practice, Bradley doesn't fire managers at the bottom of their cycle if they can articulate and stay true to their investment strategy. He figures he can count on them to outperform when their style returns to favor.

Dennison agrees that the client is better off replacing closet indexers with managers more likely to produce better results. Prodding a manager with a pitchfork to increase their tracking error won't work. Firms are set up to run money a certain way. Either the manager won't behave differently for very long because of organizational inertia or will fail to deliver the expected results because it lacks the skill a different approach demands. "If the process isn't capable of producing a commensurately larger alpha, all you're doing is eroding the information ratio [with a higher denominator]," Dennison says. His client mentioned at the beginning of this story came to the conclusion that it needed a different set of managers and has been selectively pruning its current crop.

Bradley also smokes out closet indexers by offering incentive fees for outperformance. So far, he has negotiated four deals with external managers in which the fee changes up or down every quarter based on the trailing 12 months of performance compared with an agreed-on index. The best will provide consistent alpha over time. "Otherwise, our fees will be very low," Bradley says. The terms vary, though. Those who want more downside protection are restricted on how much they can earn during a strong performance cycle.

Mercer's Dennison is skeptical about such arrangements. He finds that managers generally have good work ethics and doubts that performance fees make them any smarter or motivate them to work any harder. In addition, incentive fees create a moral hazard, potentially causing managers to gamble with client funds in hopes of hitting it big and lining their own pockets. Finally, the manager siphons off some of the excess returns even if it was randomness and not manager skill that produced the good results. He's seen one instance in which the incentive fee was structured in such a way that the manager captured all of the incremental return within a certain range of outperformance, leaving the client no better off than if it had passively indexed.

Closet indexing will exist as long as there are clients willing to turn a blind eye or tolerate it. For Ennis, the onus is entirely on the client: "It is incumbent on the client to understand the manager's value proposition and make the ultimate determination whether the results justify the fee."

Christopher Wright, an award-winning writer in Arlington, Virginia, publishes his own investment newsletter and country risk reports.

RECOMMENDED RESOURCES

"The New Organizational Paradigm: A Single Portfolio Manager and a Band of Scouts"
by Richard Ennis, CFA
Financial Analysts Journal (July/August 2008)
(cfapubs.org)

"Debunking Some Myths of Active Management"
Summarized in the *CFA Digest* (November 2005)
(cfapubs.org)

"Traditional Indexing Is Passé"
Points of Inflection: New Directions for Portfolio Management (July 2004)
(cfapubs.org)