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Snake oil funds

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So far, 2022 has been a bad year for active fund managers. Only 42 of 243 funds in Trustnet's database of all companies unit trusts have outperformed L&G's UK index tracker fund (which tracks the All-Share index) so far this year, and 18 of these are other trackers, mostly of the FTSE 100.

There's a simple reason for this. The All-Share index has been pushed up by big rises in a few huge stocks such as Shell, BP and AstraZeneca. Most shares have underperformed the market, which means that so too have most funds.

This continues a long-term pattern. When big stocks beat the market most active managers underperform, as happened in 2016 and 2018. And when big stocks underperform, and so most shares outperform, so active managers do well; this happened in 2017 and 2019. The average active manager doesn't beat the market except when conditions are in his favour.

Which corroborates a finding by the University of Bristol's Ian Tonks and colleagues. They studied UK fund managers between 1998 and 2008 and found that the "vast majority" of them were "genuinely unskilled".

Which in turn corroborates long-term evidence from the US. In 1967 Michael Jensen reported that there was "very little evidence" of fund managers doing better than one would expect from chance alone. Partly based on this evidence Burton Malkiel in his famous 1973 book *A Random Walk Down Wall Street* advised people to own tracker funds rather than actively managed ones: in 1999 he estimated that this advice would have made the average US investor $140,000 more on a $10,000 investment than would the average active fund.

We have therefore lots of evidence that active management doesn't work - hence Warren Buffett's claim that he would trust monkeys to pick shares rather than financial advisors.

Which poses the question: why, then, is it still big business?

Here, a precedent can help us. Active funds aren't the only products that have remained big business despite being of dubious utility for customers. In 19th century America, the market for patent medicines grew for decades even though most of them were useless. Some of the reasons for that growth might help explain why there is still demand for active funds.

One of these reasons is that people don't adequately distinguish between skill and luck. Some people who took patent remedies would have got better anyway but they ascribed their recovery to the medicine. Quacks thrive, says Ran Spiegler at Tel Aviv University, because "patients attribute their occasional success to skill rather than luck".

A similar thing happens in fund management. Aneel Keswani at Bayes Business School and David Stolin at Toulouse Business School have shown that investors buy funds that have done well in recent months even though such short-term performance doesn't predict future outperformance. Investors, says Christoph Merkle at Aarhus University, "confuse risk taking with manager skill and are thus likely to over-allocate capital to lucky past winners". They don't see that some funds will outperform simply by chance.

Another reason why patent medicines thrived was that people didn't know, or didn't trust, the advice of medical science - just as investors today don't know or don't trust economists' advice to avoid active managers because equity markets are mostly informationally efficient.

Such distrust has a grain of truth: economists, like 19th century doctors, don't know much. But it's also based on wishful thinking. The advice of 19th century doctors was often that the patient's ailment was incurable. Faced with such counsel of despair, why not try a quack remedy? Similarly, faced with economists' advice that we are destined for low returns, why not take a punt on beating the market?

And patent medicines weren't wholly useless. In a fantastic paper the late Werner Troesken showed that they often contained useful ingredients to relieve constipation or help patients sleep. That, he wrote, "fooled consumers into believing that maybe they were getting better". Similarly, fund managers can do something useful. They can buy momentum or defensive stocks - two types of share that have on average beaten the market - and so give the illusion of skill.

Yet another trick snake oil salesmen used was product differentiation. While some remedies stayed on the market for decades, there was also a steady stream of new ones. This meant that customers who were dissatisfied with the failure of one remedy had many others to choose from. In the same way, not only are there hundreds of funds to buy, but also waves of new ones trying to exploit new fashions such as small cap funds in the 1980s, TMT ones in the 1990s or ESG ones today.

Patent medicines also benefited from a growing market. Patients who weren't cured by one remedy switched to others, while people were getting ill with new ailments every day. Similarly, with savers no longer annuitising their wealth they are staying invested in funds late in life, while people needing to save for their retirement create new demand.

Of course, there are also differences between snake oil sellers and fund managers. One is that whereas patent medicines were often cheaper than the remedies offered by respectable science actively managed funds are more expensive than the tracker funds favoured by experts. Offsetting this, however, is the fact that active managers have an advantage over quacks. Whereas customers could tell quickly that snake oil didn't work, the failure of active management is harder to spot unless you go to the trouble of comparing the funds you bought to the trackers you did not over long periods.

The story here, however, is not just about active managers but about markets generally. We instinctively believe that competition drives out bad products. And often it does. The history of patent medicines, however, tells us that it does not always do so. Instead, we must ask: what are the mechanisms whereby some products are selected for, and some against? Sometimes, the mechanisms select in favour of inferior products. Whether this is true in areas other than quack remedies or fund management is, however, another story.