# In Search of Under-Appreciated Skill: Passive Indexation of Active Funds

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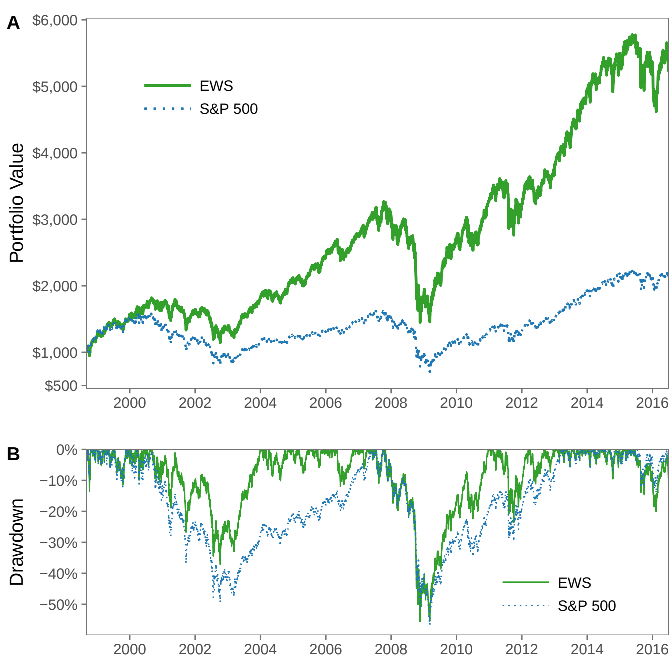
Passive investing in active funds without identifying skilled managers can achieve sizable above-market returns too. The basic idea is that active risk is fund-specific and thus provides another layer of diversification that is often neglected. We document that a passive "indexation" strategy of actively managed sector funds earns an annual benchmark-adjusted return of 5.70%, and a monthly alpha of 27 basis points over next-best investable passive funds from 1998 to 2016. We call it Equal-Weighted Sector (EWS) strategy (see figure), which is simple — buy active sector funds with equal weights and rebalance periodically to preserve the equal weighting.




- The strategy's outperformance is present in market downturns, i.e., resilient to tail risk. It has both shallower and shorter drawdowns compared to S&P 500 index. It also generates higher alpha in bear market.
- The results hold after fees and does not crucially depend on frequent rebalancing. Annual rebalancing is enough to harvest the alpha. Percentage-of-portfolio rebalancing can be used to further decrease transaction cost.
- The outperformance is not entirely driven by the equal-weight sector allocation, EWS outperforms a rebalanced equal-weight sector ETF portfolio. Active returns come from active managers in underlying funds.
- The outperformance is neither a result of style bias. The strategy has a market beta close to one and a mild tilt towards small-cap. The alternative betas for value, momentum, and other factors are essentially zero.
- Only a handful of the universe of underlying funds have statistically significant alpha. The high information ratio is a result of diversifying active risk, which is manager-specific and hence idiosyncratic.

We are the first to consider passive indexation of active funds for investors to allocate capital to external active managers. Passive indexation means to mimic a passive investor and trade active funds following simple rules to periodically rebalance to, e.g., equal weights. Passive indexation encourages institutional investors to focus on diversifying active risk and hence increasing their top-level information ratio and spend less operation costs on researching skilled managers. Skill identification is cost-ineffective and successful funds usually experience performance drag from too much capital.
While we focus on one particular strategy, the EWS strategy, the basic insights from passive indexation of active funds can be extended in numerous ways:

- Alternative benchmarks. In addition to the most common benchmark, such as the S&P 500 index, other benchmarks can be accommodated, e.g., S&P 500 Value index. The benchmarking is achieved through beta-matching.
- Alternative allocation schemes. Instead of equal weights, existing research suggest that over-weighting smaller and younger funds are conducive to higher alpha.
- Tactical asset allocation. For example, a momentum strategy with sector funds has proven to be profitable.

The key is to ensure the active returns of underlying funds are not highly correlated, so that top-level institutional investors can enhance their information ratio from higher breadth (Fundamental Law of Active Management).