Active Share and Closet Indexing in Emerging Markets

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According to William Sharpe[4]:

1. before costs, the return on the average actively managed dollar will equal the return on the average passively managed dollar and
2. after costs, the return on the average actively managed dollar will be less than the return on the average passively managed dollar.

This seems to rule out the very notion of active management as a style meant to beat some relevant market index. However, it is key to stress that this claim addresses the *average* manger/fund, therefore individual managers can still outpeform those oriented toward a passive style.

A truly actively managed fund involves substantial costs in collecting financial information and consequently more effort in security analysis. This simple fact created a florid market in the asset management industry, where investors are willing to pay higher fees to reward the more skilled active managers.

Unfortunately, this paves the way to subtle agency problems where some managers may feign an active style in order to charge higher fees to their clients. Instead, they will deviate scantly from the benchmark. While these type of managers are unlikely to deliver their investors terrific performances, they are not taking the big bets implied by a truly active management and so are relatively safe from large loss and furthermore they will not easily fall behind the index, which will give them an unfair competitive edge. These undisclosed and unethical strategies are usually known as *closet indexing*[5].

Closet indexing might be difficult to detect at level of individual funds, despite it can be more apparent at industry level. While scholars are starting to investigate this issue, there is still little or no research targeting emerging markets. Instead emerging markets show more opportunities of exploiting inefficiencies through active strategies and therefore more room for passive management approaches

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4 Sharpe, W. F. (1991). The arithmetic of active management. *Financial Analysts Journal*, 7-9.
5 Fong, W. M. (2016). On the Impact of Closet Indexing in Active Fund Management. *The Journal*, *27*.

disguised as active ones. In this study, we aim to shed some light on management styles with regards to emerging markets.

In reasoning about active management styles, it is crucial, to identify proper measure of managers' activism. A well-known measure is the Active Share[6], which weights the amount of holdings misaligned from the benchmark portfolio.
This measure can be compared with more traditional concentration indices – such as Gini and Herfindahl index – aiming to identify those funds taking big bets in individual stocks in order to exploit private information and specific security analysis.

We will present evidence concerning Russian asset management industry. In particular, relating the measures of active portfolio management with funds' performance, delivered both in terms of excess returns and in terms of generation of alphas. The latter if often recognised as a tool to quantify the mangers' skills.

As regards the closet indexing, following Cremers, Ferreira et al.[7], we assume the cutoff for an active fund to be classified as a closet indexer to be an active share below 60%. More in general, given relevant market indices, by analysing the tracking error and R-squared with respect to of overall funds marketed as actively managed, with those of the explicit indexed funds we can assess how significant is their median difference and whether its magnitude justify the active-vs.-passive taxonomy.

The study takes also into account the difference in terms of fee charged by active funds or closet funds, falsely marketing themselves as such. An explicit indexing, opposite to closet indexing, is key for a more competitive environment, which in turn favours a fair and transparent fee system.

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6 Cremers K. J. M., Petajisto A. (2009). How Active Is Your Fund Manager? A New Measure That Predicts Performance, *The Review of Financial Studies*, Volume 22, Issue 9, 1 September 2009, Pages 3329–3365, https://doi.org/10.1093/rfs/hhp057

7 Cremers, M., Ferreira, M. A., Matos, P., & Starks, L. (2016). Indexing and active fund management: International evidence. *Journal of Financial Economics*, *120*(3), 539-560.