InvestmentNews

Complex strategies lead to lower returns: study

Higher costs also come with those performance declines

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If your actively managed fund's prospectus comes with a certain air of desperation, a recent paper from Queens College in Ontario, Canada, explains why: As passive funds become harder to beat, active funds are increasingly using sophisticated derivatives, and using them badly. The result: Higher fees and lower performance.

According to the paper's authors, Paul Calluzzo, Fabio Moneta, and Selim Topaloglu, 42.5% of U.S. domestic stock funds have used leverage, short sales or options at least once during the past 17 years. Most U.S. funds are allowed to use at least one of these complex investments. The percentage of funds that can use all three has risen from 25.7% in 1999 to 62.6% in in 2015. Theoretically, those investments can allow funds to increase returns or reduce risk.

In practice, however, the opposite seems to be true. "You can get seduced by funds that make big promises about reducing risk," said Prof. Calluzzo.

According to the study, funds that use hedging strategies can fall into a moral hazard trap: That is, by using investments that are supposed to shield them from risk, they take on additional risk. "Although they use the instruments in a manner that decreases the fund's systematic risk, they hold portfolios of riskier stocks that offset the insurance capabilities of the complex instruments," the authors note.

Leverage, short selling and options can also be used to increase risk and, theoretically, boost returns as well. But the study notes that funds that use these techniques tend to have lower excess returns as well as somewhat higher expenses. Funds that use complex investments had a 0.59% decrease in excess return and a 0.072% increase in expenses, the authors report. Funds that use short sales and options are most likely to have higher fees.

Larry Swedroe, co-author of "Your Complete Guide to Factor-Based Investing: The Way Smart Money Invests Today," blamed increased use of complex investments on the flight of investor money from active managers to passive index funds. "The active world has to fight back to keep their share, and one way to do that is to add complexity," Mr. Swedroe said. "They need to say, 'We have a story to tell, and you need to be a member of our secret club, which has all these superior instruments.'"

One problem with sophisticated investments: You're dealing with highly sophisticated investors on the other side of the trade, Mr. Swedroe said. "You have to ask yourself, 'Who is the dummy on the other side of this trade?' If you can't answer, it's probably you."

Not all of the paper spells gloom for active managers using complex instruments. The authors found, for example, that funds with large institutional investors tended to behave more responsibly with complex investments. "Those shareholders provided good monitors," Prof. Calluzzo said. "They help limit bad behavior."