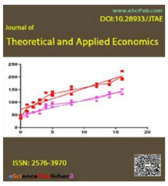
Research Article **JTAE (2018), 2:1**



Journal of Theoretical and Applied Economics
(ISSN:2576-3970)

"Active fund managers will always underperform in behavioural market?"

Yibin Liu

ABSTRACT

This paper mainly digs out reasons behind a common view that active fund managers perform poorly in behavioural market at most instances. Based on some economics theories and behaviour finance theories, the paper discusses five reasons arouse underperformance by active managers. Accordingly, these causes are divided into internal and external perspectives as well.

Keywords:

behaviour finance theories
active managers
underperformance

***Correspondence to Author:**
Yibin Liu

How to cite this article:
Yibin Liu. "Active fund managers will always underperform in behavioural market?" Journal of Theoretical and Applied Economics, 2018, 2: 1.

eSciPub LLC, Houston, TX USA.
Website: http://escipub.com/

There is no absolute statement insists that initiative fund managers underperform in behavioural market all the time. Manager may be superior in market if they are continuously obtaining returns. But active fund managers are low-performed in behavioural market in most cases, whereas to maintain the successful trade in dynamic market require appropriate timing and managers need to be expert, far-sighted and judgematic. There are some interior and exterior arguments except the intrinsic risks in behavioural market.

1. Internal reasons

The fund managers compose market, they can't defeat themselves. Their transactions cause a part of volatility in market. Just like playing a zero-sum game, someone got return means someone lost at same time. Individuals try to presume other's strategy and to fully prepare for next step with the purpose of earn more money. In dynamic market, it's a tricky game which have no time to conjecture others' behaviour with one hundred percent certainty.

1.1 Rational man and prospect theory

Based on the hypothesis of rational man, every fund manager is supposed to be a risk averter and a big fan of reward. Most fund managers become a prudent investor to avoid risks. It implies that they will lowing expected return, and short before price reach to peak point. The cautious transaction is costly because clients lost a portion of return which is they deserved. Conversely, the reflection effect in prospect theory argues that investors favour to be a gambler, not to accept certain loss. And certainty effect states that human would rather take return with certainty than gamble. Generally, individuals become risk aversion when they gain profits and become risk seeking when they are lost.

Figure 1:The decision making under Prospect Theory

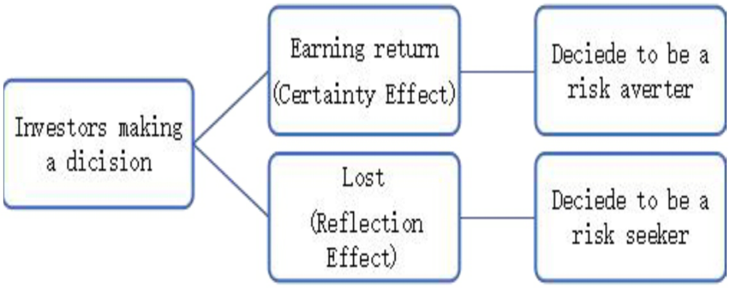
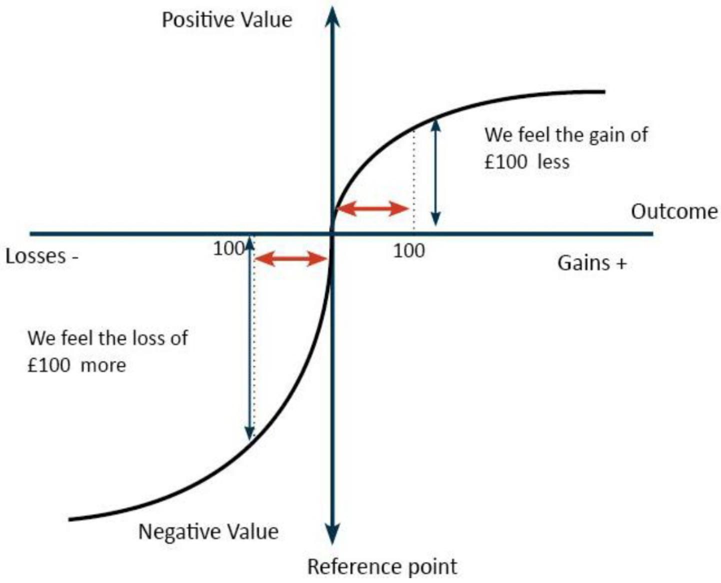


Figure 2: The Return from Prospect Theory



Source: http://www.economicshelp.org

Obviously, prospect theory points out that loss raised since investors boldly try to compensate their losses. It illustrates that even an excellent fund manager may underperform in behavioural market.

1.2 Overconfidence theory and endowment effect

People are spontaneously overvalued the information they have and tend to neglect other crucial information in the market. Overconfidence theory explains that an active manager is likely to overestimate their ability, the improper strategy leads them to incorrectly trade. Similarly, theory of endowment effect discusses that people will overprice something after it belongs to them.

The overconfidence facilitates active managers be interested in new financial derivatives and commodities. They frequently trade on financial products and prefer to acquire new experience, it's a time-consuming and energy-draining work. Consequently, ascend transaction costs and more risks cause high probability of negative return. Moreover, active managers also suffer from the influence by endowment effect, which encourage them to short on an excessive price. If market price was unable to reach the expected price of their underlying assets, losses will exceed expectation.

1.3 Human defects impact on managers' behaviours

Human being makes mistakes as well as fund managers. According to the behavioural finance theory, investors badly behave on selecting economic choice. The theory of herd behaviour demonstrates this point of view. People will follow the general trend to make decision sometimes, because it's more likely to be successful when most people pick a same choice. Furthermore, majority of investors' choices may drive the market trend. Therefore, even the action from most investors are unreasonable, the fund managers may also follow them to trade.

2. External reasons

2.1 Competitive market with consistent client's desire

Effective market can automatically equilibrate the demand and supply on an appropriate level, even fund manager made an incorrect trade, market can regulate and find a new equilibrium point by itself. In this case, behavioural market has better performance than fund managers. Due to the efficiency of behavioural market, to catch price spreads become a major challenge for fund managers.

Behavioural market becomes more competitive in recent years. An increasing number of investors participate in market with specialized knowledge, they are competitive with fund managers. Nowadays, return is shared by more participants in financial market, but client's expectation didn't change, they still desire returns as much as managers can earn. Both sides exert pressure on managers and it induce an undervaluation on manager's performance.

2.2 Restraints by clients, laws, and regulations

The laws and regulations indirectly restrain activist's outperformance. The active manager charges more trading fees since they require researches and high-frequency trading. To prevent exorbitant fees, investors need specific laws to protect them. The limited trading fees and unlimited risks mitigate the incentive for fund managers who were willing to be superior in behavioural market.

Besides, investors have vulnerable confidence, they press manager to sell when market is shrinking. One failure trading may shake client's confidence, and continuously losing let fund manager lost their clients. Their reputation was ruined and they hardly to find an opportunity to prove their capacity again. If an experienced manager couldn't involve in market, then it's difficult to prove they outperform in behavioural market.

Conclusion

Being an active fund manager is quite tough. They need to balance market change and client's requirement, meanwhile they suffer from intrinsic and extrinsic stress. Some active managers are underperformed in behavioural market, but it can't be an excuse to ignore the value of their job. I believe that they will keep outperformance in dynamic market someday.

References

1. Hulbert, M. (2017, May 13). This is how many fund managers actually beat index funds. Retrieved from https://www.marketwatch.com/story/why-way-fewer-actively-managed-funds-beat-the-sp-than-we-thought-2017-04-24.

2. Garfield, N. (2014, September 2). Six reasons why fund managers can't beat the markets. Retrieved from https://www.irishtimes.com/business/personal-finance

/six-reasons-why-fund-managers-can-t-beat-the-markets-1.1914292

3. Meyer, G. (2018, February 27). Fundamentals do not matter to new breed of oil speculator. From https://www.ft.com/content/cee7050c-1b74-11e8-aaca-4574d7dabfb6.

4. URL：http://www.economicshelp.org