Performance Constraints in Investment Management

Identifying reasons for performance shortfalls among active investment managers
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1. INTRODUCTION

Most stock fund managers fail to generate returns greater than their respective benchmarks. Current financial orthodoxy, which in this paper we will refer to as Modern Finance Theory (MFT), suggests that this underperformance is the result of stock markets being informationally “efficient”. In an efficient market, all available information is quickly (and appropriately) incorporated into a stock’s price, making active stock selection costly and futile. This theory of informational equilibrium in stock prices has been labeled the “efficient market hypothesis” (EMH).

Market efficiency has been the reigning asset price theory in MFT, but an alternative began to emerge over the last several decades with the work of Amos Tversky, Danial Kahneman, Richard Thaler, and others. Their work has been collectively referred to as “behavioral finance”, or the application of behavioral psychology to financial decisions. The work of these scholars has shown that many stock market participants can behave in irrational ways, given certain incentives and constraints. The EMH, conversely, assumes that most stock market participants act rationally, such that the collective decisions of these participants will produce rational outcomes. Arguably, behavioral finance has brought this critical EMH
assumption into question. However, proponents of the EMH, such as Burton Malkiel, have referred to behavioral finance as a “near miss”, citing underperformance by active managers as evidence of market efficiency (Malkiel 2011).

With the debate over which asset pricing theory has better explanatory value, seemingly little consideration has been given to performance constraints and misaligned incentives embedded within the money management industry. The goal of active stock selection is to generate superior long-term capital appreciation. In this paper, we present an overview of the money management industry and suggest that various constraints and impediments are at least partially the cause for the underperformance mentioned above. We should state, however, that we have mostly avoided any discussion of fund fees, as this issue has been extensively discussed elsewhere (see for example, Bogle 2010).

An understanding of the structure and economics of the money management industry is important for at least two reasons. First, small investment firms and sophisticated individual investors may find investment opportunities in areas overlooked by large institutional investment firms. Second, non-institutional investors will become more informed consumers of mutual funds and other investment products
2. MUTUAL FUNDS

Open-end mutual funds, i.e., those funds which do not trade on an exchange but rather offer and redeem shares directly to investors daily, are the investment vehicle of choice for most households. According to the Investment Company Institute, U.S. open-end mutual funds controlled $16.3 trillion at the end of 2016 and were owned by 55.9 million U.S. households (ICI 2017). Mutual funds are thought to offer investors several advantages over direct stock purchases, particularly by providing professional management and greater diversification at a relatively low cost. While mutual funds do provide many advantages for small investors, the structure of these vehicles makes superior investment performance extremely difficult.

2.1. Basic Structure and Characteristics of Mutual Funds

An open-end mutual fund is a pool of professionally managed capital which invests in financial securities. The fund itself is a legal entity which offers shares to individual investors. The fund in turn hires an investment manager to manage the fund.

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1 In contrast with a closed-end fund, which issues a limited number of shares and trades on an exchange. Since we will not address closed-end funds in this paper, we will use the terms mutual fund and open-end fund interchangeably.
Mutual fund shareholders can redeem their fund shares daily at the fund’s net asset value (NAV), which is the value of all the securities owned by the fund divided by the fund’s total outstanding shares. Likewise, new shares are offered to investors at the NAV, although some funds are periodically closed to new investors. This daily redemption feature provides fund shareholders with liquidity. However, as we will see below, this redemption mechanism can create an unstable capital base for the fund.

Mutual funds are “pass-through” entities for tax purposes, meaning any dividends, interest, or capital gains are passed through to the fund’s shareholders, who in turn pay taxes according to their individual rates. Many fund shareholders, however, can delay or avoid any tax liability by purchasing fund shares through a tax-advantaged account, such as an IRA or 401(k).

2.2. A Brief History of Mutual Funds

The first open-end funds were Massachusetts Investors Trust (MIT) and State Street Corporation, both formed in 1924. Three major trends, however, greatly contributed to the proliferation of the fund industry: regulatory reforms in the 1930’s and early 1940’s, the decline of corporate pensions, and the establishment of tax-deferred retirement savings accounts.
The aftermath of the 1929 stock market renewed interest by the federal government to create a more regulated securities market. This effort culminated in several pieces of legislation, such as the Securities Act of 1933, the Securities and Exchange Act of 1934, the Investment Company Act of 1940, and the Investment Adviser’s Act of 1940. The then-infant fund industry welcomed much of this legislation, particularly voicing support for the 1940 Investment Company Act. To the fund industry, federal regulation was “a way to address abuse and restore public confidence” (Fink 2011, 34).

Another important trend in the evolution of mutual funds was the shift away from employer-provided retirement plans. For the several decades after World War II, retirements were largely funded by employer corporations through an arrangement known as a defined benefit plan. Through these plans, employers guaranteed the employee an annuity payment in retirement. Defined benefit plans were initially attractive to employers for several reasons. Particularly, relatively high corporate tax rates in the 1940’s and 1950’s, made the tax-deductibility of plan contributions highly attractive to firms. Also, the Wage Stabilization Act of 1942, which limited wages to control war-time inflation, increased the use of pensions as a way for firms to attract employees and circumvent wage controls (Owens and Barbash 2014). Finally, labor unions, whose participation proliferated in the immediate post-war period, began to demand higher pension contributions from employers.
By the late 1970’s, however, firms began to dramatically decrease the use of defined benefit plans. This move away from guaranteed pensions was largely the result of enhanced pension regulations, a prolonged bear market, and increased foreign competition.

Congress responded to the pension shift through tax law changes which established tax-advantaged retirement plans, such as Individual Retirement Arrangements (IRAs). Particularly important was a provision in the 1978 Revenue Act, which established section 401(k) of the U.S. tax code. Under a 401(k), a company can establish and make pre-tax contributions to an employer-sponsored savings plan. The employee must be given a range of investment products from which she can choose. This type of arrangement is referred to as a defined contribution plan, since the employer is required to contribute but accepts no liability beyond that. Individuals became increasingly responsible for saving and investing for their retirement. Mutual funds, as regulated entities, were the natural product of choice for 401(k) sponsors and individual households, and fund participation proliferated (Fink 2011).

2.3. Constraints to Performance

For the last several years, hundreds of billions of dollars have flowed out of actively managed mutual funds and into passive strategies, such as index funds and exchange traded
funds (ETFs). The Financial Times, citing statistics from data-provider Morningstar, reported that in 2016 passive funds in the U.S. took in 4.5 times more money than active funds (Mooney 2017). The reasons for this shift to passive investing is seemingly two-fold. First, index funds offer lower fees than actively-managed funds. And second, many actively-managed funds have generated investment gains which are lower than those earned on a passive index. According to Standard and Poor’s (S&P), 88.3% of large-cap funds, 89.95% of mid-cap funds, and 96.57% small-cap funds underperformed their respective S&P benchmark over the five-year period ending December 31, 2016. While fund shareholders may be willing to accept higher fees for superior performance, the combination of higher fees and underperformance has these shareholders increasingly choosing passive investment products.

Investment success is, of course, never assured. However, we have always believed that under the right conditions, an investment firm or sophisticated individual investor can greatly increase the chances of achieving superior long-term investment performance. Unfortunately, just as superior investment performance in the fund industry seems increasingly elusive, these conditions are seldom seen in individual funds, and generally, funds have characteristics which will impede performance. Particularly, we find many funds facing performance constraints from size, lack of co-investment, and uncertain capital.
2.3.1. Constraints from Size

The mutual fund industry has always had a few predominant firms. However, the last several years have seen increased consolidation within the fund industry. According to the Investment Company Institute, the 25 largest firms control 76% of all fund assets and the largest 5 firms control nearly half of all fund assets (ICI 2017). This level of institutional predominance has led one fund critic to refer to the “industrialization of mutual funds” (Lowenstein 2008).

The economics of the fund industry are highly biased towards size. Fund management fees are derived as a percentage of assets under management (AUM). There are large economies-of-scale in the fund industry, so that as AUM increases very little incremental expenditures are needed to support the enlargement of the fund. And what does size do to individual funds? From a performance standpoint, size (1) limits the investment universe and (2) forces overdiversification.

According to MFT, a highly diverse portfolio of stocks whose past returns are uncorrelated will produce a portfolio in which volatility is minimized for a given level of expected investment return. The academic literature, however, seems to conflict as to the exact number of stocks necessary to achieve maximum diversification (Swedroe 2015). The typical
stock fund owns dozens of different stocks. By one estimate, the average domestic stock fund owns over 160 stocks (Lowenstein 2008). Funds which are widely diversified are generally easier to market, as they are considered safer than concentrated funds. However, such wide diversification is likely to lead to a portfolio doing little better, and likely worse, than its relevant benchmark.

Investors will observe that many funds from the most widely recognized fund companies have little statistical deviation from their relevant benchmarks. This can be seen by looking at measures such as beta and r-squared. Beta measures the volatility of a fund’s returns against the volatility of the fund’s benchmark. A beta of close to 1 indicates that a fund’s NAV movements are closely linked to the movements in a fund’s benchmark. Similarly, r-squared is often presented in conjunction with beta, and represents the extent to which a fund’s performance is “explained” by the movements in the benchmark. The r-squared measure ranges from 0 to 100 (stated as a percentage). The higher the r-squared measure, the more a fund’s returns will closely track an index. One study showed that the movements of stock funds as a group showed no statistical difference from the “market portfolio”; i.e., a hypothetical portfolio constructed of all publicly-listed shares (Lewellen 2011). This conclusion, however, is not surprising. According to the Investment Company Institute, mutual funds owned nearly one-third of all publicly-listed stocks (ICI 2017). Given the
tendency of funds to so closely mimic their respective indices, these funds will almost inevitably underperform, especially when fees, transaction costs, and taxes are accounted for.

Mutual fund size also limits the stocks which a fund can invest in, even if a fund commits to a more concentrated portfolio. Consider a fund with $1 billion in assets, which is a relatively small fund. Suppose for the sake of remaining adequately diversified, the fund will only invest a maximum of 5% ($50 million) of its total assets in any one stock. Further suppose that to maintain liquidity the fund will purchase no more than 2% of a company’s outstanding shares. Under this scenario, the fund must focus on companies with market capitalizations of greater than $2.5 billion, thus excluding thousands of smaller companies from consideration.

2.3.2. Co-Investment

Beginning in 2005, mutual fund managers were required to disclose the level of their personal investment in the fund. Unfortunately, the disclosure revealed that few fund managers had any personal investment in the fund they managed. According to a 2007 study, 57% of fund managers had no personal investment in their funds (Khorana, Servaes, and Wedge, 2007). The same study also concluded that a direct correlation exists between
fund manager share ownership and investment performance; i.e., the greater the co-
investment the greater the returns.

While fund managers (and their research analysts) may be highly credentialed individuals,
the lack of co-investment should disturb fund shareholders. Investors should realize that
the fund management company (fund “sponsor”) and the fund itself are two distinct entities
with often conflicting economics. This is particularly true for larger fund sponsors which
offer many funds. What may be worse than the lack of co-investment is that many fund
managers are incentivized with shares in the fund sponsor, creating a conflict of interest
with their fund shareholders (Lowenstein 2008).

The conflicts generally caused by a lack of co-investment have been long observed. Even
Adam Smith, the recognized father of economics, reported the following in his book *The
Wealth of Nations*: “managers of other people’s money rarely watch over it with the same
anxious vigilance with which... they watch over their own.... Negligence and profusion
therefore must prevail” (Smith [1776] 2004). In more recent times, the “principle-agent”
problem has led to a branch of economics known as agency theory (Jensen and Meckling,
1976). Post-war American capitalism gave rise to professional managers, who are generally
“agents” acting on behalf of shareholders. However, corporate stock is increasingly held by
financial institutions, such as pension funds and mutual funds. According to the Securities Industry and Financial Markets Association (SIFMA), these institutions held 62.7% of the value of all U.S. equities at the end of 2015 (SIFMA 2016). Considering that this figure excludes non-profit institutions, the total amount of institutional control of U.S. equities is even higher. As mentioned above, these institutions are mostly managed by “agents” with little direct financial stake in the funds. This leads to an arrangement which John Bogle calls a “double-agency society and the happy conspiracy” (Bogle 2012). To Bogle, this reality enhances the short-term focus of capital markets, further eroding any long-term focus from mutual funds and other institutional investors.

2.3.3. Uncertain Capital

Each year, data service provider Morningstar produces a report entitled “Mind the Gap” in which they compare funds’ time-weighted investment returns and dollar-weighted investment returns. Through this methodology, Morningstar provides a reasonable estimate for the returns which a typical fund investor earns versus the returns earned by a typical fund itself. Research firm Dalbar conducts a similar study in its annual “Quantitative Analysis of Investor Behavior”. The results of these studies are puzzling, showing that fund investors consistently earn lower returns than the funds themselves.
So why the difference in returns? The answer seemingly lies in “performance chasing”, i.e., the tendency for fund shareholders to put money into and pull money out of funds based on recent performance. According to a years-long funds-flow analysis of one successful fund, money consistently flowed into the fund after a year of strong performance and out of the fund after a year of weak performance (Gray and Carlisle 2013, p. 23).

While fund flows harm fund shareholders’ bottom line, performance chasing also denies fund managers stable capital. An important consideration in active management is that to beat the market over a long-time horizon, portfolio managers must construct a portfolio which is very different from the market. However, such a portfolio has an increased chance of short-term underperformance relative to a fund’s benchmark. This, coupled with the tendency of fund shareholders to leave underperforming funds, creates substantial “career risk” many fund managers are unwilling to accept. As one money manager put it, “It is understandably difficult to maintain a long-term view when, faced with the penalties for poor short-term performance, the long-term view may well be from the unemployment line” (Klarman 1990, p. 38).

Much academic literature has concluded that over short-periods of time securities prices follow a “random walk” (Malkiel 2011). This means that stock prices are, in the short-run,
completely random and, thus, unpredictable. If short-run stock price movements are random, then short-run fund performance is likely to be random too. While performance-chasing is futile at best and harmful at worst, the fund industry seems to encourage it. For large fund sponsors with dozens or even hundreds of individual funds, some funds will inevitably have above-average near-term performance. The incentive for the fund sponsors is to increase AUM *across all funds*, often to the detriment of performance in individual funds. These fund sponsors shift marketing and distribution budgets towards the best near-term performing funds. In one study published in 2000, the authors looked at 294 funds which were advertised in *Barron's* and *Money* (Jain and Wu 2000). For the sample, the funds' prior one-year performance was significantly superior to selected performance benchmarks. However, the superior performance eroded in the year after the advertisement.

### 2.3.4. “Style” Restrictions

For many individuals, mutual funds are part of an overall financial plan. These financial plans are often based on asset allocation models in which a finance professional will recommend that a client place a certain percentage of her assets in specific asset classes, such as stocks or bonds. The asset allocation is then often further broken down into sub-allocations. For example, a stock allocation could be further broken down into market capitalization size, domestic or international stocks, and fund manager “style”. Many of
these finance professionals rely heavily on Morningstar’s Style Box™ to assist in setting portfolio allocations. The Style Box™ categorizes funds based on the market capitalization of its stock holdings (small, mid, or large cap) and based on style (value, growth, or blend). For example, a fund might be categorized a “small-cap value fund”.

Investors often hear the terms “value” and “growth”. Unfortunately, these terms are somewhat arbitrarily defined by the financial services industry. In Morningstar’s Category Classifications sheet, “value is defined based on low valuations (low price ratios and high dividend yields) and slow growth (low growth rates for earnings, sales, book value and cash flow)”. Likewise, “growth is defined based on fast growth (high growth rates for earnings, sales, book value and cash flow) and high valuations (high price ratios and low dividend yields)” (Morningstar 2016). In other words, these styles are defined based on simple and observable statistical variables, which Morningstar monitors to determine how a fund should be classified.

While investing should be about finding the highest-and-best-use of capital (the largest discrepancy between price and value) across the widest possible selection of financial securities, most fund managers strive to maintain “style consistency”, thus creating a further constraint on investment performance. However, a focus on style-consistency helps increase
a fund’s attractiveness in the retail sales channel as the fund will fit into a size-style allocation.

2.4. Mutual Funds and Retail Advisors

Many individuals seek the assistance of a financial professional, such as a financial adviser or financial planner, to help them choose investments. According to the Investment Company Institute, 80 percent of households which owned funds outside of an employer-sponsored plan purchased funds with the assistance of a finance professional (ICI 2017).

While these professionals provide many important services, some investment product recommendations are tainted with conflicts. For example, one common practice in the fund industry is known as “revenue sharing”. With this practice, fund sponsors pay the brokerage firms for favorable promotion. Many brokerage firms enact “preferred lists” of fund sponsors, with some brokerage firms even having fewer than 10 fund sponsors on the lists (Swensen 2005, p. 273). The preferred lists are, not coincidentally, assembled from fund sponsors who pay millions of dollars in revenue sharing fees to the brokerage, to the exclusion of thousands of mutual funds which may be a better fit for the client. Any client of a large brokerage firm should request a revenue sharing disclosure from the firm, although advisers at these firms are unlikely to admit to a conflict of interest.
Fund selection from large retail advisers is also likely to be limited to the largest fund families; i.e., those with the largest marketing and distribution budgets. Unfortunately for clients, these funds are also the most likely to suffer from the performance constraints discussed in this paper.
3. HEDGE FUNDS

Hedge funds represent another type of managed investment vehicle. Hedge funds are generally structured as private partnerships, with the fund manager as the general partner and the fund investors as the limited partners. Hedge funds generally avoid registration under the Securities Act of 1933 through an exemption from the registration requirements. Rule 506 of Regulation D is a common exemption used by hedge funds to issue limited partnership units through a “private placement”. The SEC limits participation to “accredited investors” as defined by Rule 501 of Regulation D. Among the several categories of “accredited investors” are (1) a natural person whose individual net worth, or joint net worth with their spouse, exceeds $1 million, excluding their primary residence, or (2) a natural person who has an individual income greater than $200,000 in each of the two most recent years or joint income with their spouse in excess of $300,000 in each of those years and has a reasonable expectation of earning that income in the current year. The net-worth threshold for hedge-fund participation is even higher when you consider that many established funds require a minimum investment of $1 million or more; however, newer funds may offer much lower minimum investments. Consider that a household would be advised to invest no more than 10% of their net worth in any single fund, the net worth threshold may be $10 million or more for participation in an established fund.
For individuals sophisticated enough and who meet the net-worth requirements, hedge funds can offer an alternative vehicle for active stock selection. However, many hedge funds are prone to the same performance constraints which we have discussed throughout this paper.

3.1. The Modern Origins of Hedge Funds

Benjamin Graham, the father of value investing, operated a private partnership in the mid-1920’s which possessed many of the features of the modern hedge fund (Aguilera 2012). However, Alfred Winslow Jones is widely considered the father of hedge funds.

Jones did not have a formal background in finance. After earning a PhD in Sociology from Columbia University, Jones worked as a journalist for *Time* and *Fortune* magazines. It was research which Jones conducted for a March 1949 article in *Fortune* magazine (which he wrote as a freelancer) which led him to eventually start an investment firm, A.W. Jones and Company (Morris 2015, p. 207).

Jones’ insight was that he could profit from both rising and falling stock prices by being “hedged”, i.e., by both owning and shorting stocks. Despite generating impressive investment returns, Jones ran his operation in relative obscurity until he was profiled by
Carol Loomis in an April 1966 article for *Fortune* titled “The Jones Nobody Keeps Up With” (Loomis 1966, 2013). The profile of Jones’ operation led to a proliferation of funds seeking to replicate Jones’ success. However, hedge funds remained a relatively small part of the investment industry for the next several decades.

### 3.2. Constraints to Performance

Hedge funds as a group were once known for consistently generating market-beating returns (“alpha”). Since the financial crisis, however, hedge funds as a group have underperformed the S&P 500 by over 50% (Authers and Childs 2016). While there may be numerous reasons for this underperformance, we will briefly mention three: size, increased competition, and short-term performance pressures.

Since the late 1990’s, institutions have become the predominant form of hedge fund investor. As a result, the amount of AUM in the hedge fund industry has increased from $100 billion in 1997 to over $3.2 trillion in 2017 (Ritholtz 2013; BarclayHedge). There is also substantial concentration of assets among individual funds. According to data provider Preqin, 92% of industry assets were concentrated in firms with at least $1 billion in AUM. Earlier in this paper we discussed the impact that size has on investment performance. The
hedge fund industry seems to suffer from the same size-induced performance drag as the mutual fund industry.

The total number of funds has also increased substantially. By some estimates, only a few dozen funds, catering mostly to affluent families, existed in the mid 1990’s (Ritholtz 2013). Although the number of funds has declined somewhat since the financial crisis, close to 10,000 funds were operating by late 2016 according to data provider Hedge Fund Research. The increase in the number of funds has greatly increased the competition among hedge funds, leading many hedge fund strategies to become “crowded trades”. Thus, many securities mispricing which in the past have been successfully exploited by hedge funds, have been competed away.

A final performance constraint which we consider is the increasing pressure of fund managers to outperform both their benchmarks and peer groups over increasingly short periods of time. Former hedge fund manager Neil Barsky stated the following shortly before closing his fund: “When I first started in 1998, we used to send out quarterly numbers. Now investors want weekly numbers” (Nocera 2009). This focus on short-term performance may be the result of an increasing number of intermediaries, such as “fund of funds”, wealth managers, and financial consultants, who are seeking to justify their existence and high fees.
One wealth manager with whom we spoke several years ago, boasted of having a proprietary database in which he compared monthly hedge fund performance. This short-term focus represents a clear constraint on a fund manager’s ability to deliver superior long-term performance.
4. BROKER-ASSISTED PURCHASES

For individual investors, one alternative to managed funds is to directly construct a stock portfolio with the assistance of a broker. Few brokers, however, have the training or the time necessary to conduct research on individual companies. As a result, brokers mostly recommend stocks based on the research from “sell-side” analysts.

Sell-side stock analysis, however, suffers from several major flaws. First, sell-side stock analysts are subject to the same short-term performance pressures as fund managers, leading many analysts to focus on predicting a company’s earnings and stock price over a period of less than a year. And studies show that analysts are not very good at making these short-term predictions (Malkiel 2011). Second, most sell-side stock analysts are focused on specific “sectors”. While this sector-focus leads the analyst to have very deep knowledge of a select group of companies, analysts are not widely comparing the attractiveness of stocks on an absolute basis. Third, thousands of smaller-capitalization stocks are not covered by sell-side analysts. And fourth and most importantly, sell-side analysis suffers from substantial conflicts of interest.
Organized stock trading in the U.S. began in 1792 when a group of traders met under a buttonwood tree at 68 Wall Street to negotiate an agreement intended to bring order to the business of stock trading. Among the issues to be addressed was establishing a fixed-rate for trading commissions. As historian John Steele Gordon put it, the agreement established “... a price-fixing cartel, designed to keep the insiders in and the outsiders out of a closed club that was restricted to New York’s most affluent brokers” (Gordon 1999, p. 40). From the signing of the “buttonwood agreement”, stock brokerages enjoyed a profitable business of matching buyers and sellers in stock transactions. However, on May 1, 1975, exchanges ended the fixed-commission system in favor of negotiated commissions. As the profitability of traditional brokerage business began to decline, large financial firms began to focus more on other forms of business, such as securities underwriting and merger advising for larger corporate clients. Since many corporations are either an existing investment banking client or a potential future client, sell-side analysts may be hesitant to issue less-than-favorable recommendations. Analysts can also come under pressure from institutional owners of the stocks. For example, Henry Blodget, a former Merrill Lynch tech analyst made famous for placing buy recommendations on stocks which he privately admitted were overvalued, recalls receiving phone messages from irate fund managers complaining that Blodget was not being optimistic enough about certain stocks (Mahar 2003, p. XVII). While several reforms were enacted to limit some of the abuses seen in the late 1990’s tech-stock craze,
the basic conflicts facing sell-side analysts still exist. The Wall Street Journal recently profiled a relatively new and increasing conflict of interest facing analysts: “...analysts' relationships with company executives, including the ability to line up private meetings for investor clients, have become an increasingly vital revenue source. And that is increasing the pressure for analysts to be bullish on the publicly traded companies they follow.” (NG 2017). Many companies, according to the article, are denying access to those firms who issue a negative recommendation.

These are only some of the conflicts facing sell-side analysts. The consequence for individual brokerage clients, unfortunately, is that they should generally not expect objective research from brokerage firms.
5. CONCLUSION

The goal of active investment management is to generate superior long-term performance. While markets may be mostly efficient and highly competitive, institutional constraints in the investment industry make long-term outperformance increasingly difficult. In recognition of this, many individual and institutional clients have increasingly invested in passive investment strategies.

The broad criticism of active management has ignored many performance constraints which we have identified in this paper. Rather than abandoning active management altogether, individual investors can greatly enhance the chances of achieving superior long-term capital appreciation by identifying those firms that have minimized the performance constraints identified here.

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