

In what extent active management brings more value to its investors than passive management?

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Declaration

I, Sébastien DUVALLET, declare that this research is my original work and that it has never been presented to any institution or university than the Dublin Business School. In addition, I have referenced correctly all literature and sources used in this work and this work is fully compliant with the Dublin Business School's academic honesty policy.

Sébastien DUVALLET
23/05/2016

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My last thoughts go to my grandmother. This dissertation is fully dedicated to her, she has been in my mind since the day I started the MBA programme at the Dublin Business School.

Abstract

The main purpose of this study is to understand in what extent active management brings more value to investors than passive management. This study attempts to answer the theories stating that passive management performs better on the long term than active management.

Since a few years, financial markets are marked by speculation and mainly the rise of algorithmic trading, also called high-frequency trading.

Sources used in this dissertation come from secondary and primary data. The former were collected in books, journals, academic articles, newspapers, and Internet to constitute the literature review. The primary data were gathered by realising semi-structured interviews of fund managers, using active management methods.

In the first part of this dissertation, the literature review is a critical analysis of the subjects surrounding the study. The author defines and identifies the factors impacting fund managers' portfolios. The managers' psychology is seen as one of those factors and is developed with the help of Behavioural Finance.

The second part of the study implement the primary data gathered from the interviews. The information is presented, analysed, and used to answer the research questions, as stated in the introduction.

This qualitative dissertation describes and analyses the factors impacting fund managers and their portfolios. It has for objective to understand why active management is known to not perform better than passive management, and what value could it bring to investors.

This research contributes in helping fund managers to use the right investment strategies and philosophies to earn higher returns, and investors to recognise the interest active management can have by giving them the tools necessary for their choices.

As it is a qualitative study, mathematics and algorithms do not enter the scope of this study.

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Chapter 1 – Introduction

I- Understanding the different kind of management

Managing a fund requires a strategy, a framework that will guide the fund managers in their investments, and the investors trusting them to earn higher returns than the average.

Three main fund management types exist: active, passive (or indexing), and alternative (the researcher will have a closer look on hedge funds regarding this dissertation). Each one of them serves a different purpose whether you are an investor in a fund or a fund manager. The only shared objective is a performance allowing the two parts to obtain returns year after year.

Active management

The purpose of Active management is to outperform a “benchmark”, i.e. a market taken as a reference. In other words, a fund manager that has for objective to invest in European stocks will take as benchmark the Eurostoxx 50 for instance.

To overperform his benchmark, the fund manager needs to find the stocks that perform better than the market of reference.

The definition given is very broad here; it is true that active management is the main management type amongst the long list of funds managed across the world. Those funds can take a lot of form in their investment strategy, ranked by the risk they carry, asset class used or geographical repartition of the stocks.

But the fundamental principle underlined in this section is that whatever the shape taken by the fund, the purpose of the portfolio is to beat their market of reference.

Passive management

By definition, passive management is the opposite of active management. The passive fund manager will have for objective to build a portfolio replicating or tracking performances of a market of reference, a market index (such as CAC40, Dow Jones, etc...).

The main advantage for an investor is the cheap costs incurred. As for the fund manager, tracking a market index require few efforts (Tuchman, 2013).

Just like active funds, passive management is divided into multiple methods, with any instruments available for the fund manager.

If active management seek higher returns by beating its market of reference, then passive management will try to earn higher returns on a longest horizon replicating a market index.

Alternative management: the hedge funds

The third type of management refers to alternative funds, the “hedge funds”, very popular in the United States in the 2000s and known to the public since the financial crisis of 2008.

Hedge funds don't try to beat a market or replicate it, but try to earn the highest returns possible. If the performance is not correlated to a market or a benchmark then it depends only of the fund manager's performance.

This type of investment is known to be very aggressive in a sense that it requires the investor to keep his money in the fund for one year at least, and because it often uses derivatives and leverage strategies to obtain the highest returns possible.

The three types of fund, management, defined above are the most important to know for the reader, implying that some others and several versions of the ones mentioned exist.

The researcher decided to introduce active, passive and alternative management only to contextualise the topic. Also, the study is not about comparing the strategies but what factors affect the different management's returns and how (see the section III and IV of this chapter).

II- Background of the topic

Today's techniques and instruments of investments are very broad: from high frequency trading using algorithm to invest in less than a second, to indexing using trackers that copy the movement of a sector, industry or even the whole market. Regarding the instruments, some are riskier such as derivatives (they are one of the reasons for the last financial crisis of 2008), stocks, and some are seen as safer like bonds.

For each techniques or instruments used to invest, few fund managers succeed to beat the market when there are lot of investors working for banks, portfolio management companies, hedge funds, etc (Bogle, 2007).

One of the reasons for that are the costs impacting the portfolios. John Bogle, CEO of The Vanguard Group and famous investor on Wall Street, wrote that “There are, then, these two certainties: (1) Beating the market before costs is a zero-sum game; (2) Beating the market after costs is a loser's game” (Bogle, 2007). The idea expressed here is that for a buyer on the market there is a seller, so when one of them wins the other loses. But when adding the costs of investing, the two of them might be losers if the costs are too high to compensate the returns earned.

However, some investors earn high returns, even on the long term. The best example is Warren Buffett who uses value investing techniques and who built an empire with it. The fundamental principle for value investors can be summed up by Benjamin Graham's own words, mentor and professor of Warren Buffett at Columbia: "A stock is not just a ticker symbol or an electronic blip; it is an ownership interest in an actual business, with an underlying value that does not depend on its share price" (Graham and Zweig, 2003).

In value investing, the costs are not taken in account, but the idea is to see stocks as true ownership of a business. Therefore, investing must rely on calculation, evaluation of the business and paying the lowest price for one share. Benjamin Graham goes further, he considers the market (that he calls "Mr Market") as a place that allows the investor to buy or sell shares only, and not as a true reflection of what a business is worth (Graham and Zweig, 2003).

Whatever value investors think of Mr Market, the reality is that two theories are confronted: whether the market is efficient or not. A market is efficient when the "stock prices reflect everything that is known about a company's prospects and about the state of the economy" (Buffet, 1984). This is an important theory in the context of this research because if this is the case there would be no opportunities on the market, and if the market is inefficient there would be no mean of making profits (Mauboussin and Callahan, 2015).

Also, the emotions of fund managers/investors make the difference between beating the market and losing money. The psychological state of a fund manager must be considered when he builds his portfolio as it can cost him a lot in market timing or by just following the same purchases that the others make (that's what cause the bubbles of 2000 and 2008). These emotions are reflected in the prices given by the market: when the stocks are undervalued the market is pessimistic and when they are overvalued it is optimistic (Graham and Zweig, 2003). The job of value investors is to detect those undervalued to make profits when the market corrects and adjust the stock price. This is the difference between intrinsic value and stock price.

Finally, one way of investing at low costs proved to be efficient: indexing. Index funds track the performance of a sector, an industry or even the whole market. This is a long term way of investing that allows fund managers to at least get the returns earn by the market. "Indexing is superior to conservative investments in the long term. Although there were some huge market crashes after 2000 and 2008, the results of indexing were significantly better compared to conservative money market investments." (Chovancova and Arendas, 2015). The downside to indexing is the long term horizon needed to record important returns. In an era of short term speculation, index fund managers seem marginal but yet obtain good results compared to traditional active managers.

The observation than can be made here is that the different debates at the centre of asset management have been focused on "what strategy allow fund manager to earn the highest returns?" The new concepts of behavioural finance see the fund manager as the main tool

that allow him to earn high returns but also as the main problem that deprives him of getting even higher returns.

In this context, this dissertation will not focus on the strategies themselves in depth but on the factors affecting the fund managers, their portfolios, and the value brought by active fund managers to their clients.

III- Research objectives

Research objectives can be defined as different statements of goals that orient the research (Calmorin et al, 2007). Saunders, Lewis and Thornhill (2007) wrote that “research objectives are likely to lead to greater specificity than research or investigative questions”.

In other words, research objectives are a guidebook for the researcher building the dissertation.

For the reader, these objectives must attest of the researcher’s knowledge of the topic, the direction taken and the goals set (Saunders, Lewis and Thornhill, 2007).

The research objectives, or, the purpose of this dissertation can be presented as followed:

- Identify the factors affecting a fund manager’s chances of earning higher returns.
- Understand what hinders active management to perform better than passive management on the long term.
- Assess what can be the value brought by active management for investors.
- Make recommendations for fund managers on how to minimise the factors impacting their portfolio, returns, strategy or themselves; for investors on why they should use active management rather than passive management in certain cases.

IV- Research questions

The research question is what determines which methodology will be used by the researcher (Patton, 1990). Coll and Chapman (2000) assert by saying that “what is necessary is appropriate research design”. Therefore, the research questions need to be a guide through the dissertation for the researcher but also for the reader.

Also, Randolph (2009) wrote the following statement:

“Problem formulation begins with the determination of the questions that will guide the literature review. These questions should be influenced significantly by the goal and focus of the review.”

The research objectives being fixed, the research questions below will orient the reader in what he should expect to find in the core of this dissertation. From the literature review to the conclusion, the reader should keep in mind the following research questions, as they result from the research objectives previously presented, and are what the dissertation is about:

1) What factors affect a fund manager’s chances of earning higher returns on the stock market?

The objective of this question is to identify the factors affecting a fund manager’s chances of earning higher returns.

2) Why passive management performs better than active management on the long term?

To answer this question, the researcher will evaluate the factors allowing passive management to outperform active management’s returns.

3) Why investors should consider active management rather than passive management?

The last research question’s purpose is to assess the ability for active fund managers to earn higher returns than passive management, and the value brought to investors, their clients.

V- Scope and limitations of the research

The scope of the dissertation can be seen as a topic narrowed to a precise subject. According to Peter Levin, “narrowing a subject down involves setting boundaries to it” (Levin, 2011). The research will focus on the factors influencing fund managers’ portfolios, their psychology, and how active management can still be a relevant investment.

To do so, the researcher will use the literature review to identify the factors, and the qualitative data under the form of interviews from fund managers.

The reader will not find an in-depth explanation and comparison of investment strategies as it adds no value to the study. Nonetheless, some of the strategies such as value investing and indexing, will be mentioned since parts of their structure are related to the topic.

Also, the qualitative data (interviews) cannot reflect the thought of every fund managers. The time and research limitation allow the researcher to interview only a small sample. However, the analysis will take in account the size of the sample.

Finally, nowadays asset management is highly oriented towards mathematics and computerized algorithm. This dissertation will only be focused on fund managers' psychology, known factors impacting their portfolios and asset management strategies. Mathematics and algorithm do not enter the scope of the study.

VI- Contributions of the study

The study aims two kind of persons:

- First it aims the fund managers and their employers (banks, portfolio management companies, hedge funds, etc). By simply explaining the existence of factors impacting the fund managers, their portfolios and therefore their returns, the study finds its purpose by helping them identify what those factors are and how they can deal with them. The benefits will be higher returns and more satisfied clients.
- The second contribution targets the investors, client of the funds. By showing them what the fund managers face on a daily basis, it also helps them in their decision of investment at the moment they need to choose a fund.

On a wider range, the contribution of this dissertation is an up to date study of what composes the asset management landscape. It helps fund managers realise that simple (but not easy!) theories can help them earning high returns, and investors are given tools to recognise the management that suits them best.

VII- The organisation of the dissertation

The dissertation is broken down into six chapters, each one serving the purpose of helping the reader understanding the ideas and positions of the researcher. Their content is as followed:

Chapter 1 – Introduction

The introduction carries the following seven sections: understanding the different kind of management, rationale for undertaking this topic, research objectives, research questions, scope and limitations of the research, contribution of the study, and the organisation of the dissertation.

The purpose of this chapter is to introduce the topic, its background, the research objectives and to give an overview of the content the reader should expect to find in this dissertation.

Chapter 2 – Literature review

This chapter is key for the dissertation as it raises all the academic, scientific and knowledge existing on the topic researched. The reader will find all the secondary research gathered to settle the framework of the topic.

It is mainly composed of all the theories and opinion about the factors affecting fund manager's chances of earning higher returns.

Chapter 3 – Research methodology

The research methodology describes the path taken by the researcher building the dissertation and more particularly gathering the primary data. It is composed of the following sections: methodology introduction, research design, and limitation of methodology.

Each section will explain the choices made by the researcher to undertake or not the methods necessary to the good conduct of the research.

Chapter 4 – Data analysis and findings

After presenting the research methodology, this chapter aims to analyse the primary data collected and the results arising from them. The reader will find analyses and results from qualitative data. The choice of gathering primary data will be expressed in chapter 3.

Chapter 5 – Conclusions and recommendations

This chapter will be the final point of the dissertation regarding the study undertaken. It aims to present the conclusions by answering the research questions and giving recommendations to fund managers, investors or anyone carrying interest to this topic.

Chapter 6 – Self-reflection on own learning

The last chapter is a personal reflection of the experience researching, analysing and writing this dissertation.

It will start by presenting the one-year learning experience at the Dublin Business School Master's programme. Then, the researcher will express the influences of the courses undertaken during the year on the construction of the dissertation.

The end of this chapter will be dedicated to the experience's assessment of this work and how it will help the researcher integrating the professional world.

Chapter 2 – Literature review

I- Introduction

Blaxter et al (2010), state that the literature review has for purpose to give the background, the context of the topic, and to provide information on what has already been said around the subject.

Ridley (2012) goes further by writing that its goal is to link what the literature says about the topic and where the author expresses his point of view regarding those sources.

In this second chapter, the author will present the sources found in the literature about the topic, with a critical mind. From the factors impacting the portfolio and the fund managers, to the presentation of value investing and indexing, the reader should expect to find the literature surrounding the topic from the researcher's point of view.

Those sources found in books, papers, and academic journals don't answer the research questions but are the foundation of the research.

Randolph (2009) says that "if the literature review is flawed, the remainder of the dissertation may also be viewed as flawed". Building a literature review is a difficult task. For that reason, it is divided in clear sections to facilitate the reading.

The topics covered are economics, behavioural finance, portfolio management and management strategies.

II- The factors impacting the portfolio

Transaction costs and turnover rate

Fund managers' portfolio are subject to direct costs; they take the form of fees or commissions and will be referred as transaction costs in this section.

For each transaction made by a fund manager, a cost will be applied by his intermediaries (brokers, financial counsellors, investment bankers, etc.). The more a fund manager will buy or sell shares, the more he will pay fees and commissions.

When realising a transaction on the market, before any movement in the stock price happens, the only winners are the intermediaries because they get a commission for both sides of the transaction (Lynch and Rothchild, 2000).

By the effect of those costs and trading too actively fund managers hinder themselves from having returns superior to their benchmark or even having positive returns (Basu, 1977; Rubinstein, 2001).

Maneesh Shanbhag, founder of Greenline Partners, showed that reducing the transaction costs by 2% per year results in three times more capital gains after 50 years (Stefanova, 2014).

At this stage it is relevant to say that a lot of actively managed funds fail to beat their benchmark by 1% or 2%. If they can reduce their transaction costs, they would have at least as much returns as their benchmark.

Investors in managed funds are also subject to costs. If most of them can be found in the fund's prospectus (document that presents its investment strategy, limits, costs and legal information), some of them are hidden because it is not a requisite to be shown on the prospectus.

For example, the transaction costs paid by the fund manager will be incurred by his clients under the form of management fees. But, the turnover rate is not always available to the clients. It is not a direct cost but it is a measure of the fund manager's activity that can help clients to determine whether the fees are high or not. For a €1 billion fund, a ratio of 50% means that he bought €500 million worth of shares and sold another €500 million. John Bogle noted that from 1945 to 1965, on the US stock market, the turnover rate averaged 16% per year when it averages 100% per year nowadays (Bogle, 2007).

Inflation

Inflation is the generalised increase of prices, most of the time measured by the "Consumer Price Index" (CPI). This economic indicator, published by all the countries, has a growing importance since decades.

The European Central Bank (ECB) has for main objective "to maintain price stability: safeguarding the value of the euro" (www.ecb.europa.eu), measured by an inflation indicator around 2%. The Bank of Japan has a similar objective due to a deflation period over twenty years. The Fed (for Federal bank, central bank of the USA), has a double objective: inflation and full employment (Jovène, 2016).

Inflation is a cost for fund managers. Because 1€ in 2000 is not equal to 1€ in 2010, returns are affected by the inflation. A fund manager will pay his costs (fees, commissions, taxes) in current currency year after year, while in the same time assets are valued in "real currency", eroded by the inflation (Bogle, 2007).

Two things need to be taken in account here. First, it is impossible for a fund manager to influence the inflation and therefore he can only be a "victim" of it. Second, the inflation rate taken by Bogle in his calculation is a mean calculated over a certain period when, in reality, some periods can be deflationists or hyper-inflationist.

Nevertheless, if no correlation has been proved between inflation and performance of the stock market, behaviour of investors have shown some connections. When confronting performances of the stock market with the bond market, the former showed a better

resistance to the increase of prices on the long term (Benz, 2016). It is important to note that it was helped by the low returns offered by bonds over the past three decades and a deflationist politic sets by most of the countries.

Finally, Benz (2016) wrote in an article on Morningstar website that one possibility of hedging exists for fund managers: “wide moat stocks” (stocks from companies having a competitive advantage). The more “wide moat stocks” in a portfolio, the less impact inflation has on returns.

This can be explained by the fact that investors who are confronted to low interest rates and uncertainty about the future of the economy, tend to favour stocks from companies having a strong balance sheet and potential in its cash-flows’ growth.

Market timing

Market timing is the fact that a fund manager is able to buy a share where the price is at its lowest and to sell it at its highest price. It is basically the job of any investor on the market. But it becomes a cost when the investor don’t have a good timing (Graham and Zweig, 2003).

For instance, this is what happens during and after a bubble explodes. In 2000, it was the rush after technological and dot com stocks. From the middle of the 1990s to the year 2000 a lot of investors earn a lot of money with stocks that showed important returns. But, other investors believing this would continue for years onwards, finally decided to listen to their financial adviser, and bought shares just before the Internet bubble exploded. This left nothing for most of them.

This is what Bogle called “the near-inevitability of counterproductive market timing” (Bogle 2007).

This is relevant to our topic as investors tend to follow their emotions, news and what the majority of the crowd thinks, and end up buying when the market is at its peak and selling when the market is at its lowest.

Exchange rate

This section refers to all the fund managers investing in stocks in a different currency than the country they work in. Obviously, the exchange rate influence the returns of a portfolio when it is not favourable for their “home currency”.

This obliges the fund managers to intervene on the Forex (Foreign Exchange), market for all the currencies. It is a highly volatile market and therefore very risky.

Also, fund managers who invest in foreign stocks see their transaction costs increase. If their portfolio is made of plenty of those shares and the exchange rate is unfavourable, his returns

will be eroded or this even can make the difference between having positive returns and having negative returns (Graham and Zweig, 2003).

By investing on the Forex, the fund manager also reduce his money available to invest in stocks or bonds in favour of instruments riskier, on a market very volatile. Investing in foreign stocks is therefore a strategy far from being optimal to obtain greater returns.

Taxes

The last “visible” costs incurred by fund managers are the taxes. Each capital gain realised on a transaction is taxed, as well as the dividends earned each year.

After tax, portfolios (whether they have a speculations or investment form) seem to have difficulties obtaining superior returns than the market and even positive returns (Basu, 1977). Also, the more a fund manager is active, i.e. his portfolio has a high turnover, the more he will pay taxes.

This means that a fund manager has more interest in selling his shares at the right time, when he thinks he reached the maximum returns he could expect from a company (Bogle, 2007; Graham and Zweig, 2003).

Also, actively managed funds have troubles to overperform their benchmark after transaction costs but also because of taxes. The time stocks are held in portfolio nowadays is under a year when 50 years ago it was 10 to 15 years (Bogle, 2007; Graham and Zweig, 2003). It affects directly the returns of fund managers: besides paying taxes on dividends and costs under the form of commissions and fees, fund managers pay taxes more regularly now than decades ago.

Finally, in a time where high frequency trading and speculation is famous, some strategies such as indexing are known as “tax-efficient”. The more a fund manager is passive, the less he will pay taxes.

III- The factors impacting the fund managers

Behavioural finance: the fund managers’ emotions

Martin Sewell (2010) defines behavioural finance as “the study of the influence of psychology on the behaviour of financial practitioners and the subsequent effect on markets.”

What is commonly said in the world of financial markets is that investors, traders or fund managers are driven by greed or fear in their decision-making process (Byrne and Utkus, 2013).

Behavioural finance applies theory from Psychology to investment behaviours. The findings show that some biases exist and affect the decision-making process.

The first bias is **overconfidence**. Some researchers found that people tend to have an optimistic view on the world and on their own capabilities compared to others (Byrne and Utkus, 2013). In the investment world overconfidence is translated when, for instance, a fund manager thinks he is totally in control and his skills are better than the average investor on the market. By overestimating their abilities they forget the overall view of the market and the effect it can have on his portfolio.

Overconfidence also often leads to trading too much without thinking the costs incurred (Rubinstein, 2001). The problem of being too active on the market brings the opposite reward; Barber and Odean (2000) confronted results of investors according to their trading frequency. They found that the investors the most active underperformed the returns of standard benchmarks because of transaction costs (Barber and Odean, 2000). But in terms of behaviour, what explains underperformance and excessive trading is overconfidence (Barberis and Thaler, 2003).

Another bias linked to overconfidence is the fact that when a fund manager has successful earnings he will automatically believe it is due to his skills. But if he records loss it is due to misfortune.

Loss aversion is the second bias. Traditional finance rests on the risk/return couple. A fund manager will accept to take a certain amount of risk depending on the return expected from the investment. The more risks are taken, the more returns are expected.

Behavioural finance rather asserts that an investor is more influenced by probable loss than the risk/return couple (Byrne and Utkus, 2013).

In other words, when an investor is in a favourable position (earning profits from a position), his behaviour is highly risk-averse. But, when he is in position of loss, this is the moment he is the least risk-averse, driven by the hope of earning back profits.

Looking at this second bias, the fact an investor is willing to take more risks when he holds a losing position, shows also the link with the first bias, overconfidence. This is what drives him to think he can earn back what he lost.

Also, holding a losing position too long is what Professors Shefrin and Statman (1985) refers as "the disposition effect". In their conclusions they found that investors willing to sell winners too quickly and hold losers too long affects the returns of a portfolio.

Behavioural finance, through the explanation of these biases, brings a proof that fund managers are driven by their emotions that often harm their returns. Benjamin Graham started a course saying to his students at Columbia Business School: "if you want to make money on Wall Street, you must have the proper psychological attitude" (Legacy of Benjamin Graham: the original adjunct professor, 2013).

His statement underlines the difficulty for investors to think by themselves, for themselves. Indeed, rather than having their own opinions and stick to it when every other actors on the market think differently, investors tend to follow the opinion of the majority.

Also, Benjamin Graham wants his students, his readers, or everyone listening to him, that the majority of fund managers fail to beat their benchmark, beat the market or even earning returns year after year. And yet, an individual investor, as expert as he can be, will follow the crowd opinion at some point.

In the 1940s, Solomon Asch, a social psychologist realised an experiment about social conformity. He placed eight people in a room including seven accomplices of Solomon Asch. He showed them three lines of different lengths. Then, he presented one line and ask them to tell him which one of the first three match the new line.

One after the other they gave their answer. Some of them were wrong on purpose, the goal being to know how much persons would conform to the majority or stick to their opinion.

On 12 “critical trials” (when every accomplices in the room gave the wrong answer), 75% of the participant followed the opinion of the others (McLeod, 2008).

The results show that an individual tends to follow the crowd opinion because he thinks they know better than him or because he is afraid to stand alone (Mauboussin and Callahan, 2015). This can be summed up by John Maynard Keynes’ statement in his General Theory of Employment, Interest and Money (1936): “worldly wisdom taught that it is better for the reputation to fail conventionally than to succeed unconventionally”.

Finally, one last trait of an investor’s emotions is his tendency to overweight new information and underweight previous one when making a decision (Bondt and Thaler, 1985). Recent and extreme news have important consequences on stock prices (Keynes, 1936). The daily flow of information is overwhelming. Therefore, fund managers lose track of older information and have difficulties to see the bigger picture. By this mechanism of “mis-weighting” information, fund managers led themselves to bad market timing.

Market inefficiency and psychology in the literature

When investing on the market, the worst enemy of an investor is himself, i.e. his emotions (Graham and Zweig, 2003). Irrational behaviours support the theory of an inefficient market (Shleifer, 2000). Emotions of fund managers are driven by an asymmetry of information in the market.

A market is efficient when the information is the same for every actors and therefore the prices reflect the reality. If all investors interact on the market with the information at their disposal, then the market is efficient and the prices adjust to all the bet placed on the market. Just like voting at an election. (Hayek, 1945).

The liberal Hayekian hypothesis is based on the assumption that every investors have the same information.

It is true to say that financial theories are not an exact science. That is why the debate is still open to know whether markets are efficient or not.

The Efficient Market Hypothesis (EMH), developed in the 1970s by Eugene Fama, asserts that the stocks are priced correctly; in other words the market gives prices representing the fundamental value of a company according to the information available at the disposal of all the investors.

Those in favour of the EMH maintain that the market is more and more efficient with the automatization of the financial markets. Despite more performing computerized systems, the decision remains human, influenced by his emotions.

The main critic made by theorist in favour of an inefficient market is that some fund managers are able to find discrepancies in stock prices, allowing them to overperform the market. Also, market efficiency assumes that investors are rational, but behavioural finance showed that fund managers are driven by their emotions.

First, the volatility of the market demonstrate that the theory of an inefficient market is more plausible: “emotions” of Mr Market (Graham and Zweig, 2003) are visible when speaking about a bull market or a bear market. If the market is optimistic it will overvalue the stocks, if it is pessimistic it will undervalue the stocks.

Those short-term changes in stock prices do not reflect the fundamental value of a company but the emotions of the actors on the market.

In those conditions of high volatility it is hard for investors to control their emotions and that's when they tend to follow the “crowd” (Mauboussin and Callahan, 2015). The direct consequence is that they are pushed to buy shares when they are overvalued (bull market) and sell them when they are undervalued (bear market).

An inefficient market causes market timing mistakes that burst the returns of a fund manager.

But, the same volatility and market inefficiency can allow fund managers to take advantage of discrepancies in stock prices and thus having excess returns.

Basu demonstrated in 1977 that investors in low Price Earning ratios stocks earned excess returns, larger than high Price Earning ratios (Basu, 1977).

In other words, in an inefficient market, some stock are undervalued and others overvalued. This short-term volatility creates opportunities for fund managers: as the stock prices adjust on the long term, fund managers that are able to invest in undervalued stocks will have excess returns if they hold their positions on a long period.

Theorists like Mark Rubinstein are more nuanced when trying to prove if the market is efficient or not.

Rubinstein introduces the concept of “minimally rational markets”. It is the idea that the market can be inefficient but investors can't find profit opportunities because some obstacles hinder them from investing and taking advantage of this situation. (Rubinstein, 2001).

He goes beyond the idea of an efficient or inefficient market. Some factors must be taken in account by fund managers to invest in a stock. It is not because the market sends a signal

that stock prices are undervalued that the fund managers will find the right company to invest in.

To him, the fact that investors spend too much on research and trade too fast are proofs that the market is at least minimally rational: average funds would be average investors so logically they would have average performances. But he asserts that they are not average investors as they have more means for research and advantages from economies of scale. "If the market were not minimally rational, the extra cost would surely be worth the effort" (Rubinstein, 2001).

He also finds the opposite true: "If markets were maximally rational, investors would probably trade relatively infrequently and would make intensive use of index funds". (Rubinstein, 2001)

Finally, the fund manager must be convinced of his own judgement and expertise, and only consider the market as a place where he can buy and sell shares, not a source of information (Graham and Zweig, 2003). This is the only way to control his emotions and take advantage of the discrepancies of prices from an inefficient market.

Portfolio Management: from Markowitz to naïve diversification

It is hard to write about portfolio management without starting to speak about Harry Markowitz's portfolio theory. He is a Nobel Memorial Prize winner in Economics. His work in 1952 on Modern Portfolio Theory changed the investment world. Before him investors were selecting high-yield stocks without thinking about the repercussions on their portfolio. He underlined the importance of portfolios, risk, diversification and the correlation existing between securities.

In 1976 he wrote the following statement in his book Portfolio selection: "to reduce risk, it is necessary to avoid a portfolio whose securities are all highly correlated with each other" (Markowitz, 1976).

With his efficient portfolio concept Markowitz asserts that an optimal diversified portfolio exists and is based on the following postulates:

- The investment took place on a single period
- There are no transaction costs
- Investors took in account only two criterias: the risk and return expected
- Markets are efficient
- Investors are risk-adverse.

His theory integrates the idea that fund managers must diversify their portfolios by choosing assets that are not correlated and by taking in account the couple risk/return of an asset.

The difficulty of building a portfolio is the broad range of financial instruments a fund manager has at his disposal: derivatives, stocks, bonds, currencies.

In the literature, derivatives and currencies are considered riskier as the first imply a lot of costs and leverage, and the second due to the volatility of the market.

Graham consider than depending on the state of the economy and the type of investor (active or passive), an investor must keep the weight of this portfolio between 75% of stocks and 25% of bonds or 75% of bonds and 25% of stocks (Graham and Zweig, 2003).

Investing in the instruments less risky and the way a fund manager will build his portfolio (through diversification) will allow him to capture more return in a more efficiently manner. Or, as Asness et al (2015) explain in other words: “the most reliable way to sustained investment success involves cost-effectively harvesting multiple return sources that have low correlation with each other” (Asness et al, 2015).

But, Markowitz already knows in 1952 that building a portfolio is a complicated task. He recognizes two stages to build a portfolio: the first stage is about observing the market and acquiring experience. The second stage is about anticipating future performance and choosing the right asset weighting in the portfolio (Markowitz, 1952).

This division into two stages highlight the difficulty for a fund manager to build his portfolio. Following the theory of Markowitz, he must reduce the risk of his portfolio by choosing assets that will give him the most returns. This is where the reality of the market strikes: the selection of assets is based on forecast about future performances (the highest expected return of an asset, the riskier it is), and the efficiency of the market needed by Markowitz’s theory has not been proven to this day.

Shefrin and Statman, behavioural economists, created the behavioural portfolio theory. This theory is based on mental accounts by the sense given by the economist Richard Thaler: investors divide their assets in groups. Each one has a specific purpose, utility that affects investors’ decision making process and behaviour (Thaler, 1999). The behavioural portfolio theory is formed of a “layered pyramid” (Byrne and Utkus, 2013), one layer representing a mental account. The base of this pyramid represents the assets used as insurance against poverty (conservative investment mainly to avoid losses), and the top representing hopes of becoming rich (investment in riskier assets for a high expected return). Shefrin and Statman adds that this layered pyramid helps to understand the investors’ behaviour, as they can take risk and insurance at the same time, depending on which mental account they use (Shefrin and Statman, 2000).

The relevance of Markowitz’s theory appears well in the need for diversification. Shefrin and Statman notes that investors see mental accounts separately when they need to see them at one single portfolio.

Byrne and Utkus (2013) note the tendency for investors to have an attitude of “naïve diversification”. When they lack information they will diversify their portfolio in the simplest manner possible without taking in account the risk and expected return of each asset class. That kind of diversification is called “naïve” because it can lead investors to build portfolios based on only equities, or only bonds for example. The reason why this is possible is the known rule in the investment world saying that an investor must invest only in familiar assets,

when with little help or via funds he could diversify his portfolio, reduce its risk and increase its return.

To conclude this section, some exceptions to the rule exist. Warren Buffett made his fortune by investing only in stocks and bonds. Whereas he is in favour of diversification to cover the risk of a stock plummeting, investing in only two asset classes is not really considered as diversification in the sense of Markowitz.

In his letter to Berkshire Hathaway's shareholders of 1988, he says "in addition to our three permanent common stock holdings, we hold large quantities of marketable securities in our insurance companies." (Buffett, 1988).

As he explains not long after, what is looking for when building his portfolio is investments in assets he understands and providing him with high after-tax expected returns. He adds, "our goal is to maximize eventual net worth" (Buffett, 1988).

The diversification strategy put in place by Buffett is based on confidence, knowledge in assets he understands, and a lack of confidence for any financial instrument requiring leverage.

IV- Active and passive management in the literature

Warren Buffett's value investing

Value investing is a technique of investment born from the mind of Benjamin Graham and David Dodd in the middle of the 20th century. It has been popularized by Warren Buffett (student of Graham at Columbia) who built an empire with value investing.

Most of the ideas of Buffett comes from Benjamin Graham, but he improved his investment techniques with experience he gained working in financial markets.

Value investing is based on few principles, known to all analysts and investors who read and tried to learn from Warren Buffett. His investment principles have been subjects of numerous books, from specialists are people close to him.

The first principle is a fundamental analysis of a company. He doesn't look at financial statements of a random company. The type of company he is ready to value is one benefiting from a competitive advantage: a company which offer a product that customers are willing to pay a high price and brings more value than competitors' (Angwin et al, 2014). This competitive advantage gives a company a situation of monopoly on the market as they can sell more products or at a higher price than the competition (Buffett and Clark, 2011).

If Buffett innovates Graham's theory with this concept, he goes further by seeking the best companies, those with a sustainable competitive advantage, such as Coca-Cola; it sells its product since more than a century and there's a high probability that it will still be the case a century from now.

Once Buffett identifies a company with a sustainable competitive advantage, he will, just like every analysts, study its financial statements. His primary focus is on data showing good and stable earnings rather than exceptional results coming from radical changing in the company's structure, his business or changes in the management (Buffett, 1988).

He also look at the liabilities on the balance sheet. What he calls a "good" company is one that doesn't use leverage; it is a sign of a healthy management.

Those are few examples of how he considers a company worth investing in from the financial analysis point of view.

The second principle is a close look at the top management of a company. Governance is an important criteria in his decision making process. A good company is run by exceptional managers and take in account the shareholders even in minority (Buffet, 1988). Exceptional managers are people able to manage debt, having a long term vision in their decisions for the future of the company, and act as leaders. In his letter to Shareholders of Berkshire Hathaway in 1988, Buffett describe the role of managers:

"Our managers protect their franchises, they control costs, they search for new products and markets that build on their existing strengths and they don't get diverted. They work exceptionally hard at the details of their businesses, and it shows."

The third principle is buy only undervalued stocks. When his fundamental analysis ends he knows what a company is worth, its intrinsic value. He will only buy the stocks that give him a margin of safety: the stock price is far lower than the intrinsic value (Graham and Zweig, 2003; Chovancova and Arendas, 2015).

The "buy and hold" logic (buying stocks and holding the position as long as the company grow) allow Buffett to wait for market prices to adjust to the intrinsic value he calculated. He is willing to sell only if the business changes radically, the management is not honest, or if the market overvalue the company.

The fundamental analysis is then really important and has to be very precise. It is important to note that the market value of a company is only a criteria in his process of investment; what he uses to judge if his margin of safety is high enough (Buffett, 1988).

Value investing is based on the expertise on how to value the business of a company, and allow fund managers to obtain superior returns on the long term as it is a buy and hold technique. The low turnover ratio and prudence in the valuation make this technique of investment an efficient way of beating the market.

John Bogle's indexing

Indexing is a passive management strategy. As said previously in the introduction, the passive fund manager will have for objective to replicate or track performances of a market of reference.

If active management seek higher returns by beating its market of reference, then passive management will try to earn at least the return of the market replicated.

Active managers buy and sell stocks more or less frequently whereas indexing consists on replicating a market by building a portfolio with the stocks of that same market. The portfolio requires few attention from the fund manager: as he seeks to earn at least the returns of the market of reference, the portfolio is automatized.

Graham advises this type of investment for individual investors who are willing to invest in stocks without spending too much time watching it (Graham and Zweig, 2003).

William Bernstein, financial theorist and neurologist, says that an individual investor takes too much risk by failing to diversify his portfolio, he would be better by simply buy a “well-run index fund and own the whole market” (Bernstein, 2002).

John Bogle, founder of the Vanguard Group, has been one of the best fund manager in the indexing world for decades. Just like value investors, he looks at the growth of businesses and not at what the market has to offer. He noticed that over the last century US companies have earned “a return on their capital of 9,5% per year” (Bogle, 2007). Knowing that the last century had two world wars and two major financial crisis, an investor owning the market at the same period would have earned a lot.

Indexing requires few efforts but a very long term horizon of investment. That investment strategy proved to get better returns than active ones, but needed a longer horizon to do so (Chovancova and Arendas, 2015; Buffet, 1984).

Rubinstein considers that in the hypothesis of a maximally rational market, i.e. an efficient market, this is only viable strategy for investors (Rubinstein, 2001).

In term of costs, indexing is an advantage for fund managers and their clients, individual investors. Fund managers build their portfolio and hold the positions for as long as necessary. On the long run, transaction costs are low and so is the turnover rate of the portfolio. This is the central idea of Bogle’s book (2007) “the little book of common sense investing”. He compares the performances of actively managed funds and index funds: actively managed ones fails to beat the market because of the transactions costs (Bogle, 2007). He adds that compounding earnings (reinvesting earnings that will generate more earnings) is what gives indexing better returns on the long term.

As for the individual investors, index funds takes low fees and commissions compare to actively managed funds. By owning the whole market, holding their position for years and having less costs to pay, individual investors seeking to invest on the market for the long term can find this strategy ideal.

The interest of index funds is summed up by Mark Hulbert, financial analyst and journalist, in the New York Times: “you can outperform more than 80 percent of your fellow investors over the next several decades by investing in an index fund — and doing nothing else” (Hulbert, 2006).

V- Conclusion

The literature review highlighted the challenges fund managers are confronted when building their portfolio in the attempt of earning the highest returns.

Although some factors affect their chances of earning higher returns, fund managers' psychology and emotions take a big part in failing to beat their benchmark.

Some strategies have been presented as support and relevant alternatives for fund managers to focus on their analysis and less on the public opinion, their emotions, or advices from financial intermediaries.

The literature confirms that passive management show better performances on the long term than active management, and seems to be a better alternative for "defensive investors" (Graham and Zweig, 2003) seeking a long term investment requiring few attention and efforts.

The secondary data critically analysed, they will be used to support primary data and make recommendations in the end of the study.

Chapter 3 – Research methodology

I- Introduction

After looking at the topic of the dissertation and the literature it is based on, this part will detail how the research has been conducted regarding the primary data. As Swetnam (2007) wrote, “all research requires techniques and instruments for the collection of data”. This chapter is composed of the Research Design (philosophy, approach, strategy and sampling), the data collection instruments, the data analysis procedures and the research ethics.

It will be concluded by the limitations of the methodology, i.e. the weaknesses of the methodology for the dissertation and what can be done to overcome them.

The division of this chapter is based on the “research onion” (figure 1) of Saunders, Lewis and Thornhill (2007). The author will present the choices he made to conduct his research, specifying why some methods were not chosen in the researching process.

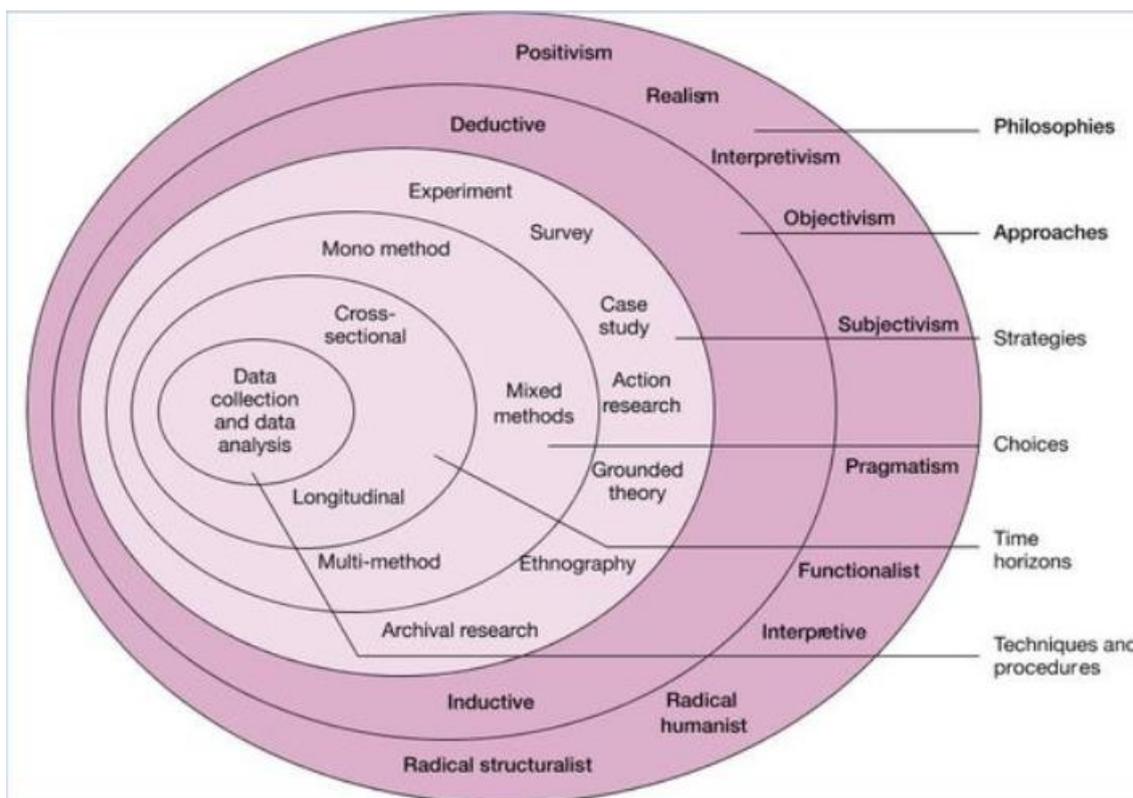


Figure 1 – Research onion
(Source: Saunders, Lewis and Thornhill (2007))

II- Research design

Research Philosophy

The first layer of the Research onion (Saunders, Lewis and Thornhill, 2007), is about the research philosophy. Saunders, Lewis and Thornhill (2007) explains that research philosophy “contains important assumptions about the way in which you view the world”. Furthermore they assert that these assumptions guide the strategy made and the methods used to complete the research.

Also, the research process is oriented by “three major ways of thinking about research philosophy: epistemology, ontology and axiology” (Saunders, Lewis and Thornhill, 2007).

Epistemology:

This term refers to what is considered as “acceptable knowledge in a field of study” (Saunders, Lewis and Thornhill, 2007). In this subsection, the author will explain his research philosophies by explaining his approach to the information gathered; in other words, whether the information is approached and presented as facts, or with a possibility of interpretation according to one’s beliefs.

Epistemology can take three traits for a researcher: positivism, realism and interpretivism.

Positivism:

This philosophy has a scientific approach; it uses existing theory to challenge hypotheses. Positivism is used to analyse the costs impacting the portfolio as presented in the literature review. When looking at all the costs impacting a fund manager’s portfolio, the data collected is viewed as facts. However, the information collected comes from secondary data and not primary research. Therefore, it is only relevant in this section as it allows the researcher to use existing theory to develop hypotheses in order to confirm or deny them. The costs of impacting the portfolio presented in the literature review raise some questions, hypotheses that will be answered part by analysing them as facts, but also by the interviews that were conducted.

This philosophy is important in the development of the dissertation as it tends to prove that beating the market is not only a matter of fund managers’ behaviour or choices (unquantifiable variable), but also relies on facts which fund managers can deal with.

Realism:

This is another philosophy which has a scientific approach. Saunders, Lewis and Thornhill (2007) divides realism in two categories: direct realism, what a human sees is captured as the truth, and critical realism, what a human sees is only a perception, feeling, sensation of the truth that lies behind.

The philosophy used in the research process is critical realism. The purpose of this dissertation is to give an opinion of what is the future of active management when passive management seems to be a better answer on the long term. Also, the author, even if he relies on facts, existing theories, or opinions from professionals, gives his own opinions and recommendations. Therefore, only critical realism can be considered. From secondary research to primary data collected by interviews, information is subjective to the eyes of the author.

Interpretivism:

This philosophy is presented as an opposition of the two first previously mentioned. Far from the scientific approach, interpretivism has a “social orientation”: humans, companies, situations are complex and unique. Therefore, the researcher cannot see information and data as facts but needs to take in account the point of view of people taking part in his topic.

In the context of this dissertation, interpretivism is used only when referring to the topic of behavioural finance and when analysing the data collected from interviews. The reason is that both of those topics can be considered as social studies; behavioural finance explains what happens in the mind of a fund manager and the interviews are subjective (interviewees are active fund managers that already have a precise opinion the topic).

Also, the fact that all the fund managers react differently, that the author has his own bias and background will influence the interpretation of the qualitative data collected. In this case, the researcher needs to see beyond scientific facts in order to have a more objective view, to obtain in the end the best analysis and make the best recommendations possible.

Then, fund managers and portfolio management cannot be seen separately but all the fund managers are different. Opposite to positivism and realism, this philosophy focuses on fund managers’ behaviour and interpretation of their environment, the market.

Ontology:

Ontology “is concerned with nature of reality” (Saunders, Lewis and Thornhill, 2007). There are three aspects to ontology: objectivism, subjectivism, and pragmatism.

Objectivism vs subjectivism:

As mentioned previously, there are two sides in this dissertation. There is an approach by the facts when speaking about what impacts the portfolio, and an approach more subjective when speaking about fund managers’ behaviour and decision making process.

Objectivism is related to the first part. Costs impacting the portfolio exist whether fund managers have biases or not. They need to be studied objectively, as they are what fund managers need to act on to better their return. There is no subjectivity in the way those information can be treated.

Then, subjectivism's view is that "social phenomena are created from the perceptions and consequent actions of social actors" (Saunders, Lewis and Thornhill, 2007). Therefore, behavioural finance and the analysis of interviews (primary data) are subjective since they are interpretations of someone's perceptions or consequent actions.

Objectivism and subjectivism are opposite philosophies but both used according to the part of the dissertation treated.

Pragmatism:

Pragmatism can be defined as the "philosophy of human conduct and practice that seeks to account for lived experience" (Simpson, 2010). Saunders, Lewis and Thornhill (2007) asserts that in this research philosophy, the most important criteria is the research question.

From these two definitions and explanations of what is pragmatism, the author does not consider himself as a pragmatist in his research process. Nonetheless, some parts of the dissertation, particularly when answering dissertation after analysing data from interviews, requires pragmatism. Therefore, even if it can be used at some point in the study, pragmatism cannot be considered as a research philosophy fully embraced by the researcher.

Axiology:

As stated by Saunders, Lewis and Thornhill (2007), it "is a branch of philosophy that studies judgements about value". They point out that it might include value possession, but what they are referring to is someone's own values, here the researcher's.

The selection of the topic for the study and the treatment of it reflect the values of someone's mind according to Heron (1996).

The values of the researcher are unconsciously present in the core of the dissertation. The reader should keep a critic eye, as the analysis, the conclusion and the recommendation represent a subjective view (or interpretation) from the author.

Research paradigms:

Saunders, Lewis and Thornhill (2007) define a paradigm as a "way of examining social phenomena from which particular understandings of these phenomena can be gained and explanations attempted".

They created a "matrix" of the following four paradigms (figure 2): Radical humanist, radical structuralist, interpretive, functionalist.

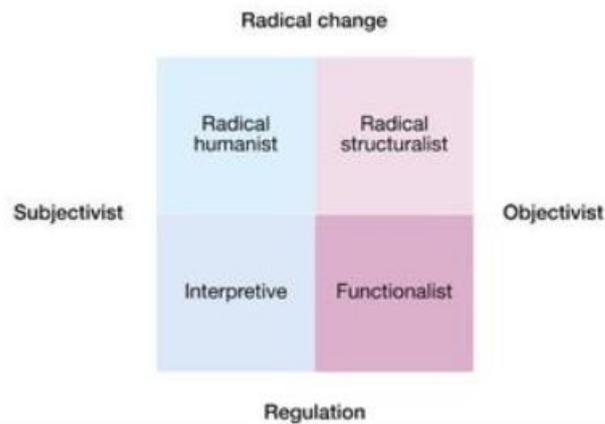


Figure 2 – The four paradigms for the analysis of social theory (Source: Saunders, Lewis and Thornhill (2007)).

The paradigm in which the author sees himself evolving in is the interpretive paradigm. Saunders, Lewis and Thornhill (2007) describes this type of researcher as follows: “your concern here would not be to achieve change in the order of things, it would be to understand and explain what is going on”. Furthermore, the interpretive paradigm brings the researcher to question himself and all he sees to find out where the problem comes from.

Research Approaches

The theory developed in this dissertation raises the question of the research approach used; there are two approaches: deductive and inductive.

Deductive:

Berg (2001) asserts that in a deductive approach “researchers use some categorical scheme suggested by a theoretical perspective, and the documents provide a means for assessing the hypothesis”. Saunders, Lewis and Thornhill (2007) confirm this view by adding that this is an approach close to scientific research; the hypothesis is tested through experiments of scientific nature and by applying known theories.

The deductive approach does not fit the topic of this dissertation. There is no theory to be tested. As it was previously mentioned above, the research philosophy is close to interpretivism, far from deriving from scientific experiments.

Furthermore, the author made research about behavioural finance, where science needs more interpretations than proofed theory scientifically tested.

Inductive:

In inductive approach “themes and categories emerge from the data through the researcher’s careful examination and constant comparison” (Wildemuth and Zhang, 2009). This means that by gathering data from secondary research or by interviews, a theory emerges from their analysis (Saunders, Lewis and Thornhill, 2007).

Inductive approach was born from the emergence of social sciences. When deduction has a rigid methodology, induction is based on how humans interpret the world around them. The strongest advantage of inductive approach upon deductive is its flexibility: it allows the researcher (and the reader), to have an open and critical mind, and interpret differently the data according to his beliefs, knowledge and values.

Also, Saunders, Lewis and Thornhill (2007) explain that “if you are particularly interested in understanding why something is happening, rather than being able to describe what is happening, it may be more appropriate to undertake your research inductively rather than deductively”.

This sentence reflects the approach undertaken by the author. Indeed, the topic uses social sciences to understand what happens in the mind of a fund manager, and mainly why it happens. The inductive approach seems more suitable for this dissertation.

But, as it was raised in the previous section, the first part of this dissertation relies on facts, and their analysis are based on scientific theories. The objectivity required to treat those data implies a deductive approach. However, this is a small part of the dissertation and this dissertation is more focus on the fund manager than his portfolio: the research needs to take in account the psychology of a fund manager in order to understand what mistakes are made and therefore what can be changed in his behaviour to beat the market in a more efficient way.

The part focused on his portfolio his important but the literature covers the subject efficiently enough to allow the researcher to take more time to assess fund managers’ psychology and emotions in depth.

Research Strategies

Research strategy is the “general plan of how you will go about answering your research question(s)” (Saunders, Lewis and Thornhill, 2007).

In this third layer of the “research onion”, research strategies refer to the tools directly set up to collect data and answer the research questions. As the latter derive from the research objectives, the researcher needs to know where he is going, and what the best option to reach his objectives is.

To obtain the most accurate answers to the research questions, there are seven research strategies available to the researcher: Experiment, Survey, Case Study, Action Research, Grounded Theory, Ethnography, and archival research.

Each one of those strategies can be linked to explanatory, descriptive or exploratory research (Yin, 2003).

The author decides to present the attributes of each research strategies according to Saunders, Lewis and Thornhill’s definitions, and then explains at the end of the section what strategy suits best the dissertation.

Experiment:

As Saunders, Lewis and Thornhill (2007) notes, the purpose of experiments “is to study casual links; whether a change in one independent variable produces a change in another dependent variable”. An experiment relies on a theoretical hypothesis, the study of a sample of a determined population, submit this sample to experimental tests, manipulation of variables to see how the sample react, measures, and controls.

An experiment is costly and complex. It has a very scientific methodology approach and leave few room for interpretation of the results.

Survey:

This strategy is very popular in the business world. It consists in establishing a questionnaire proposed to a sizeable sample representative of the population studied. “Data are standardised, allowing easy comparison” (Saunders, Lewis and Thornhill, 2007).

The goal of a survey is to collect quantitative data, easy to analyse, to obtain statistical data in the end.

The limitation of a survey are the following: the questionnaire needs to be limited in size so the answers of the participants are honest and so they can take time to do it, the sample participating to the survey needs to be relevant of the population studied, the data collected cannot be changed to fit the hypothesis and conclusion of the researcher.

Surveys can also take the form of interviews where the questions asked are the same for all participants. There is no obligation to have quantitative data in the end.

Case study:

A case study “is a research strategy which focuses on understanding the dynamics present within single settings” (Eisenhardt, 1989). Case studies can take multiple forms from documentary analysis, to interviews, or also observation or questionnaires (Saunders, Lewis and Thornhill, 2007).

Case studies are often used to answer “why?”, “what?” or “how?” questions. The two latter can also be answered by surveys (Saunders, Lewis and Thornhill, 2007).

Action research:

The action research grouped theory and practice in order to find solutions by the common efforts of the researcher and the other participants. Also, Saunders, Lewis and Thornhill (2007) consider that “findings of action research result from involvement with members of an organization over a matter which is of genuine concern to them”.

It is clear in this definition that the researcher needs to be part of the study or the sample studied.

Grounded theory:

It is a “theory building” strategy. “Theory is developed from data generated by a series of observation” (Saunders, Lewis and Thornhill, 2007).

They add that this strategy is an inductive/deductive approach as the data build the theory at the same time as they are collected.

In other words, the researcher can have predictions, small hypothesis. By the time he gather the data, new theories can emerge in addition to the one which are already confirmed or denied.

Ethnography:

It directly comes from anthropology and has an inductive approach. As Saunders, Lewis and Thornhill (2007) describe it, “the purpose is to describe and explain the social world the research subjects inhabit in the way in which they would describe and explain it”.

This strategy is time consuming as the researcher would need to immerge himself in the social worlds of the research subjects to apprehend it.

Ethnography is based on scientific models and results in new theories as the research advances in time.

Archival research:

The main trait of archival research is to “make use of administrative records and documents as the principal source of data” (Saunders, Lewis and Thornhill, 2007).

Archival research answer research questions focuses on the past, whether the data are historical information or of a recent history.

The researcher decided to adopt certain traits of surveys, grounded theory and case studies. The primary data will take the form of semi-structured interviews of fund managers. Although the questions are prepared, answers given by fund managers and the orientation of the conversation can bring the researcher to new questions or omitting to ask some of them.

Observation of fund managers' behaviour, linked to the observation of secondary data are the traits from grounded theory, as well as theories emerging from the interviews.

Interviews are qualitative data which correspond to both surveys and case studies. Also, as mentioned above, the author is aiming for an inductive approach, which is a component of grounded theory.

Finally, as Saunders, Lewis and Thornhill (2007) assert, the choice in research strategy can be a mix of multiple strategies. The author is convinced that semi-structured interviews is the best way to answer the research questions and reach the research objectives.

Research choices

The research choices Saunders, Lewis and Thornhill (2007) refer to are between qualitative data, quantitative data or a mix of both data.

After choosing the research philosophies, approaches and strategies, the next layer of the “research onion” asks the researcher to think about what kind of data he should gather to reach his objectives and answer the research question in the most accurate manner possible.

As Saunders, Lewis and Thornhill (2007) point out at this layer is that there are two categories of data: qualitative and quantitative. The former correspond to every non-numerical data (interviews, pictures, videos); the latter represent all the numerical collection techniques data or analysis procedures.

The researcher has then three choices in his collection techniques and analysis procedures:

- Mono-method: using only one method to gather and analyse qualitative or quantitative data.
- Multi-methods: using two or more methods to gather and analyse qualitative or quantitative data.
- Mixed-methods: combination of the two previous methods. For instance, using quantitative data collection techniques and analyse them to exploit them as qualitative data (transforming figures into words).

The choice considered by the author is a mono method as he is convinced it is the most appropriate choice to answer the research questions.

As mentioned in the research objectives, the aim of the dissertation is to find non-numerical ways for active managers to beat the market; the literature review demonstrated via behavioural finance that fund managers’ emotions and biases take a big part in their failure to beat their benchmark. Hence, the goal is to make recommendations for fund managers on how to manage their emotions, how their work might be relevant versus passive management and what values they bring to their clients on the long term.

The author is convinced that semi-structured interviews (qualitative data) is the best option to complete the study, and that no numerical data is necessary in those conditions.

To conclude, Brannick and Roche (1996) argued that qualitative data provide a better level of comprehension than quantitative ones raising some more questions and open to interpretation.

Time horizons

Saunders, Lewis and Thornhill (2007) recognise two types of times horizons: cross-sectional and longitudinal. The former can be seen as a “snapshot” of a particular moment in time when the latter represent events happening over a certain period of time.

They add that time horizons can be independent of the research strategies, choices or approaches taken by the researcher.

Longitudinal research requires a certain amount of time for the observation. Its main strength “is the capacity it has to study change and development” (Saunders, Lewis and Thornhill, 2007). Longitudinal studies answer questions about changes happening over a period of time.

For that reason, cross-sectional study seems to be more appropriate for the realisation of this dissertation. The time necessary for its completion and the research questions do not fit longitudinal study definition.

Also, as Saunders, Lewis and Thornhill (2007) assert about cross-sectional studies, “they may be seeking to describe the incidence of a phenomenon”. This is indeed the case in the study chosen by the author.

As described in the research objectives, the purpose of the study is to identify the factors hindering fund managers’ chances of earning higher returns, understand what is the consequence for active management that passive management gets better result on the long term, in what conditions active management brings value to investors and finally make recommendations for fund managers on what are the tools at their disposal to overperform their benchmark and passive management on the long term.

Techniques and procedures

Data collection and sampling

The dissertation is a mix of explanatory and exploratory study. The first “aims to provide causal explanations of phenomena” (Terre Blanche, Durrheim and Painter, 2009). The second “is particularly useful if you wish to clarify your understanding of a problem” (Saunders, Lewis and Thornhill, 2007).

The study is explanatory as it tries to understand what causes passive management to be a better option on the long term than active management; it is also exploratory as it aims to get a better understanding of the problems faced by fund managers and the current situation of the sector.

Since this dissertation is not based on hypotheses, it cannot fit a descriptive study approach.

The data collected are of two kinds: primary and secondary data. The results of the latter have been presented in the literature review above. The data were gathered from academic journals, books, reports, etc. They are necessary to better understand the scope of the topic, and to identify and understand its key concepts.

Primary data are exclusively qualitative and are gathered through semi-structured interviews. It is impossible to interview the whole population of fund managers in the context of this study. Saunders, Lewis and Thornhill (2007) assert that “for all research questions where it would

be impracticable for you to collect data from the entire population, you need to select a sample”.

The sample chosen is three semi-structured interviews of fund managers using active management style that will not allow the author to make generalisation about all the fund managers but to find correlations, differences and shared ideas in the sample chosen.

The sample is composed of equity fund managers: one from SMA Gestion (third best French portfolio company in term of “alpha” management, i.e. its ability to beat its benchmark), one from Aviva investor France (French insurance firm) and one from Palatine Asset Management (subsidiary bank of the BPCE Group).

Interviews are a reliant source of data, relevant for answering research questions (Saunders, Lewis and Thornhill, 2007).

Data analysis

Secondary data:

Once gathered they serve the purpose of providing information which are critically reviewed in the chapter 2, the literature review.

Those are data that are not collected by the researcher but by other people from scientific fields (economics, psychology, finance, sociology, etc.). The author found secondary data in many sources: journal articles, textbooks, academic journals, Internet, eBooks, and newspapers. All the sources are present in the Bibliography, at the end of the dissertation, using the Harvard Referencing System.

Secondary data are easier to collect than primary data. However, they are numerous and can be contradictory as they do not always serve the same purpose, answer the same questions, or simply because they are not written at the same period in time.

The researcher paid a particular attention, when collecting secondary data, to the relevance of the information, their veracity, and their sources.

Furthermore, their analysis has been made so as to propose the reader a critical view of each piece of information, put in the context of the topic studied.

Primary data:

The other source of data gathered and used in this dissertation are primary data which take the form of qualitative data collected via semi-structured interviews.

Saunders, Lewis and Thornhill (2007) say that qualitative must not be seen as an “easy option” in their analysis. The latter must be prepared, organised, and thorough before drawing any conclusions and make recommendations.

The interviews were audio-recorded. The first advice given by Saunders, Lewis and Thornhill (2007) is to transcribe the interviews: it is time-consuming because it is not only transcribing what has been said. The researcher must pay attention to what have been said, how it has been said and every other piece of information that can provide non-verbal communication orientation to the conversation.

The next part is the categorisation. The purpose of a semi-structured interview is to have the same questions prepared for all the participants. Even if they are not all asked the base of the interview is the same. Therefore, all the information gathered must be classified into categories. “They provide you with an emergent structure that is relevant to your research project to organise and analyse your data further” (Saunders, Lewis and Thornhill, 2007). Under each category, words or sentences from the interviews will be classified as to raise the main points in common or detached the differences between the participants.

The last part is dedicated to developing and testing hypotheses or theories. This asks a critical point of view from the researcher, as to find the right hypotheses, answer the research questions correctly and to not fall into generalisation which is not relevant with only three interviews made.

Finally, it is relevant to note that the analyses of the interviews (chapter 4), the conclusions and the recommendations made (chapter 5) are from the author’s point of view. The transcriptions are available to the reader in appendix of the dissertation. The interpretation of the primary data made in this dissertation is only one interpretation possible: as it was raised earlier in this chapter, interpretation depends on the values, beliefs and knowledge of the researcher. Therefore, the reader can have a different interpretation but the author engages himself to analyse and make conclusion truthfully and faithfully.

III- Research Ethics

“Ethical concerns will emerge as you plan your research, seek access to organisations and to individuals, collect, analyse and report your data” (Saunders, Lewis and Thornhill, 2007). They also define Ethics as “the appropriateness of your behaviour in relation to the rights of those who become the subject of or are affected by your work (Saunders, Lewis and Thornhill, 2007).

First, secondary data and the whole dissertation is concerned by ethics. The author made sure that every piece of information taken from the researches of others have been rightly quoted and referenced in the core of the text and the bibliography. This rule is made as to protect the intellectual property of the people quoted, their point of view and to avoid plagiarism from the author of the dissertation.

Secondly, all the interviewees were aware of the purpose of the interview, the realisation of a dissertation in the context of the MBA at the Dublin Business School. They were also provided the title and the objectives of the dissertation, so as their statements cannot be out of context.

Before starting the interview their consent was asked about the interview being audio-recorded and their decisions were of course respected.

Finally, the storage, analysis and report of the information provided by interviewees have been carefully managed, with confidentiality when necessary.

As for the ethics required towards the potential readers of this dissertation, the author certifies that each information, word, sentence or section has not been changed to serve the purpose of the research; the declaration statement located at the beginning of the document, certifies the originality of the work and that the author's work is fully compliant with the Dublin Business School's academic honesty policy.

IV- Limitations of Methodology

This section is dedicated to the discussion about each limiting factors that happened during the research, the analysis, the writing and their impact on the study.

Time frame:

This study is the last step of the MBA programme at the Dublin Business School. The time allowed to the author for completion was twelve weeks. Although it is a sufficient time frame to complete the dissertation, the author decide to make compromises in his research choices. The most time-consuming methods were put aside to allow more time for research, analysis and writing.

Also, the last interview was made few weeks before the deadline. Therefore, less time was spent to let the interview mature and analyse it.

Sample size:

The author is fully aware that the size of the sample is not representative of the overall population of fund managers. Moreover, the three interviewees are French fund managers; this can be explained by the fact that the author decided to come back in France to do the dissertation, and therefore it was easier to meet managers there.

The fact that the sample is reduced and confined to three people hinder the researcher to make generalisation in his statements.

Nonetheless, the research objectives and research questions are answered properly, as the topic was adapted to the size of the sample.

Interviewees' and author's background:

Fund managers interviewed were aware of the topic they were going to speak about. Therefore, personal biases and preparation on the interview might take away reliability and authenticity from their statements.

Also, the author had knowledge on the topic prior to the beginning of the dissertation. This is why he undertook this study. Although he decided to stay objective, authentic and thorough in his analysis, the reader could wonder about the reliability of the dissertation and the conclusions made.

However, Merriam (1995) asserts that:

“Qualitative researchers are not seeking to establish ‘laws’ in which reliability of observation and measurement are essential. Rather, qualitative researchers seek to understand the world from the perspective of those in it”.

Therefore, what seems to be a limitation is at the end a possibility for the reader to also develop an opinion about the topic and have his own interpretation.

Chapter 4 – Data analysis and findings

I- Introduction

The objective of this chapter is to present, critically analyse and interpret the primary data resulting from the interviews. The latter represent the totality of the primary data. The second section of this chapter present how were conducted the semi-structured interviews, from the interviewees to the questions asked. The next section will be dedicated to the analysis of the primary data. The last part will be used to answer the research questions by interpreting the secondary and primary data.

II- Semi-structured interviews

As previously mentioned, the qualitative data were collected through semi-structured interviews. For this research, the author conducted 3 semi-structured interviews of fund managers.

The first interviewee is Romain RUFFENACH, financial analyst and fund manager at SMA Gestion, portfolio management company of the SMA Group, insurance company specialised in the building sector.

The second person is Frédéric GUIGNARD, fund manager at Aviva investor France, asset management department of Aviva, British insurance company.

The last interview was realised with Pierre DUVAL, managing director of Palatine Asset Management, from the group BPCE (Banque Populaire Caisse d'Épargne), one of the biggest banking firm in France.

The three of them work in Paris and have a great experience of the asset management world.

The researcher prepared a dozen of questions which would be all the same for the three interviewees. The topic covered by the questions are, financial behaviour, value of active management over passive management, market efficiency, the factors impacting their portfolios, and more common questions about their investment strategies and decision making process.

It can be noted that the researcher tried to reach more fund managers to interview but he received few responses. The three interviewees agreed to be recorded and that their name could be quoted in this dissertation. Should the reader be interested by the content of the three interviews, the full transcription of each of them are in appendix of this dissertation.

III- Findings

Investment strategies and decision making process

The three fund managers have a different approach in their investment strategies and decision making process.

M. RUFFENACH manages a “long only” fund: he only takes buying positions and not selling like other funds in his company. He invests in European stocks. This long only strategy is coupled with a “buy and hold” strategy. The goal is to invest in quality stocks, buying them at reasonable levels of price, diminishing the turnover rate and the transaction costs. As he says, the latter “can reach very high levels in funds with a turnover superior to 30 or 40%, representing 1 to 2% of the annual performance.”

M. GUIGNARD does not manage a fund per se: he can buy stocks for numerous funds and the asset allocation among the funds is the responsibility of another person. Nevertheless, he invests in European stocks, and his strategy is close to the one of M. RUFFENACH; he did not quote the buy and hold strategy but said “we have long term vision (sometimes more than 10 years) which is reflected in our turnover rate probably around 20 to 25% (stock’s conservation averaging 4 years).”

Also, both of them have a bottom-up strategy, also called stock picking. Their decisions is based on a qualitative analysis of companies and sectors, but also on valorisation criteria. They take their decisions collectively. At SMA Gestion it takes the form of management comities where one manager present a company and the others challenge his ideas. At Aviva investors France, it is more informal: managers speak freely about a company most of the time, it is rare for them to have formal meeting to discuss about a company.

M. DUVAL speaks about a different approach in his company. The strategy is in three steps: first the index (market of reference of the fund) is always invested. Secondly, he analyses sectors to find the one which is the most promising. Thirdly, once the sector is identified he will try to find the company in this sector which is the most performing with the help of annual reports, activity reports and financial documentation.

His strategy is then considered a mix of top-down and bottom-up analysis; he uses macroeconomics to analyse the sector to invest in, and microeconomics to have a financial analysis of the companies. Furthermore, unlike the two first managers, he is not in a buy and hold strategy: “the principle is not to have a high turnover but to always be reactive to take advantages of opportunities offered by the market. Our management is highly oriented towards growth stocks because long term performance passes by an increase in income and earnings.”

Finally, M. DUVAL considers formal meetings useless as they tend to be long and that no decisions come out of them. He believes that the decision making must be the responsibility of the fund manager, in total independence and autonomy. However, each of the fund

manager in his company has access in real time to the operations realised by others. They also can discuss with others in an informal way, and small meetings are organised to orient the analyses but not the management.

M. RUFFENACH is the opposite. Most of the decisions are collective (with the responsible of analysis and the managing director), even if he can work in independence sometimes.

M. GUIGNARD is between the two others, as the collective discussions are informal and the rest of the time he relies on his own judgement.

Regarding collective decisions M. RUFFENACH considers that being more than three to take a decision is counterproductive. But, making an analysis and taking decisions in group is a big advantage: "what is a good criteria for me is not necessary the same for my two other colleagues. The more you are, the more exhaustive is your checklist and in the most qualitative way possible." M. GUIGNARD confirms this idea as he asserts "we have the experience of six persons instead of one. We can have contradictory opinions that avoid us to make mistakes in our investments." However, he finds a disadvantage similar to the one of M. DUVAL, which is a slow decision making process.

The factors affecting their returns

In the chapter 2, the author presented the factors found in the literature. The ones the three interviewees agreed on are the transaction costs and the turnover rate. However, M. GUIGNARD says that when you have a turnover rate which is around 20% or 30% your transaction costs are very low and are not really relevant when looking at the weight of the portfolio.

Then, they don't speak about factors affecting their chances to earn higher returns but "what can provide me better returns at low costs?"

The answer is unanimous: a solid and thorough analysis. DUVAL affirms that "our big risk is at first an error in our choices." He adds "if our choice of sector is not the one the market is waiting for, we can have periods of underperformance".

GUIGNARD includes the couple risk/return in his statement. By definition if you take risks you have the potential to earn more returns. His main goal is to generate returns on the long term. Therefore, he states that "the quality of the portfolio management is what will create value for our clients".

RUFFENACH goes more in detail by affirming that what brings more returns is analysing a good company with an economic moat (strong competitive advantage), buy a stock at a reasonable price, and holding the position as long as possible to minimise the transaction costs.

He also asserts that it is really difficult to act against inflation, market timing, taxes or exchange rate. Hedge a position is really difficult and often counterproductive. The three of them agrees that the best way to earn high returns is a thorough analysis, reasonable choices, and minimising transaction costs.

The role of the market

The researcher collected different opinions about the role of the market. First, GUIGNARD reminds “the role of the secondary market is to facilitate access to capital for companies so they can finance future investments.” His main objective is to create value for his clients. It is true that the market has periods of stress; when a company loses 10% of its price in one day, it does not reflect the reality and this is where he finds opportunities for investments and creation of value for clients of his fund.

DUVAL considers that sometimes the market is right, this is when he is efficient, and sometimes he is not because behind it “there are people not always guided by a perfect objectivity.” The market is then used as an indicator of where the analyses must be oriented, but the behaviour biases are taken in account as well. He states “on one hand there is the work, the analysis we make, and on the other hand the psychological side.”

Finally, RUFFENACH considers the market efficient on the long term but inefficient on the short term. The periods when the market is stressed (optimistic or pessimistic) create opportunities on the short term, but on the long term the actors are rational and the prices adjust themselves.

In the end they all agree that the periods when the market is inefficient, due to speculation, irrational behaviours and a stressed market, create opportunities on the short term: as RUFFENACH states “the market considers that the environment (of a company) will not be as positive as it was, so the stock price move but its intrinsic value does not really change.”

Behaviour biases

Behaviour biases theoretical point of view have been widely presented in the literature review. As it was mentioned above, DUVAL recognised some behaviour biases in his decision making process. To fight those behaviours he says “I wonder if I am taking in account basic principles, am I not participating in a sheep-like behaviour, or am I not panicking over nothing? I always avoid to jump on conclusions, it costs a lot.”

What he really pays attention to is following indications from brokers or sell-side analysts as they can pursue objectives different from him. What costs the most in term of behaviour to a portfolio is to hold positions which are already losing in the hope they will increase again, he says.

GUIGNARD works with sell-side analysts as well; they are analysts external to the company. “We lose in autonomy and independence but we save time because they are still experts.” Still, he recognises that his judgement may be influenced from time to time, it is a true existing risk. To avoid this kind of situation, it only depends of the fund manager: “we receive contradictory information on a daily basis. It is our job to sort those information to give them the importance they deserve.”

RUFFENACH know the importance of behaviour biases in his job. He always bear in mind that a broker who calls him has an ulterior motive. “An important quality in the business is to be independent.”

Finally, they all know that behaviour biases exist and they cannot control them every time. Their strategies, analyses, independence and experience seems to be the general consensus towards the reduction of those biases.

Diversification in their portfolios

Diversification is an important notion in the asset management business. As GUIGNARD asserts “Markowitz’s principle is unavoidable. It brings flexibility and allow managers to get opportunities when they are possible.” Nevertheless, his job is not to care about diversification. He says himself that his job is to find performing stocks.

This point is similar to the one raised by RUFFENACH: “if you have strong companies in your portfolios, why should you feel the need for diversification?” For him, diversification is a short term thinking; on the long term companies show growth and will continue to be strong and make profits. He takes the example of big companies which were hardly hit during the financial crisis of 2008, losing sometimes until 40% of their prices. Even with this stress in some periods, the same companies, on the long term have a 15% annual return.

As for the case of DUVAL, diversification is not part of his business: “my risk is to underperform my index (benchmark), not to lose money.” On the long term, he asserts that with a good analysis and the right investments, he wins without diversification.

He concludes by saying that diversification leads to asset allocations techniques; a mistake in this allocation brings to the surface behaviour biases that lead to more mistakes.

Active vs passive management

One point was raised in the literature review, stating that few active managers succeed to beat their index of reference. According to DUVAL this is mainly because of the behaviour biases and transaction costs.

GUIGNARD reminds the researcher and the reader that the statistics behind this statement are a mean of performances. “We forget to precise several schools [...], mainly value investing of Graham and Buffett, generate excellent results on the long term.”

He adds that this school of thought nowadays takes in account not only the valuation of financial data but also entry barriers, quality of a company’s management, alignment of management’s interests with those of shareholders, etc. “Active management keeps a meaning to me today.”

RUFFENACH states that with “experience and hard work you can be part of the few fund managers beating their benchmark. For that you need to not listen too much noises from M. Market and be cautious in your approach.”

Furthermore, DUVAL notes that passive management cannot do better than the index whereas active management can. RUFFENACH adds that for a person looking for investing in stocks and does not want to take too much time on building his portfolio and watching it, he would recommend passive management.

Finally, some managers from the value investing school succeed in beating regularly their benchmark. This school contradicts the theories saying passive management beats active management on the long term. The only risk of active management is “it can fail to beat its benchmark whereas passive management always gets at least the returns of the index”, says DUVAL.

IV- Answering the research questions

1) What factors affect a fund manager's chances of earning higher returns on the stock market?

Theories about factors affecting the fund managers' chances of earning higher returns on the stock market have been presented in the literature review.

Their existence is undeniable but the qualitative data gathered from interviews shows that they are not always taken in account in the daily management of funds.

Transaction costs and turnover rate are the factors affecting the most portfolios' returns. The more a fund manager is active the more costs he will pay and his returns will be reduced by the amount of those costs. Or, the less transaction he makes, the more chances he has to have superior returns.

Inflation is an important factor; the more inflation there is on a period, the more returns are eroded. However, it has been shown that fund managers cannot act or hedge their positions against inflation.

Studies demonstrated that if no correlation exists between performance of the stock market and increase of prices, one solution exists for fund managers: “wide moat stocks”. Those are companies with a strong competitive advantage and a potential for growth, and regular earnings and income. Indeed, fund managers interviewed all agreed to say that investing in those companies is the best way to avoid inflation.

Inflation and exchange rate have the same problem according to them: trying to hedge a position to protect their portfolio against those factors is expensive and counterproductive as it requires derivatives instruments or intervention on the Forex. It adds risks and complexity to avoid losing returns when, according to them, a thorough analysis and a good stock picking strategy is already an insurance on the long term.

The last factor are taxes on capital gains. Bogle (2007) explained that the time stocks are held in portfolio are nowadays under a year when 50 years ago it was 10 to 15 years. This means that taxes were paid every 10 to 15 years on capital gains when today is every year.

Considering the high turnover rate existing today, fund managers pay taxes more regularly than before. But in the end, taxes have the same amount. Also, it is relevant to point out the differences in taxation among the countries. In the USA, portfolio management companies average 3 to 4% in taxes yearly when in France they are not taxed on their capital gains; they are taxed as any other companies, on their earnings.

This is why the fund managers interviewed did not consider taxes as a factor affecting their returns.

But, it does not hinder them to have tax-efficient strategies. The most efficient one is indexing according to Bogle (2007). The reasoning is simple: a fund manager or an investor can use indexing and hold his position for years (even decades), as in the end the market always grows on a long period.

Then, fund managers tended to speak in terms of what factors can give them the best chances for superior returns rather than factors hindering them to earn higher returns. This positive attitude brings them to have successful strategies on the long term.

If one says that the more risk is incurred to your portfolio, the more returns you can expect, it does not mean his strategy is not successful. Their strategies are different but rely on a thorough analysis and the biggest factor affecting their returns is their choices.

Their strategies are divided in analysis on one hand, and behaviour on the other hand. To have superior returns and beat their benchmark, their choices rely on financial analyses (market or sector analysis, company valuation, quality of the company's management, etc.). Their objective is to determine what the performing companies are to buy their stocks at a reasonable price and holding the positions until the prospects of the companies change.

But, they can be influenced by "market noises", behaviour biases which can lead them to make mistakes. Respect of their strategies, independence and experience are the main tools to avoid those mistakes.

Finally, the factors presented in the literature review exist and affect fund managers' returns, each one in a different way, but the explanation given by the fund managers are more relevant to the study. Their investment strategies and decision making processes are built to minimize the factors affecting the portfolios. But, behaviour biases (overconfidence, loss aversion, naïve diversification, etc.), are the factors affecting the most fund managers and their returns. They are invisible and cannot be quantified.

2) Why passive management performs better than active management on the long term?

80% of active fund managers fail to beat their benchmark. Moreover, on the long term, passive management has superior returns than active management.

Passive managers have for objective to replicate an index, sector or market of reference. The logical conclusion is that in the end they at least earn the returns of the market. Also, it is

known as a tax-efficient management; low turnover rate, low transaction costs and a long horizon defined this strategy.

Active management is defined by the necessity to beat their benchmark. The difference with passive management is that they need to find, within their market of reference, the most performing stocks to outperform it. As the market evolves, from one sector performing to another according to the period considered, active managers have a higher turnover rate. The main consequence is then more transaction costs and returns reduced by the same amount of those costs. The stress generated by those changes in the market and the rumors spreading on a daily basis about companies' prospects, create behavior biases in fund managers' minds.

Therefore, passive management does not perform better than active management, but active management fails to perform better than passive management. The nuance in this statement is justified by the definition of the two strategies.

Indeed, the statistics explaining that passive managers perform better than active ones are a mean of all the performances. As any market grows on the long term, passive management will have positive returns in the future for those willing to hold their positions.

Performances of active managers are more contrasted: if 80% of them fail to beat their benchmark, 20% of them succeed to beat the market, sometimes with a double digit percentage.

When analyzing this category, it exists a school of thought, management, that seems to emerge from the others: value investing, created by Warren Buffett. The strategy relies on valuation of a company's financial statement, the quality of its management, its competitive advantage, buy its stock at a reasonable price, and hold the position as long as the company remains coherent in its choices (buy and hold strategy). The market is therefore reduced to a place where fund manager buy and sell shares according to the value they give to a company and not what the market tells them to believe.

Finally, active management can outperform passive management with a high percentage. It only depends of the fund manager's strategy. Speculators and costs inefficient funds cannot expect to beat their benchmark on the long term. Value investors remain the best option to earn higher returns, not only what the market has to offer through indexing strategies.

3) Why investors should consider active management rather than passive management?

Like any bank or portfolio management company, the profile of the investor is the base for building a portfolio. Benjamin Graham (2003) in his book "the intelligent investor" always makes a distinction between an aggressive and a defensive investor.

First, a defensive investor, with a strong aversion to risk, should be more interested by passive management. It requires few effort to buy an index fund and hold it for as long as he can, without the need to watch it regularly.

The aggressive investor, can consider to build his own portfolio if he is willing to put enough effort into it and if he knows the underlying risk of the stock market. This is the first difference.

However, this does not mean that active management incurs great risks and that he will lose in the end. As it was shown in the answer of the second research question active management can earn high returns.

The first important thing to note is that 80% of the fund managers fail to beat their benchmark or even earn positive returns, while this is their job. It is relevant to assume that someone who is not working at full-time on the construction of his portfolio has few chances to beat the market.

But, the same way an investor can trust an index fund, some actively managed funds, value investors, succeed to beat the market and can be trusted. An investor must investigate on the fund he wants to invest in, to find all the tools that makes a value investing successful:

- The fund's strategy is based on a solid valuation of companies, sectors, market, and takes in account external factors of the financial data from companies
- The turnover rate is low
- Low commissions or fees
- No use of derivatives or other instruments using leverage
- The fund manager has a long term objective
- Take in account the experience of the fund manager.

If an investor is willing to investigate the funds, he can find managers beating their benchmark regularly, and who offer great returns on the long term, better than passive management. The latter offers at least the returns earn by the market, but needs a long term horizon (from 20 to 50 years). Value investing, when done properly offers superior returns whether it is on medium or long term. The risk relies on the fact that active management still can fail to beat the market. It is the case in period of crisis. Even in this time, value investing seems to be a better option as it can lose less than the market when passive management lose as much as the market.

Active management has a bad reputation in a period marked by speculation, high frequency trading, and following the financial crisis of 2008. Adepts of passive management try to convince investors that indexing is the solution. But, active management, under the form of value investing is the right choice for investors looking for greater returns than those offered by the market (indexing).

Also, the multitude of actively manage funds offer investors a flexibility in their choice of investment. They can choose a sector, the size of companies invested (small, mid or large capitalizations), the market, the geography (European stocks, US stocks, etc.), or even the type of fund (long only, long/short, etc.).

Active management is too often associated with speculation. With research, an investor has a real choice offered to him: find the right fund manager that will earn higher returns than the market (value investing), or invest in an index fund with a long term objective, earning returns from the market's growth.

Finally, as it was raised by the managers interviewed, investors must find the 20% of the funds beating the market. Value investing funds are the best option among all the active management strategies which contain a lot of speculative funds.

Chapter 5 – Conclusions and recommendations

I- Conclusions

The purpose of this dissertation is to answer the research questions and complete the research objectives following methods developed in the Research Methodology and helped by the literature review and the primary data collected.

The main objectives of this research are to identify the factors affecting a fund manager's chances of earning higher returns, understand what hinders active management to perform better than passive management on the long term, assessing what can be the value brought by active management for investors, and make recommendations for fund managers on how to minimise the factors impacting their portfolio, returns, strategy or themselves; for investors on why they should use active management rather than passive management in certain cases.

The first objective was achieved by recognising the factors as presented in the literature and confront them with primary data collected from fund managers. The semi-structured interviews showed that most factors impacting a portfolio are true, yet theoretical; the managers' strategies cannot take in account all the factors as it would be counterproductive. The psychological factors, also called behaviour biases are present in the decision making process of fund managers. Those biases must be compensated by a solid and thorough strategy in the analyses made, and as they are not quantifiable, fund managers must challenge their ideas on a daily basis.

The main factors they are confronted with are transaction costs and behaviour biases. The former is reduced by a low turnover rate. Also, the more performing is the fund, the less weight transaction costs have. The latter requires reconsideration of any decision made by the fund managers. They can also confront ideas with colleagues or analyses without failing to their convictions.

The second objective, understanding what hinders active management to perform better than passive management, was mainly answered via the semi-structured interviews. If the literature demonstrated that 80% of the fund managers fail to beat their market, and that passive management performs better than active management on the long term, it fails to mention that in those 80%, a lot of funds are speculative. In the 20% successful funds, there are some existing since decades, keeping the same strategy and investment philosophies, and that resisted different crises.

In the three interviews conducted, the same theory raised from the others: value investing. Fund managers following this philosophy have succeeded in earning high returns since its beginning with Warren Buffett.

If statistically, passive management performs better than active management, the reality shows that active management contain a lot of philosophies and strategies. The most successful ones seem to earn high returns and perform better than indexing strategies.

The third objective, which is assessing what can be the value brought by active management to investors was answered by the primary data, even if one component is already present in the literature review: value investing. This school of thought born from the mind of Warren Buffett, student of Benjamin Graham at Columbia, is based on an analysis of a company's financial statements. But, it also takes in account the quality of the management, the alignment of management's interests with shareholders', and the competitive advantage possessed by the company. This has for consequence to invest in a company with a strong potential for growth, with an intrinsic value known. The buy and hold strategy allows fund managers to have a low turnover rate and low transaction costs.

Active management, through this cost efficient management, allows investors to earn greater returns than passive management's, which earn the market's returns at best.

The last objective, which is make recommendations for investors and fund managers will be dedicated to the next section of this chapter.

II- Recommendations

Based on the results of the research, it is relevant to note that some actions and initiatives can be undertaken by investors and fund managers.

Regarding investors, the following assumptions can be made:

1. The profile of an investor is important when he wants to invest on the stock market. If he is a defensive investor who wants an automatized portfolio, passive management seems to be a better option. If he wants to invest himself and review regularly the performances of his portfolio he should consider active management funds.
2. The selection of the fund he wants to invest in must be a real investigation. The investment philosophy of the fund manager must be the same as his own. He must look for low costs funds, with low fees and a low turnover rate as well.
3. If he wishes to build his own portfolio, he must have the approach of a value investor. This means no speculation, no financial instruments using leverage, and avoiding sheep-like behaviour.
4. In every cases, an investor should have a long term objective (from 10 years to 50 years).

5. His investment strategy must be adapted to the state of the economy.

Regarding fund managers, the following assumption can be made:

1. The behaviour biases are an important factor hindering them to earn higher returns. Therefore, they must avoid any behaviour towards speculation, panic, or sheep-like behaviour.
2. Following the idea of speculation, the cornerstone of value investing is a long term objective, translated by the buy and hold strategy. An objective of long term allows fund managers to take decisions based on the future of a company and not what the market is currently saying about it.
3. Diversification can take many forms. As it was raised in one interview, Graham said that it is better to have 3 or 4 stocks the fund manager know really well than 10 he does not know. Furthermore, fund managers must remain on the stock, bond and monetary market as they have a true underlying asset compared to derivatives for instance.
4. Fund managers must learn to reduce transaction costs by holding more their positions and pay less attention to their brokers and market rumours, recommending them to buy and sell more often.
5. Fund managers must see the market as a place where they can buy and sell shares only. Each investment they make is an ownership of a company they believe in, with a potential for growth in earning and income, and with a sustainable competitive advantage.

III- Limitations and suggestions for further research

The objectives of this dissertation have been met with secondary data presented in the literature review, and primary data collected through semi-structured interviews. The primary data have been hard to collect as few fund managers have answered the proposition for an interview. Therefore, the primary data have been presented as they are, not as a generalisation of what all the fund managers think on the topic.

Also, this topic is mainly focusing portfolio management companies and institutional investors. Speculation and high frequency trading answer different problematics and that is why they are popular, mainly in the banking industry. The point made in this study is to not

believe speculation can be classified as “asset management”. This is an important lesson for small investors willing to invest on the stock market.

Finally, it should be interesting for further research to investigate on a larger sample of the fund managers’ population, from different countries. Also, a quantitative analysis could be made to compare the performance of passive management with the 20% of the fund managers who succeed to beat the market.

Chapter 6 – Self-reflection on own learning

I- Introduction

This is the last chapter of the dissertation; it is dedicated to provide the reader an overview of the author's background, of the knowledge and experience gained in the process of researching and writing this study, and to explain how the skills learned in the MBA programme at the Dublin Business School helped in the process of building up this dissertation.

Also, the researcher will try to project himself in the future by describing how this dissertation, the MBA programme, and the skills learned can help him in his career which is about to start.

Therefore, this chapter is divided in three parts. The first part is about the impact of the MBA programme on the process of making the dissertation. The second part is the researcher's self-reflection on the development of this study. Finally, the conclusion is an attempt at figuring out how conducting a dissertation, spending one year in Dublin, and undertaking an MBA programme, will affect the researcher's career.

II- Undertaking the MBA programme: an experience of learning new skills

Before choosing to go in Dublin, the author was undertaking a Master's degree in "Engineering and Financial markets" at the ISEG Business and Finance School in Paris. He was offered the opportunity in his last year of study to undertake the MBA programme at the Dublin Business School in the context of an exchange programme. This programme, more oriented in corporate finance, would offer him a double specialisation and an opportunity to discover new learning skills and methods.

In his first years of studies, in 2011, he had already studied abroad in Spain for a bachelor in economics for the Erasmus programme. The experience was positive as it allowed him to have a first experience abroad, discover another culture, the Spanish learning methods in a public university, and witness the living conditions of a country in the middle of a recession.

Though, this new opportunity in Dublin was not in the same context. The maturity acquired in four years, the fact that he would be staying a whole year and the challenge an MBA represents, would make this year a complete different experience.

The courses topic were very broad; some were oriented in Finance such as Financial Analysis, Corporate Financial Management or Operations and Governance of Financial Markets. Others were dedicated to the preparation of this dissertation: Writing for graduate studies, Research methods, and Personal and Professional Development. The last category concerned strategies and management of companies: Business Strategy, International Management, and Performance Driven Marketing.

Looking backwards, the progress made in a one year time is a giant step. The assessment was the same for almost all the modules: an individual and a group work to submit. The researcher already worked in team but the differences in this programme were the adaptation to others' culture to learn how to work efficiently, and the organisation necessary to produce a Master level assignment. Also, people undertaking the MBA programme are very different; some already have work experiences, some have only done internships, or only the theories learned during their studies. This is a mix of personalities, culture and experience, which gave group assignments another dimension and a lot of character.

Regarding the individual works, the researcher faced new methods and learned new skills. In this programme, students are asked to research (not only referencing Internet sources), analyse, and most importantly bring a critic opinion on their assignment. The challenge of each course, assignment, and the rhythm of the MBA allowed the author to bring a new pallet of skills and methods to his resume, provided by professionals and in a spirit of comradeship and mutual aid.

Finally, the process of conducting the dissertation was eased by the modules previously mentioned, helping us to prepare it. The research methods, writing methods and analytical skills were provided in those courses and were very helpful for the making of this study.

The other courses provided the author with new knowledge which helped him to choose the topic and understand the literature.

Also, the assignments realised during the year helped him in the process of critically analyse the literature and present his own point of view supported by relevant sources.

III- Dissertation making process: knowledge, skills and learning styles

First the topic of the dissertation was inspired by the knowledge acquired by the author in his previous years of study. It started by an observation that most of the fund managers fail to beat their benchmark.

Far from the actual study realised here, the secondary data helped the researcher in finding the right scope of the dissertation to have the most precise subject possible.

The secondary data were mainly gathered via the Athens database, Google Scholar and other online resources. Also, some books were essential to read as they are written by the very people at the origins of asset management methods. The journal articles, textbooks, academic journals and newspaper articles provided the most relevant and current information available.

The gaps in the literature allowed the researcher to develop the research designs and find the right methodology to go more in-depth in the topic.

The researcher started by categorising the literature topics related to behavioural finance, market efficiency, value investing and indexing. For each category, sources came to support or contradict the statements. The essential elements of the literature review were analysed and critically reviewed so as the information are relevant to the context and the topic studied. The literature review demanded organisation, analytical and time management skills.

Then, choices needed to be made in the research designs regarding the primary data. The research objectives and questions being fixed, the literature review being covered, the researcher opted for semi-structured interviews. Quantitative data seemed inappropriate to answer the research questions; the goal was not to find numerical or statistical answers on how much returns an active fund manager can earn but how can he succeeds in beating the market regularly, on the long term and overperform passive management.

Qualitative techniques improved the researcher's interview skills and critical thinking. Furthermore, being able to meet fund managers is an enriching experience in a field he would like to evolve at some point in his career.

Finally, Honey and Mumford (2006) found four learning styles: activist, reflector, theorist, and pragmatist. The researcher adopted the reflector and theorist and reflector learning styles; the latter observe and reflect when the former wants to understand concepts and interpret results.

The MBA programme taught the author to be pragmatist, someone with the will to experience things to determine if it is realisable. Unfortunately, the topic of the dissertation did not allow him to practice this learning style.

IV- Conclusion

The author is convinced that the MBA programme was a wonderful experience. Besides learning new skills, methods and knowledge, this diploma is an opportunity to meet people from all around the world. Wishing to work in an international company, the Dublin Business School offered the author the possibility to experience working and living with people from different horizons.

As mentioned above, this second trip abroad was different from the first. With more maturity, staying in Dublin for one year is an enriching and memorable time. Dublin offers its inhabitants the possibility to live in a European capital, as big as a medium-size city from France (in numbers of inhabitants).

People are solidary and welcoming wherever you go and whoever you are.

This type of experience goes very fast. The only thing to do is to enjoy every moment, gather every piece of information given in class, and make that stay useful for the future.

The author wants in the long term (10 years from now) to become a fund manager. The tools he was given during this year complete perfectly his previous years of study.

The dissertation is also a bridge between his studies and his professional career. This dissertation represents his opinion and point of view at some point in time, prior to the beginning of his career.

However, he would recommend any student hesitating to undertake an MBA programme and is willing to share his experience. Furthermore, the Dublin Business School is a perfect environment as it is the better business school in Ireland.

To conclude, Dublin makes a perfect bridge for a student in his last year of study; the biggest firm in the world settle in Dublin and open opportunities for any person willing to seize his chance.

Appendices

Transcription of Frédéric GUIGNARD's interview

Can you start by presenting the funds, investment strategies, type of clients you have?

I joined the team of Aviva Investors France about three years ago. Aviva Investors is the Asset Management Company of the British insurance group Aviva, itself listed on the London Stock Exchange. Besides London, Aviva Investors has offices in a number of countries such as Paris, Chicago, Warsaw, Singapore. I work for Aviva Investors France, am based in Paris, and am part of a team of 6 people specialized in the stocks of the euro area. A US equity fund manager, two Japanese equity fund managers and a multi-asset fund manager complete the equity department. In Paris we manage about 100 billion euro of which 12 billion invested in the equity markets through funds called "pure" (100% stocks) or diversified funds. The funds under management are mainly from Afer, which we manage the fund since its inception, the fund's Aviva network and part of UFF funds.

Although our clients are different, we work with other teams in the group, particularly in London where two managers operate on European stocks, two global managers and a team of 5 people dedicated specifically to the British actions. We trade on our areas of expertise and generations of ideas.

Although within our team, we are all general managers, we have and develop individual skills in certain sectors. On my arrival in the team, I got the chemicals, mining and metals, and the media sector. Two of the six managers are specifically dedicated to small and mid-caps, the other four including myself are positioned on European large caps (ex-UK). But these small and mid managers also cover global areas (and therefore do not limit their expertise to the average values).

Our management is collegial, it's a team effort. As I told you we have areas of competence but that does not stop us from being able to leave to intervene in other areas, folders, or market capitalization levels. We all have some latitude to intervene in all team funds. We follow a "bottom-up" methodology also called stock picking in our stock market jargon. We are all primarily financial analysts and we rely on both a qualitative analysis of companies and sectors and on valuation criteria. We constantly are in discussions as a team that will lead to investment decisions (or not).

We do not actually have bias of the kind of value or growth. We have a long-term vision (sometimes more of 10 years), which is reflected in our portfolio turnover rate is probably around 20% to 25% (an average retention of a line of 4 years). Our management is rather flexible. We do not hesitate to make trade offs in terms of upside potential estimated.

The size of our funds being consistent, we must take into account a number of criteria including that of liquidity. The part in mid and small caps in our large cap funds will remain reduced.

What factors affect your chances of earning higher returns?

First the risk taking: the more we invest on non-consensual companies (annoying purchase, restructuring companies), more mechanically we have the prospect of high returns. We must continuously manage the risk / return in our portfolios.

Of course, transaction costs must remain low. Nevertheless, with a turnover rate of 20%, the transaction fees that range between 0.1% and 0.2%, it is not transaction costs that make the difference.

To me, it is the quality of management that is the most important and will generate alpha, that is to say, create value for the customer. In volatile markets such as stocks, generate long-term

outperformance (10 years) is the goal. Having a long-term management vision does not, however, prevent the generation of medium-term performance.

Training of students lingers long on the efficient market theory. In business terms, this would mean that if markets are efficient there is no opportunities of outperformance on the market. This theory of efficient markets has been the basis of all education provided in asset management for many decades. This is in my opinion a big mistake. Warren Buffett and his followers have long proven that this assumption is false. If markets were efficient, Warren Buffet could not build the empire he has today.

Bogle proved in his book « the little book of common sense investing » that passive management brings more returns on the long term than active management. Why keep having an active management when you have a long term objective?

It is no doubt true statistically. An experiment was conducted in the US in the last century: one asked monkeys throw darts at a table full of names of all the companies' stock prices. Each dart that reached the name of a company represented a buying decision. Experience has shown that these portfolios built on this basis performed better than the average results of managers. These results are all arguments for those advocating passive management based index funds.

But these arguments which conclude to the absence of value creation of the active management are based on average performance. So we forget to mention that there are several schools including in particular, Benjamin Graham and Warren Buffett -and generally called "value investing" - generates excellent results in the long term.

The contribution of Warren Buffett compared to Graham (his mentor and professor at Columbia), is to go beyond the study of the intrinsic value of a company from its accounting statements, to reflect the quality of management, the aligning of interests of management with those of the majority shareholder and those of minority, competitive advantages, entry barriers etc ... He created what is now called investment value (value investing).

Active management is to my point of view still relevant.

What are the advantages and inconvenient of a collective management as practiced at Aviva investors France?

First, it benefits from the experience of six rather than one. So we can have conflicting opinions, which can prevent us to make investment mistakes.

The risk when one is specialist of a sector is to have a vision too focused without seeing what opportunities that may arise on other market segments, other companies in other sectors. The team members bring this global vision which makes it relevant analysis and investment decision. On the negative side, this may be a delay in the management process, decision. Therefore some investment opportunities you may miss (market timing issues). This risk is exacerbated by the fact of our many trips, we are not necessarily all present simultaneously. We must be vigilant on this point.

Have you ever taken decisions based on market rumors, brokers analyses or crowd noises?

As part of our business, we rely on the work of sell-side analysts (analysis offices of our brokers). So we lose autonomy and independence, but it saves time because they are still experts. The challenge is therefore to take height from the opinions given to us. So there is a good chance that our judgement might be influenced.

In our business, we receive a very large flow of sometimes contradictory information. It is our job to sort this information and give them the importance that should. I look at some conclusions provided by sell-side analysts, trying to keep a critical eye on valuations provided but considers that these analysts are a good way to have qualitative answers on a sector or a company.

When you take decisions collectively and you have an opinion, won't you try to comfort your ideas rather than give an objective opinion?

Our process is rather informal, orally. Collective management sometimes provide conflicting viewpoints. We have sometimes heard strong views. It is also to other members of the team to play the role of opponent for the investment decision to be as objective as possible.

When you are a long term investor, what is the role of the market? How do you consider the market?

The secondary market's role is to facilitate access to capital for businesses to finance future investments by capital increases, for example. It is the role of the market for companies. Our goal in our asset managers is to create value for our customers, to increase the capital entrusted to us.

In my view, the market goes through phases of excess stress or short and medium-term optimism. Indeed, how do you explain that in less than 24 hours, stock price of a company can vary more than 10% on the basis of often minor or irrelevant information? It is these phases that create the opportunity for our customers.

Graham says in the "intelligent investor" that a portfolio must be composed of 75% stocks and 25% bonds (or the contrary depending on the state of the market). What do you think about it?

Warren Buffett said that "it is better to have 3 or 4 stocks well known in portfolio than 10 merely mastered." This is perfectly true, although in my opinion, Markowitz principle of diversification seems to be unavoidable.

The distribution of its assets over several asset classes (equities, bonds, real estate etc ...) brings more because it provides flexibility in the context of the management of investments, allowing to seize opportunities to arbitration when they materialize.

How to diversify his portfolio when a fund is composed in a large majority of stocks ?

My job is to invest in high-performing values, not worrying about the allocation between the different asset classes within diversified portfolios managed. We have in Paris at Aviva Investors Multi-asset manager who handles asset allocation by choosing what he sees as the optimal allocation depending on market conditions. His decisions are based on the opinions of the managers of the various asset classes within Aviva Investors and market strategists that particularly study major macroeconomic trends.

Equity CFD are very popular. What is the advantage to use them? In what situation?

CFDs are often used in long / short funds. They especially avoid securities borrowing for performing short positions on the market. CFDs are legitimate in this type of management. It's not in our mandate to use such products because we only manage fund called "long only" that is to say buyers without net selling position.

We use derivatives, index futures or options to manage liquidity in some of our portfolios.

Transcription of Romain RUFFENACH's interview

Can you start by presenting the fund « bati actions investissements » and the investment strategy?

This is a fund that is long only: our goal is to take only long positions vendors and unlike other SMA funds. The fund specializes in European equities. We have the right to buy sparingly Swiss or

Scandinavian stocks but roughly it is Europe. Bati actions Investissement is a fund that has about 200 million euros under management. Our strategy is to have a low turnover rate. It is a long-only strategy coupled with a "buy and hold" strategy.

How do you justify the buy and hold strategy rather than a more active management or a passive management?

The main advantage of "buy and hold" is a low turnover rate, it allows you to significantly reduce transaction costs. These can reach very high levels in some funds with greater than 30-40% turnover rate of the order of 1 to 2% of annual performance. If we can save only 1% per year over the long term it makes a very significant difference.

The buy and hold strategy decision is made before building the fund or after considering the needs of your clients?

This strategy is a cause but also a consequence. This means that our strategy is to invest in securities of qualities and buy them at reasonable levels. If you buy a quality stock and it remains of quality because it has strong competitive advantages, you have little reason to sell it.

You spoke about transaction costs, what other factors hinder you from having higher returns?

These are all that are the opposite of those that prevent you to get better returns. The three factors that allow you to get better returns:

Buy good companies: those that correspond to a certain number of quantitative criteria (among sma is considered a good company one that has a return on capital employed of at least 10%, a healthy debt structure, ie level of debt / ebitda less to 4 times, a wide coverage of its financial expenses, a significant ebitda margin, able to reinvest its free cash flow to at least equal the rate to 10%). So this is the quantitative part.

The qualitative part is to analyze the company. Once you've found one with a ROCE of 10%, the question is: in the future will it be able to maintain these ROCE of 10%. And for that it must be what Warren Buffett calls the economic moat, it has to be a fortress, it has competitive advantages: a very low cost structure, network effect, brand, etc. It is the first pillar. Because when you buy a company with a high ROCE each year it will achieve significant earnings power. It is as if you owned a bond that pays you a coupon. So over a very long period, you will receive higher coupons.

The second pillar is to buy at reasonable levels. If you buy a company with a 40% discount to its intrinsic value all things being equal you will make a better deal in the long term if you buy it at 0%.

The third pillar is to be a logic of "buy and hold" to have the lowest turnover rate because you can minimize your management costs and therefore you maximized your returns.

If I speak about inflation, market timing, fiscality, exchange rate, what do you think?

If we take the example of inflation. In an inflationary scenario, the question I ask myself is "what is the best way to protect myself?" This is having companies that have pricing power and are less intensive capital. Why ? because when you renew your current assets and that you actually have inflation you'll buy more expensive machines. If you are less capital intensive you'll need to purchase a capital asset that has been impacted by inflation. It is the first point. If the company is of quality she has a pricing power, so it is able to pass on the costs it had, which were inflated at least partially to its customers.

On the exchange rate it is extremely difficult to hedge against the exchange rate because if I buy a stock like Nestle. What happened with the Swiss franc controlled by the Swiss bank. The date that control goes it unscrews the Swiss franc. How does that impact Nestlé? it really does not impact Nestlé because what matters is the percentage of sales that the company makes abroad. For example Nestlé is 98% of its sales outside Switzerland.

But at the time you bought Nestlé stocks and by the time you sell it, you will have a loss in your portfolio.

If I did not protect the Swiss franc, yes. But it's very difficult to protect against this type of problem. However what I can say is that if the Swiss franc rises, it can have a positive effect on export companies.

The example we give most frequently is that of industrial companies which produce in Europe and export many in the USA. When the Euro decreases, it's a good thing for them because they become more competitive than their US competitors. So yes the currency decreases and it's not good because when you translate your Swiss franc euro account you lose but you can tell you that the export capacity of your company becomes stronger and it gains an advantage. The second point is that to cover yourself is expensive. There is an insurance that you pay and the long term it costs you money. And the third point is that I do not know where the Swiss franc will be tomorrow and if I do not know why I would take a position on it? Maybe some have the ability to say "Romain in the next 6 months the Swiss franc will fall sharply compared to the euro," and they may be right, and in this case it is right to cover over a short period but I don't know for sure.

If a colleague, financial adviser, broker give you an information, will you integrate it in your analysis and investment decision?

If I have someone calling me saying "I am convinced that the Swiss franc against the euro is necessary to cover you," my answer is: I probably will not cover myself because I know that nobody can with high probability to predict what will be the rate of the Swiss franc against the euro in six months. It is not our method, it is not our investment philosophy. Now there are people on the forex wins lot of money, who know how to do, and that respond to their customers' demand.

An important quality in the trade is to be independent. A broker when he sends me a note I ask myself the question what is his business; he takes a commission for every transaction he does. His job is to tell me a story that encourages me to buy a stock or sell. Moreover you will see that there are very few brokers who make recommendations "hold" or even "sell". Most of the recommendations, you're in a bull market, bearish or flat, are to purchase. But what I like about brokers is that they develop an analysis, they emphasize the points that you have not seen or they offer you another perspective angle: something you see as a threat they can present it to you as an opportunity; not only to sell you a story, sometimes there are a reality behind it. They also have access to management so you will have access too. This is also an important issue because you will never discuss with a CEO who will tell you in my company "things go wrong" even if it does, they always have a very positive speech.

You say brokers do recommendations to buy more often, but they take a commission whether they buy or sell. Why only recommendation to buy?

The main answer is: when a broker tells you a story he also sells services to asset managers. This service is that they bring you top management companies. It's hard to build a good relationship with a CEO when they recommend to sell their company. There is a kind of conflict of interest. If for example I'm analyst Orange and I want to participate in the roadshow of Orange, I'll do a lunch with Stéphane Richard and I will invite all the clients I have in asset management, it is still easier if I have a recommendation to buy than if I have a recommendation to sell.

At SMA Gestion, those decisions are taken collectively. What are the advantages and disadvantages?

I see more advantages than disadvantages, I do not even see drawbacks. There must be a framework in place. Under bati actions investissement decisions are made at 3, which is enough. When we are more the message can be diffuse. This is very positive because earlier I was telling you about the three pillars to achieve good returns: detecting a good company, make a valuation and hold the position as long as possible.

For the first two pillars there is a sort of checklist to have. On your first pillar requires that you graduate certain criteria for it to be a good company. What is a good test for me is not necessarily the same for my two other colleagues. The more you are the many more chances you have of your checklist is more comprehensive and more qualitative manner possible. The second pillar, a valuation is subjective. If you ask me the intrinsic estimate of a stock I will not give you a fixed price but a range because there are a certain number of elements to include: the growth rate, the ebit margin and there are adjustments to make. So the more you are, the more you look the more you work and will be able to detect errors.

When you present a company in front of your colleagues, won't you try to comfort your ideas rather than confront them?

So when I present a case, we are three to study it. Usually I focus my presentation in a sense. After what is interesting is when you take subjects in group there is one who is supposed to be the devil's advocate and see a bit all the negative elements and challenge you. If I make a presentation it will not be me who'll challenge my other two colleagues. I expect them to challenge me. The ideal is that if I am positive on a case, they are negative and ask me many questions. Once all the negative elements are delimited you have a better vision on it. Similarly, when someone is going to present me a case I'll get negative elements and be as picky as possible.

In the strategy of "buy and hold" there is margin of safety; when I invested I have to lose the least amount of money and for that we must avoid to make errors in the valuation and above all must not be mistaken about the quality of the business.

Does it not join the factor I was speaking about earlier : market timing ? If you don't buy or sell at the right time, it affects your returns.

If you buy at a bad price you necessarily are not going to do a good deal. But we do not think in terms of market timing, we take the problem from the other side. We identify a good company, what is believed to be a good company after qualitative analysis, and an intrinsic value we put him. For example, it is given 100, may be that the course is 150, you don't know. Maybe one day, for a reason, it drops below 100, 80 70 or even 60. At that time we will revisit the case and we review our valuation under 100, and the market Mr. Market is a strange fellow, once optimistic once pessimistic. If one day you have the chance to have a great company with a discount to our fair value even affecting our purchase price (this is a very stressed scenario), well there we will invest. What matters is not market timing. You can buy 60 and will continue to go down. The important thing is how much the company is worth, it is able to achieve such profitability, and whether you buy it at a price that is discounted.

You were speaking about M. Market : do you consider the market efficient or inefficient ?

Over the long term I would say the market is efficient but the short term is rather inefficient. In the long run when you have a great company, it is able to achieve significant earnings power and regularly, operators realize the quality of the company. The price will then be adjusted. But sometimes for some reason, there can be a big stress on a company. This is also what made Warren Buffett when he took his participation in American Express, there was a scandal about the company that has plunged the course. It has considered that the problem was not insurmountable and that it was therefore an investment opportunity.

But the quick fall of a stock, does it represent the reality of the business behind it?

When the price falls it means that the market believes that the environment will not be positive in the future but the intrinsic value of the company does not really change.

Graham in the "intelligent investor" says that a portfolio must remain between 75% of stocks and 25% of bonds (according to the state of the economy). Do you agree or do you see other asset classes?

I tend to agree with Graham personally. I think the best asset classes are stocks and bonds because they are not speculative products. I buy them but I know that in return I have a coupon, people who work, who produce something. When I buy gold I do not really know its intrinsic value, it will not give me a coupon. I do not know the intrinsic value of a currency relative to another, I do not know what it will bring me as coupon.

But when I invested in a stock, I know it has a benefit margin each year, it distributes or not in the form of dividends, I know I'll have a coupon as a bond.

What do you think of CFDs which are popular since their creation?

A CFD stock is a special case for me. I put it in the class of shares. It is a derivative but the underlying asset of a CFD is a stock.

The value of CFDs is that you can put leverage (20 times) and you cover against the risk of currency we were talking about earlier. The currency position is closed when you sell your CFD. Your CFD gain is the price of the CFD you sell less the price of the CFD you bought in local currency. And the translation they do to you between currency and local currency is at your closing. The currency risk is therefore borne by the broker.

But for me the main categories of investment that I consider are stocks, bonds (rate or credit), real estate, commodities, currencies and art.

I therefore agree to the 75-25 Graham but I do not agree to a number. If you have plenty of opportunity why be limited to 75% of shares.

I think that over the very long term, stocks are the best investment vehicle.

To take the less risk you have to diversify your portfolio. How is it possible when you manage an equity fund?

This is where I do not agree. If you have some great companies in your portfolio, why did you need to diversify?

If there is a crisis and prices fall : stocks you have fall too and your returns as well.

That is true. If there is a stock market crash and the market down 50% already I'm not sure that the course of my best companies also fell by 50%. This is the first point. Second, it's a short-term reasoning. In the long term these companies are fortresses, they will continue to be strong, to make a profit, so they will be victims of stress (which also cause opportunities to buy some more if the value is good). When looking at companies like Coca Cola, L'Oreal, which are more than a century, they have experienced two world wars, some who experienced the Great Depression, the 2008-2009 financial crisis. Yet the rate of annualized returns of the same companies are higher than 15% per year. So it does not bother me in the short term to lose 40% if in the long term I am sure to have strong returns.

Bogle says in "the little book of common sense investing" that passive management brings more returns. Why choosing active management when you have a long term objective?

When looking at the performance of the fund of Bogle, Vanguard, they are excellent. The stat that I know is that one out of 5 funds outperformed only. When you do this business, you're passionate and you think that by working hard, with experience, you can get to be in the fifth. If you succeed and you can get even a little outperformance on your benchmark, it can make a very high difference.

If someone wants to invest in stocks but did not want to spend time on it I will advise him indexing and probably a driven portfolio.

But I am sure that when you work hard, you do your job, you read the annual reports, you read the best investors, you pay attention to your valuation and you're careful, that you do not listen too much noise from Mr Market, you invested in good companies and you know how to wait, with the experience I think you're doing better than the benchmark.

Transcription of Pierre DUVAL's interview

Can you start by presenting your investment strategy?

Our goal is to assign a so-called active management of conviction. We have three performance drivers for our funds. The first thing is that the benchmark is still invested. It may possibly to consider that in our management it is authorized to have up to 15 or 20% in cash. If the market drops sharply, it makes you an important shock absorber and makes outperformance relative to the index. The last time we used it, for example, it was at the time of the 2008 crisis, and it enabled us to significantly outperform the fall. The second criteria we have is the choice of sector; that is to say, the basic principle is to say that in fact you have at times more or less promising sectors since they have a more or less favorable environment. Being positioned on these areas allows us to outperform the index. The third criteria is when you choose the areas you'll focus is to find in these sectors the best performing companies through the financial documentation, quarterly report of activity.

Your strategy is one of bottom-up or top-down?

If you make a sector analysis you are interested in macroeconomics. When the economy starts again, it means that consumption recovers, the most cyclical stocks, investment restarts and therefore cyclical stocks will also start. That's why in our sector analysis you have to make macroeconomics. But at some point we will also do what you call the bottom up. Once we made our sector allocation we will look at companies one by one, their half-year results, strategy, management quality, etc. So combining the two. Our goal is to remain responsive. Also, on average we have concentrated portfolios, that is to say from 40 to 50 stocks in the portfolio, simply because once you have a good idea, in order to have positions which are not too weak they must be carriers.

Are you in a mind of buy and hold or if a sector is fragile you leave your positions?

We do not do "buy and hold". If the sector is persistently carrier, if the company is well managed, there is an exposition we always find in our portfolios. These are values that have good growth, good visibility and good performance. The principle is not to rotate too much our portfolios but to always be responsive to enjoy the opportunities the market has to offer. Our management is very oriented towards growth stocks because performance over the long term through increased revenues and profits. But these values there are times they can be very overvalued by the market, especially if the market is a little worried it tends to overpay and can ignore other values; This is the case of cyclical stocks, heavy cyclical and financials. That is why we have a portfolio of heart which are growth stocks and using the opportunities offered by the market to make trading on more volatile sectors, financial and cyclical stocks.

Having a turnover rate more important, does it not penalize you in term of transaction costs ?

That depends if you make good operations, no. But if you actually make bad operations, yes. The goal is to increase the performance being as responsive as possible. If you buy a value, sell another one and the differential of 15% between the two, transaction costs are lower. The question is whether the choices are wise.

What factors other than transaction costs affect your chances to get better returns?

The number one factor is a better analysis, sector choice. If our choice of sector does not match what the market expects there may be periods of significant underperformance. Active management is somewhere in the hope of winning more, you have to take more risk. Our biggest risk is first an error of choice.

What role do you give to the market?

When working every day on the market we cannot be completely indifferent to the rumors, this is part of the job. The market provides guidance in addition to our macroeconomic and microeconomic analyses. It is often found that when the market says we are wrong, 3 out of 4 times the results are not good.

The market gives certain indications; if you want to return to an area that had been neglected. For example a value that has declined but not bad basically, quarterly results come out and they are not good but the stock ended the session up. It is a technical factor that the market announces that it is now willing to bet that it will get better. It is a strong signal that you can return to this sector and value. Although I do not like that kind of term, the market complete our analysis to find the right "timing" to buy or sell stocks.

When a stock loses 5 or 10% on one session, it does not reflect the reality of what the company is worth. Where is the frontier between technical analysis and fundamental analysis?

We favor fundamental analysis but when a value is expected to rise but fall, it's worth reviewing our analysis and to look into his case. The market may be wrong but when a value that fall in an area that is well, the market is often right. Usually it will show up bad news behind.

There are two theories to say whether the market is efficient or not. Is it important in your daily work or is it only theory?

There are indeed times when the market surprises me, he is right and in such cases it is efficient. It's not always the case because behind the market there are people who are not always guided by the perfect objectivity.

In everyday life this is not a theory that I will consider. However I'll make sure to be as logical as possible. Behavioral analyzes were performed because there are behavioral biases we all have. The market is what it is, what makes the difference is how each is equipped to respond to the market.

On one hand there is our work, our analysis and on the other hand the psychological side.

How do you fight against those behaviour biases?

When I make a purchase or sale I wonder if I take into account the basic principles, is that I do not participate in a herd movement, is that I do not panic as this is not justified, etc. I always avoid jumping to conclusions, it is often costly. We must work our analyses being done upstream, analyze the values, one can be mistaken but it severely limits against breakage. What must be avoided is when a broker calls us with a "great idea" to follow his instructions without thinking. If we speak of a value that is already up 50% you are at risk. A bias that cost the most is to sell values that increase and keep those that decrease in the hope that it will go up and we will be able to recover our bet.

Do investment decisions are taken collectively or each manager is independent?

The base is the same for all, as I explained to you: sector analysis, growth stocks etc. After all managers already do not have the same type of fund to manage. Our principle is that each manager must be empowered and that large management meetings that last for hours where no one agrees and no decision is taken at the end, do not bring anything. There are some formal meetings but each manager is autonomous.

The managers are paid in part by the performance of their funds so they need to be autonomous and independent.

This type of wages has been criticized during the last crisis of 2008. The fact they act in total independence, does it not reinforce behavioural biases?

Being responsible does not make you subject to behavioral biases. They can also compare their ideas because everyone works in a large room and we have a system where each manager can see the operations performed by the other managers in real time.

We are a small structure so communication is easy. In addition, we have no "buy side" analysts so people are autonomous, some meetings are organized to formalize the organization but it would be counterproductive to impose some type of management.

The wealth of a manager is that he is empowered, he has the chance to show his qualities. Each one of them brings something more to the team.

Graham in the "intelligent investor" says that a portfolio must remain between 75% of stocks and 25% of bonds (according to the state of the economy). Do you agree?

Graham is no active or passive manager but manager of the absolute, without comparison with an index. If you're managing relative to an index, when it goes up you have no interest in having only 25% of the portfolio in equities.

It is authorized from time to time to have up to 15 or 20% in cash. The index is 100% invested and the other goal is to beat him. When it falls, the fact of having more cash helps you take the shock.

Do you have constraints in the choice of asset classes?

We do not use derivatives, only pure products; that is to say, when it's too expensive we sell that's all. Hedging is made when the value was already well down. We have Equity funds that are sold to institutional. They do not pay us to manage money. We have mainly stocks and the rest of cash we have is sometimes used to buy monetary instruments.

How do you diversify when 75% of your portfolios must remain stocks?

We are an equity fund. My risk is to do worse than the index, not to lose money. I occasionally use the cash but over time the experience has been that the allowance shares + cash is hard to beat in terms of asset allocation.

If you stick to a sector analysis, and good values in these areas there is no reason why in the long run you don't do better than your index.

And allocation between action and bonds is very difficult. In addition, behavioral biases make managers panic quickly when they have wrongly allocated their assets and this is where there are mistakes made.

Why managers fail to beat their index?

Because of the behavioral biases we talked about. From time to time one is caught by the market and we jump to conclusions. There is also the fact that in active management we have more costs to deal with.

Why choosing active management over passive management?

The advantage of active management for investors, especially institutional, it is when their manager offers them a higher return than his benchmark since it is always relative to a benchmark; it must be a basis for reflection. And if possible, also with lower volatility. That is to say that an institutional investor may still be susceptible at one point to take back his money, so when the market falls he wants his portfolio to be more resistant than the market. So the objective is beat the index with a lower volatility over time. It is the goal of active management. The advantage is that the index still has stocks from sectors that go wrong in his portfolio when we can withdraw from these positions and outperform the index.

Passive management cannot do better than the index while the active management if it is good we can do much better. However, passive managers will tell you that 80% of managers do not do as well as their index.

We over time do better than our index, 80% better.

The institutional investor will make an overall asset allocation between investment rate, monetary investments and equities. If he does passive management, he can find the same performance as the market, while active management is both an advantage and a disadvantage: the least is that it is not

sure to do at as well as the index, and the most is that if it works well, the manager will do much better than the index. It will further increase the efficiency of its asset allocation.

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