Gage Wealth Management Group

Updated April 2012

Actively Managed Mutual Funds

The review was first written in 2000 and since then evidence for the advantage of passive and index funds over actively managed funds has continued to accumulate. It seems fair to say that at this point it's not even a debatable issue; passive and index management is clearly superior to active alternatives.

Popular financial magazines such as Money, Forbes, and Worth, and subscription newsletters such as Morningstar and Lipper, offer investors advice and information on selecting actively managed mutual funds and "hot" managers. Central to the selection process promoted by these periodicals is the notion that mutual funds and managers can be ranked, rated, and compared and the great, good, and not-so-good can be sorted out. This page briefly reviews the evidence for this belief and some related issues.

PAST MUTUAL FUND PERFORMANCE DOESN'T PREDICT FUTURE PERFORMANCE. Extensive, oft-repeated studies of five, ten, and twenty year track records for mutual funds indicate that there is no useful statistical relationship whatsoever between a funds past performance and its future performance. A recent Morningstar study found that of 452 domestic equity funds in their database that had existed for 20 years, only 3% outperformed their respective indexes. And, this doesn't take into account survivorship bias; the funds that survived were the better performing funds. DFA examined survivorship bias for July 2004-June 2009. They found that, on average, 5.7% of the actively managed fund universe disappeared each year. In that study they also found that 63% to 90% of active equity funds and 93% to 100% of active fixed income funds underperformed their matched indexes. And, only about 1.4% of actively managed funds outperformed their benchmark over the five year period. Another study found that of the 248 stock funds receiving Morningstar's (highest) five star rating in January 2000, only four, or 1.6% kept that rank after ten years (12-31-09). Few retail investors would have missed the financial media's coverage of fund manager Elaine Garzelli's forecast of the Crash of 1987. Money streamed into her fund. In 1988 her fund lost 13.1%, lagging the market by 29.7%. In her fund's six years of operation, it trailed the S&P 500 by 9.6% annually.

Past performance doesn't predict future performance though there is some weak evidence that outperforming funds in one year tend to slightly outperform the next year but it is of little practical use to investors. Yet, mutual fund rating systems and investors continue to focus on historical performance, particularly long-term performance, as a primary criterion for recommending funds. Morningstar provides analysis and rankings of mutual funds primarily based on past performance. The financial community boasts about and promotes top rated Morningstar funds and investors move money into them in far greater amounts than lesser ranked funds.

"HOT" MUTUAL FUND MANAGERS CAN'T BE CHOSEN IN ADVANCE. There's no evidence that outperforming mutual funds can be chosen in advance. This makes sense since past performance doesn't predict future performance so we have nothing to assist us in choosing funds in advance. A sixteen year study of Forbes recommended "Honor Roll" Funds found that they substantially underperformed compared to the S & P 500 index. A New York Times contest pitted five prominent, very experienced mutual fund advisors, including the publisher of Morningstar, against the S & P 500 for a three year period. They underperformed it by an average 5% per year. An update on the study in July of 1999 reported that the leader of the five fund pickers had managed a gain of 157.9% over the six year period, while the S & P 500 rose about 250%.

FUND RATING COMPANIES ADD LITTLE OR NO VALUE. Commercial fund rating systems, as noted above, appear to be of little value. Studies on Morningstar’s track record show that investing in top rated five-star funds produced future underperformance for subsequent one and three year periods, not superior performance, for both stock and bond funds. Weston Wellington of DFA (April 2004) looked at a curious anomaly in Morningstar's rating of three DFA funds. Morningstar rated one DFA fund two stars, one three stars, and one four stars even though the funds were all virtually identical. It turns out that Morningstar's rating scheme is dependent on the period of time a fund has been in existence, performance of course depends on the time frame examined, and the three funds started at different times. Investors may be further mislead by following Morningstar's exclusion of loads, sales charges, and taxes when reporting fund performance. These factors very significantly reduce returns in actively managed load funds when compared with passive and index funds.

Mutual fund rating services seem to know that their ratings and rankings systems shouldn't be used to select funds. But, it is doubtful they would have a marketplace for their services if they didn't offer them; they make their living selling this "information". Morningstar’s User’s Manual contains only a few much un-emphasized disclaimers: "It's important that investors not place too much emphasis on this rating when evaluating funds", and "a rating is neither a predictive measure nor a "buy/sell" recommendation". Yet, the public, many investment advisors, and mutual fund companies select, promote, and sell funds emphasizing Morningstar "star" ratings.

ACTIVELY MANAGED FUNDS DON'T DO BETTER IN BEAR MARKETS. During bear markets, marketers of actively managed funds often promote the idea that they'll protect investors and avoid the losses indexes produce since indexes merely track a declining market and they supposedly are capable of profitably moving into and out of markets. There is no evidence to support this claim. In 2008, a very bad year for equities, Morningstar data show that actively managed funds lost 1.4% more than index funds.

ACTIVE MUTUAL FUNDS ARE FAR MORE EXPENSIVE THAN PASSIVE AND INDEX FUNDS. Extensive research indicates that after management fees, trading costs, and other expenses, the average actively managed equity fund underperforms its respective index benchmark by about 2-2.5% per year, and the average actively managed fixed income fund underperforms by about 1% per year. The average actively managed equity fund has an expense ratio around 1.3% versus between 0.1% and 0.50% for passive and index funds, depending upon asset class. The average actively managed fixed fund has an expense ratio around 1% versus 0.1% to 0.3% for passive and index funds. Expenses hold back actively managed funds.

INVESTORS ARE PRONE TO MOVING INTO AND OUT OF ACTIVE MUTUAL FUNDS, GREATLY REDUCING THEIR RETURNS. Repeated studies done by DALBAR, an independent research group, have found that broker advised fund investors, and investors self-managing their own mutual fund accounts, dramatically underperform the S & P 500 index and advertised fund and manager returns. In one study, DALBAR found that the average stock fund investor earned annual returns of only 2.6% for the seventeen year period from 1984 through 2002, while the S & P 500 index averaged 12.2% per year, and one month C.D.'s returned 5.8%. Investors as a group would have done far better avoiding the risk in stock markets, and simply buying C.D.'s at the bank. From 1984-1998, the average fixed income fund investor received an annualized return of 6.33%, while the long-term government bond index yielded over 6% more per year, 12.76%.

ONLY ONE VARIABLE PREDICTS FUTURE MUTUAL FUND PERFORMANCE BETTER THAN CHANCE: THE EXPENSE RATIO

Paul Farrell on Marketwatch (4-10-12) mentions a study prepared for mutual fund industry insiders by the Fund Research Corp., FRC, "Predicting Mutual Fund Performance II". FRC studied funds in five asset classes; US equities, international equities, corporate bonds, government bonds, and municipal bonds. They tested ten variables often used to predict mutual fund performance and select mutual funds likely to outperform. These included past performance, Morningstar ratings, expense ratios, asset size, and four riks-volatility measures; alpha, beta, standard deviation and the Sharpe ratio. FRC concluded that only one of these variables predicted future mutual fund performance-the expense ratio. Passive and index mutual funds offer, by far, the lowest expense ratios.

CONCLUSION: Since the evidence clearly shows that "good" active mutual fund performance cannot be determined in advance and that active managers significantly underperform passive and index portfolios over long time-frames, investors should avoid using rating and ranking systems for selecting mutual funds or advisors who use such systems in managing money. Real investors in real fund portfolios do far worse than the advertised numbers, so avoid trading actively managed mutual funds. The far better choice is to employ a buy and hold strategy with passive and index portfolios for both equity and fixed income investing.