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Making the Important Decisions

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Mast Report

ACTIVE FUNDS VERSUS PASSIVE INDEXES

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Twice a year, S&P Dow Jones Indices distributes its SPIVA U.S. Scorecard report. These reports compile the investment performance of actively managed mutual funds compared to selected benchmark indices. The latest report was distributed on September 21st and can be found on the S&P Dow Jones Indices website at us.spindices.com. That report contains information on performance though June 30, 2017, covering performance over the prior 1, 3, 5, 10, and 15 year periods.

Among the information covered in the report, the percentage of actively managed funds that outperform their respective benchmark indices receives the most attention. This is because it addresses the question of whether or not actively managed funds have, overall, outperformed the returns of indexes, which investors can invest in using index funds.

By now, most reasonably informed investors know the answer to this question is no; the majority of actively managed funds have not performed better than benchmark indices. Some have, but the majority has not. There is always debate about if, how, and why a higher percentage of actively managed funds can outperform indexes. For example, current debate is focused on lower correlations of returns among individual stocks. This is thought to provide more opportunities for actively managed funds to outperform. This may be true. However, there is reason for skepticism, simply because relative performance is a zero sum game. More than 50% of all actively managed funds cannot outperform the median performance of all funds, even before management fees and transactions' cost are taken into account. And those fees and cost are much higher for actively managed funds than they are for nearly all index funds.

Historical data provided in the SPIVA U.S. Scorecard reports indicate this. These reports assign actively managed funds into one of four broad categories: U.S. equity funds, international equity funds, U.S. fixed income funds, and international fixed income funds. Within each of these four broad categories, funds are assigned to subcategories. For example, within U.S. equity funds, there are subcategories based on market capitalization and style, that is, growth and value.

A spreadsheet is available which provides the number of funds in each of these categories, the index that is used as the measure of benchmark performance in each category, and the percentage of funds that outperformed that benchmark for the various time periods covered. This is a lot of detailed information to scrutinize, more than most would want to wade through. But it is provided if one wants to.

Here is a summary of key observations. First, across all categories covering a total of 4354 actively managed funds, their performance over the past year through June 30, 2017 was much improved with 46.1% of all funds outperforming their assigned benchmark indexes. Over the one year period through December 31, 2016, the percentage of funds that had outperformed was a much lower 23.60%. I was surprised that the percentage of outperforming funds over the prior year through December 31, 2016 was that low. The improvement to 46.1% over the past year through June 30th has brought forth optimism that active management is back. Expect there to be a lot of pointing to superior rates of return over the past year as evidence of what could come.

Of course, it is returns that are sustained over longer periods that are much more important. Here, the data show what will more likely occur in the future. Again to summarize, across all categories, 23.9% of actively managed funds outperformed their benchmark indexes over past 3 years. Over the past 5 years, the outperforming percentage was a bit lower, 20.9%. Over the past 10 years, the percentage of outperforming funds fell to 15.2%, and to just 9.9% over the past 15 years. When all funds covering all periods are combined, the percentage of funds that outperformed their benchmark indexes was 24.5%.

The implications of these data are obvious. Outperforming a benchmark index is rare. This is because it is very hard to accomplish, especially with any consistency. For investors in actively managed funds, this is compounded by a requirement that one will be able to identify actively managed funds that will outperform before it happens. The odds of accomplishing all of this are far lower than those of correctly calling the flip of a coin.

The better approach for nearly all investors is to use lower cost, better diversified index funds to build and maintain a portfolio. Take a long-term perspective. Focus primarily on overall asset allocation, because asset allocation will, by far, be the most important and significant determinant of the performance of your portfolio. Set the allocation of assets in your portfolio based on your financial needs, circumstances, and objectives, your age and plans for retirement, and your tolerance for and ability to take investment risk. You provide this and a financial planner can help. If the financial planner makes projections of future rates of return on your portfolio, make sure you know and understand how these projections are made and what inputs go into making them. Make changes in your portfolio when you and your situation change.

Also, set and make changes in asset allocations in your portfolio when economic and financial market conditions change. This is not the same thing as periodic portfolio rebalancing using a calendar as you primary investment tool and metric. Find a source that can help with this. Consider these Reports as a useful source. Contact us with questions and observations.

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