

MAKE IT

The importance of being idle

Actively managed equity and fixed-interest funds have again been outperformed by benchmark indices.

By John Kavanagh

Research company Standard & Poor's has delivered a heavy blow to the credibility of the investment-management industry, reporting that only a minority of actively managed equity and fixed-interest funds have been able to beat their benchmark indices over short and long terms.

The S&P report, *Indices Versus Active Funds Scorecard*, covers the US and international investment markets. It will be of interest to any investor thinking of getting into the international equity or fixed-interest market.

S&P observed funds for a five-year period to the end of 2008. It found that the S&P 500 index outperformed 71.9 per cent of actively managed large-cap (investing in large-capitalisation stocks) funds. The S&P MidCap 400 index outperformed 79.1 per cent of actively managed mid-cap funds and the S&P SmallCap 600 outperformed 85.5 per cent of small-cap funds.

It was a similar result in the US fixed-interest market. Benchmark indices beat most actively managed fixed-income funds over the five-year period.

S&P says these results are similar to the findings of its previous five-year study, 1999 to 2003.

The report compares the performance of active managers against their relevant indices during 2008 to see how the managers handled the bear market (see table, right). Again, the indices came out ahead of most active managers.

"One of the most enduring investment myths is the belief that active management has a distinct advantage in bear markets due to the ability to shift rapidly into cash or defensive securities," says S&P. "We dispelled this myth in 2003 using the case study of the 2000 to 2002 bear market. The downturn of 2008 provided another case study."

S&P's analysis of international equity funds also shows the indices coming out ahead. Over a five-year period the S&P Global 1200 index beat 63 per cent of



active global funds and the S&P International Small Cap Funds index beat 59 per cent of active funds using that index as a benchmark.

Over the one-year period the S&P Global 1200 beat 59.8 per cent of active global equity funds and the S&P International Small Cap Funds index beat 50 per cent of active funds.

One of the interesting aspects of the report is that it looks at the impact of

active fund returns using only surviving funds, the comparison would be biased in favour of the funds. S&P corrects for this by including the funds that operated at the start of the survey.

What is interesting is to see how many funds close over a five-year period. S&P reports that of the 2024 US equity funds operating at the beginning of its survey period in 2004, 73.4 per cent were still operating at the end of the

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survivorship on returns. So-called survivorship bias means long-term returns show only the performance of funds that have lasted the distance. In many performance tables, as the dud funds close and drop out, their weak performance is no longer recorded.

If index returns are compared with

five years. More than a quarter had closed or merged.

Even more striking was the finding that of those funds that did last to the end, only 51.9 per cent maintained a consistent investment style.

One of the common themes in the marketing of managed funds is the

BEAR MARKETS - PERCENTAGE OF ACTIVE FUNDS OUTPERFORMED BY BENCHMARKS

	2008 %	2000-02 %
All Large-Cap Funds	54.3	53.5
All Mid-Cap Funds	74.7	77.3
All Small-Cap Funds	83.8	71.6
Large Growth	90	49.4
Large Core	52	53.4
Large Value	22.2	36.5
Mid Growth	89	82.4
Mid Core	62.3	70.2
Mid Value	67.1	82.8
Small Growth	95.5	87.5
Small Core	82.5	70.8
Small Value	72.6	58.3

SOURCE: STANDARD & POOR'S

ability of the manager to maintain a disciplined approach to investing and not chop and change with the cycle. The survey suggests many managers do not have that consistency.

Survivorship and consistency figures were better for global-equity funds. Of the 95 global-equity funds operating in 2004, 80 per cent were still there at the end of 2008 and 69 per cent were still employing the same investment style.

To be fair to the fund managers, while most produced lower returns than the relevant indices, the level of underperformance was not great.

Last year the S&P 500 fell 37 per cent and the average US large-cap fund lost 38.6 per cent. During the same period, the S&P SmallCap 600 fell 31.07 per cent and the average small-cap fund fell 36.3 per cent.

In the international market the S&P Global 1200 fell 40.1 per cent in 2008 and the average global fund lost 41.1 per cent. The S&P International Small Cap index fell 47.6 per cent in 2008 and the average international small-cap fund lost 39.6 per cent (notching up a win for the fund managers).

Still, active managers charge higher fees than index managers, claiming they can produce higher returns.

The evidence suggests that only a minority of them can do that.

Difficult markets ... active managers have not earned their keep.
Photo: AFR