In Mutual Funds, is Active vs. Passive the Right Question?

Whether we're talking about sports or investing, people have an urge to win. In investing, investors seek outperformance. Thus, most mutual fund shareholders aren't satisfied with the performance of a humble passive benchmark such as the S&P 500 Index. Instead, they search for an actively managed fund that they believe will beat the benchmark. Gerstein Fisher examined the perennial active vs. passive question from a few vantage points and made some interesting discoveries.

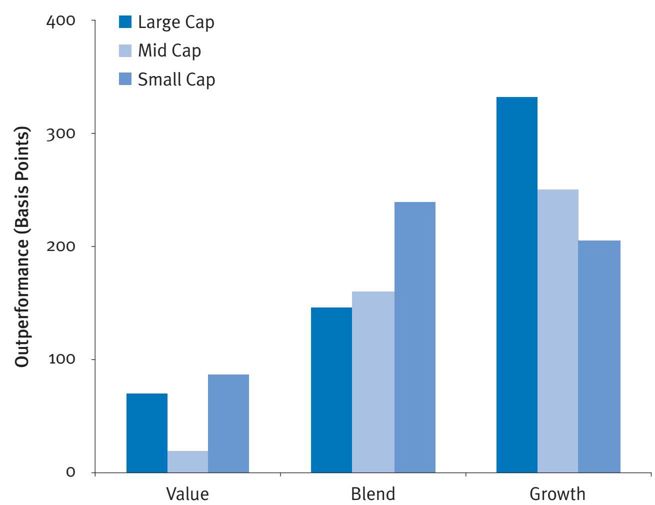
The Choice

The first conclusion should be no surprise to most investors: over extended time periods (15 years, in the case of this study), most actively managed funds have a challenging time beating passively managed index funds after fees. Using Morningstar's fund database, we examined the performance of more than 2,000 active US equity funds during the 15-year period from July 1, 1998 to June 28, 2013. Result: only 25.6% of the active funds currently in existence outperformed their benchmarks (nearly 75% trailed the benchmark or had an insufficient track record to compare). Many other studies over extended time periods have reached a similar conclusion, including Standard & Poor's, which found that 69% of all domestic equity funds were either outperformed after expenses by their benchmarks over the prior five years or had been liquidated during the period from Jan. 1, 2008 to Dec. 31, 2012 (Source: S&P Indices Versus Active Funds Scorecard).

At Gerstein Fisher, we tend to think that markets do a pretty good job of pricing risk; thus, investors are better off buying the market than trying to beat it. Considering how much information is embedded in the price of securities, it's not an easy task to identify mispriced securities and outperform the market based on information that only one of us has versus the average for all of us. In the market, a dollar of outperformance by one investor is matched by a dollar of underperformance by another. Add to that higher costs for actively managed funds, such as annual expense ratios and transaction costs, and it's clear why active funds start with a large handicap.

But here's an interesting twist: across company size and geography (see Exhibit 1), growth appears to be the investing style that quite consistently performs best among actively managed funds. For example, during the same 15-year stretch, 85% of large cap growth funds beat their Russell 1000 Growth Index benchmark after fees, while only 47% of large value funds bested the Russell 1000 Value Index (note that there is survivorship bias in this comparison since it measures only funds that have survived the 15-year stretch, while in the active vs. passive calculation above we have accounted for funds that did not exist for the full 15 years). This edge for active growth managers may be due to momentum (the tendency for winning stocks to keep winning and losing stocks to continue on a downward trajectory) and the ambiguity of valuing growth stocks. Thus, passive investing makes sense overall, but if you're intent on picking some active funds, growth may be the place to be.

Exhibit 1: Actively Managed Domestic Equity Funds vs. Their Benchmarks, Jan. 1, 1998-Jun. 28, 2013



Source: Morningstar, Gerstein Fisher Research

Costs Matter – to a Degree

As we indicated earlier, fund costs matter. But they are not the only factor in picking a fund; nor should they be the most important factor. Contrary to the belief of many investors, selecting an active fund based solely on a low fee is a mistake.

Gerstein Fisher went back and compared cost and performance for equity funds from July 1, 1998 to June 28, 2013 (see Exhibit 2). We found that the best performing quintile of funds was the second most expensive quintile (i.e., the 21-40% highest-cost ones), whether we equally weighted funds or asset-weighted them. The consistent results of the study: the cheapest quintile of funds was not the best performing, but the most expensive funds were the worst performing. For example, the second cheapest quintile of funds was twice as likely to outperform as the most expensive funds (30% vs. 15.7%). Clearly, high costs are a very high hurdle for active fund managers to clear.

The Tax Drag

From our vantage point as financial advisors, we see that investment loss to taxes is very often overlooked. After all, the fund industry tends to report and advertise their returns on a pre-tax basis. We examined the loss to taxes during the same 15-year period (starting in 1998) and concluded that it ranges from 70 to 120 basis points per year for active funds, depending on asset class and fund manager type (we used Morningstar's monthly tax calculations, which are adjusted for tax changes over time). For equity active managers, tax costs were much higher, averaging 94 vs. 51 basis points annualized for active and passive funds, respectively, during the 15 years. This stands to reason: passive funds attempt to replicate index performance and so generate relatively few capital gains. Active managers, in attempting to add value and capture alpha, are generally much more actively buying and selling equities, thereby increasing capital gains exposure for the fund shareholder who holds these assets outside of qualified accounts.

The High Cost of Behavior

Now it's time for perhaps the most surprising of our findings. The greatest cost of all – larger than fund fees, the tax drag, or the performance gap between passive and active funds – is the loss due to investor behavior. We can define this figure as the difference between mutual fund returns and investor returns; in other words, poor timing decisions on the part of investors, who have a well-documented behavioral tendency to pile into "hot" funds or asset classes and then head for the exits when the manager or asset turns cold. A typical example is an investor who puts her money with a hot fund manager, and then yanks it out and invests in a passive index fund when the active manager appears to lose his touch.

We studied the behavioral cost for active equity fund investors during the 15 years from July 1, 1998 to June 28, 2013 and determined that the average loss to investors was 3.56 percentage points per year (see Exhibit 3). For active international funds, the behavioral cost was an even larger 4.62 points. Domestic large growth fund investors lost 3.05 points annually to behavior, compared to 3.19 points for large value investors (recall that the loss to taxes was .94 points overall for active US equity funds). Not surprisingly, the behavioral cost for investors in passive equity funds was much more modest than for actively managed funds, just 1.36 points (and recall that the annual tax cost for passive funds was a more gentle 0.51 points).

Exhibit 2: Probability of Outperformance and Returns by Decile, Jan. 1, 1998-Jun. 28, 2013

Quintiles (1 = Cheapest)	1 Year	3 Year	5 Year	10 Year	15 Year	Asset Weighted Returns (15Y)	Equal Weighted Returns (15Y)
1	86.21%	5.06%	10.57%	32.64%	29.43%	6.97	5.89
2	82.35%	4.47%	10.12%	31.53%	30.12%	6.56	6.07
3	76.10%	4.39%	12.06%	29.17%	28.29%	7.20	6.42
4	76.66%	7.86%	14.99%	27.52%	24.32%	8.11	6.67
5	68.22%	8.18%	9.11%	21.26%	15.65%	6.09	5.77

Source: Morningstar, Gerstein Fisher Research

Exhibit 3: Cost of Investor Behavior, Jan. 1, 1998-Jun. 28, 2013

	Active			Passive		
Domestic Equities	**Value**	**Blend**	**Growth**	**Value**	**Blend**	**Growth**
Large	(3.19)	(2.29)	(3.05)	(1.58)	(0.51)	(3.02)
Mid	(3.15)	(2.56)	(5.77)	–	(1.64)	–
Small	(2.83)	(4.12)	(5.08)	(1.54)	(0.98)	(0.26)

Source: Morningstar, Gerstein Fisher Research

For more discussion on the important topic of passive and active funds, Gerstein Fisher invites you to watch a recent television interview that we did on the subject: http://wealthtrack.com/season-09/actively-managed-funds-vs-passive-index-funds/

Conclusion

Investors expend much energy searching for low-cost funds and trying to decide between an active and passive fund strategy in building a portfolio. The larger issue may be investor behavior – whether an investor can stick with a strategy and stay invested in order to earn the long-term equity premium in the stock market. Too many investors fail to stay the course with their investment strategy, and instead tend to sell funds when they underperform, or rush in when a manager has been performing well. In doing so, investors can be their own worst enemies. So perhaps a better question to contemplate than whether you can do better with an active manager or a passive one is, do you have a sound long-term investment strategy, and do you have the discipline to stick with it?

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