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Comparing index mutual funds and active managers

ON INVESTING
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The index fund recently celebrated its 40th birthday. The Vanguard 500 Index Fund, the very first indexed mutual fund, began on Aug. 31, 1976. That might not seem like such a big deal, but consider that during a typical 10-year period, roughly half of all stock mutual funds close their doors. Merely surviving for 40 years is quite a feat, but the fact that the Vanguard 500 Index Fund is now among the largest mutual funds in the world makes it all the more impressive.

In fact, of the 25 largest mutual funds, all but 10 are index funds. Of the 10 non-index funds on the list, only six are actively managed. The remaining four are money market funds.

All of this is a testament to the vision of the Vanguard Group founder, John Bogle, or Jack, as he likes to be called.

> **When net returns are compared, the naïve index fund is superior to the really good active fund manager. Over time, this cost advantage compounds, further benefiting index funds.**

Jack wrote his Princeton thesis in 1951 on the notion that most active fund managers fail to outperform their benchmark indices. His research was novel at the time, but he was not the first to notice this phenomenon.

Alfred Cowles studied active stock pickers in the 1920s, finding that most stock pickers and market forecasters underperform a buy-and-hold approach. Subsequently, Adam Smith's book "Supermoney" noted in 1972 that "There is no evidence that any group of funds can beat the averages."

Nobel Laureate Paul Samuelson, Professor Burton Malkiel, and investment guru Charles Ellis were all making similar observations around the same time Bogle launched the first index fund. There have been numerous academic studies since, also showing that the vast majority of actively managed funds underperform appropriate benchmarks.

Twenty-five years after his Princeton thesis, Jack Bogle was the first to marry the academic theory with practical application, resulting in the first real-world index fund. This was a dramatic departure from the more traditional approach of actively managing investment portfolios.

Active management involves a portfolio manager trying to select the best stocks and avoid the worst stocks in order to outperform a passive benchmark, such as the S&P 500. Often, these portfolio managers reap large salaries, as do their analysts. Active stock selection may also involve the use of expensive research and technological tools. While experience, research and technology may give the manager an edge in selecting stocks, the evidence shows that the edge is not large enough to overcome the significant costs involved.

For example, if the stock market rises by 10 percent, a really good fund manager might be able to generate a return of 10.5 percent before costs and fees. However, a 2014 study published in the Financial Analysts Journal showed that total costs for actively managed investment portfolios average more than 2 percent annually.

Half of this is explicit management fees, and half is implicit costs such as trading commissions for stock trades in the underlying portfolio. So, even a really good manager who earns 10.5 percent would net only 8.5 percent for his/her investors after costs.

An index fund, on the other hand, would earn the same return as the market: 10 percent in this example. That is true because an index fund buys all of the stocks represented in a particular benchmark index. The S&P 500 is made up of 500 stocks, and Standard & Poor's publishes the list of stocks and their weights in the index.

It is therefore quite simple for an index fund manager to purchase all of the stocks and hold them until the index changes, which doesn't happen that often. Because the process is uncomplicated, it does not cost much to run an index fund. So, if an index fund rises 10 percent with the market, it might net you 9.9 percent after costs. When net returns are compared, clearly, the naïve index fund is superior to the really good active fund manager.

Over time, this cost advantage compounds, further handicapping active managers and benefiting index funds. Several studies show that over longer time periods, only around 15 percent of active managers are able to outperform appropriate benchmark indices. What's worse is that the 15 percent who are successful in any given period are statistically unlikely to repeat that success in the subsequent period.

So, reaping outsized returns by selecting actively managed funds has proven all but impossible. With their market-meeting returns, index funds therefore seem like the better option.

Index funds also generally offer a lower tax bill than actively managed portfolios. This is because most index funds trade infrequently. Active funds, almost by definition, trade more aggressively and are therefore more likely to incur capital gains taxes. The money lost to taxes further erodes your net investment return.

Despite their successful track record, index funds are still widely maligned. Some argue that indexing will ultimately be a victim of its own success. They suggest that as it gets to be too large a part of the market, it may stop working. However, there is still a long way to go before that is a risk. As long as there are active managers and traders looking for bargains in the stock market, asset prices should reflect fair values, providing fertile ground for low-cost index funds to continue to reap the market's returns.

Others argue that index funds suffer the full brunt of any market declines. That is certainly true, but the evidence shows that even active managers are unable to accurately forecast coming market declines and sell out of the market in a timely fashion. In fact, during the 2008 bear market, active managers as a group declined in value more than index funds did.

Indexing will continue to have its adherents and detractors. What can't be denied, however, is that the discipline has grown significantly through time. Fifteen years ago, indexed assets represented around 10 percent of the total U.S. stock market. The number now is closer to 30 percent. In the future, indexing is likely to continue to grow. There will certainly be periods when it is in vogue, or out of fashion, but the simple, quiet truth of low-cost, tax-efficient investing with top-tier returns will continue to win investors' confidence over time.

Now at age 87, Jack Bogle is still a vocal defender of individual investors. The advent of the index fund remains his crowning achievement, but he has continued to advocate for sound, ethical business practices in the mutual fund industry and across corporate America.

Regardless of whether your personal investment philosophy leans toward active or indexing, lower costs and taxes are tough to argue with. It is largely because of Jack Bogle's invention and tireless work that investing has become so efficient over time.

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