

Performance shades merits of active management

I come to praise active management, not to bury it. Active management has been much maligned recently, including in this column, because of the increasing dominance of index investing over active stock picking.

Indeed, according to estimates from Morningstar, actively managed U.S. stock funds have seen outflows of over \$185 billion so far this year. By comparison, U.S. stock market index funds have attracted almost \$125 billion in new assets. What's driving this disparity? In a word, performance.

Active management involves a portfolio manager trying to select the best stocks in order to outperform a market benchmark, such as the S&P 500. Often, these portfolio managers and their team of research analysts have decades of experience, work long hours and have strong educational pedigrees. Active stock selection also may involve the use of sophisticated research and cutting-edge technological tools.

Diversification, low costs, a minimal amount of trading or portfolio turnover and a consistent approach through time are all traits that are associated with strong long-term performance.

An index fund, on the other hand, simply buys all the stocks in a given index, such as the S&P 500. Standard & Poor's publishes a list of all the stocks represented in the S&P 500, and index fund managers can buy all of those stocks in the open market to closely replicate the risk and return of the index.

Despite their experience and often superior technology, actively managed mutual funds as a group have generally underperformed their benchmark indices. This is despite the fact that they charge higher fees than index funds for the service they provide.



ON INVESTING
Mark Armbruster

Higher costs with less return should not be a sustainable business model. Sure, there are always some managers who beat their benchmarks in any given time period, but those who have outperformed historically usually fail to do so in subsequent periods, calling into question whether they were truly good or merely lucky.

There are a number of reasons for this underperformance. One theory is simply that no skill exists in the world of investment management. Independent studies by academics have tested this theory and have come to different conclusions.

Some have found very little evidence of skill, but others have found that out-sized performance is indeed possible, if extremely difficult to achieve. One study found that "experts" are correct in their predictions only 47 percent of the time. Active trading combined with this poor ability to select winning stocks can only lead to lagging performance.

Costs are another significant drag on performance. Experienced portfolio managers and analysts usually command large salaries, and technology and research can also be expensive. Those implicit costs, combined with the expense of active trading add up and can reduce performance by significant amounts.

There are also sometimes conflicts of interest between managers and clients. Unfortunately, investment decisions are not always made in the sole interest of clients. Considerations of job security for the manager or increased revenue for the management company sometimes interfere. This can skew performance in adverse ways.

So, why would anyone invest in active funds? Some say it is the triumph of hope over experience. However, there have been

star managers who have racked up impressive track records.

Peter Lynch, who used to manage the Fidelity Magellan fund, is the poster boy for successful active management. He handily outpaced his benchmark over the course of his career. Bill Miller from Legg Mason Value has had ups and downs, but outperformed the S&P 500 for 15 straight years, which is no small task.

Naysayers correctly point out that Peter Lynch and Bill Miller are few and far between, but outperformance is possible with an active approach. In fact, I would argue that outperformance via active management is not as hard as it seems. It is just that the active management industry offers perverse incentives that make most managers veer from a path that would likely lead to more success.

For example, a study published in the *Journal of Portfolio Management* back in 2004 compared the performance of Vanguard's index and actively managed funds. It found that Vanguard's actively managed funds outperformed its index funds, a result that many found shocking.

The study looked at a 27-year time period. However, if shorter time periods are reviewed, index funds won sometimes and active funds won other times. Thus, the results were time dependent, and therefore not terribly conclusive one way or the other. However, the close results of this study, and the fact that it showed active management as superior, refuted many other studies showing that active funds clearly underperform.

The difference in results between the 2004 study and other studies on active versus index funds is that this study focused solely on Vanguard funds. Vanguard is a company that is perhaps best known for its index funds, but even its actively managed funds adhere to many tenets of sound investing: They have low fees, minimize trading and maintain style consistency through time.

While many active managers have cited this study as a justification for their existence, I take away a different conclusion. Primarily, I believe that management style

is irrelevant. Much ink has been spilled in the active vs. indexed debate, but it probably is all for naught. What really matters are the ultimate characteristics of an investment portfolio, not the means by which those characteristics are achieved.

Diversification, low costs, a minimal amount of trading or portfolio turnover and a consistent approach through time are all traits that are associated with strong long-term performance. Vanguard's funds adhere to these characteristics regardless of whether the funds are indexed or actively managed.

Unfortunately, Vanguard's active funds

are unique in this regard. Most active managers charge high fees, trade too often, and may chase segments of the market that are outperforming in the short term. Job security often trumps long-term performance, and investors ultimately pay the price. Over time, these practices have resulted in unsatisfactory performance, and investors are fleeing actively managed funds in droves.

It is too bad really, because there is a lot of merit to active management. In fact, all of us owe a debt of gratitude to the active managers who rigorously research stocks, trade on their research, and help set efficient prices for stocks in the open market.

Often these managers do this selflessly and with significant risk that they will earn sub-par returns. However, without them, the efficient pricing mechanism all investors rely on would not exist.

So, if you are an active manager or you invest with active managers, I thank you for your service. Just make sure your research results in good portfolio characteristics so your efforts are profitable and not just selfless community service.

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