

THE FOLLY OF ACTIVE MANAGEMENT

By William Hammer, Jr.



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“... the best way to own common stocks is through an index fund that charges minimal fees. Those following this path are sure to beat the net results (after fees and expenses) delivered by the great majority of investment professionals.”

-Warren Buffett

Are you taking Buffett’s advice or ignoring it and trying to pick fund managers the way he picks stocks?

Passively managed portfolios, where holdings mirror specific market segments or indexes, have consistently outperformed¹ those that are actively managed and seek to beat some sort of benchmark.

Evidence of this is overwhelming and is backed by voluminous research over a long time. One study² of equity mutual fund performance between 1970 and 2009 found that the market return beat 84% of the actively-managed funds. In the 16% where this didn’t happen, only one in 14 beat the market by 1% or more annually and one in 100 by more than 2% annually.

The point is: very few funds beat the market and even fewer beat it by a significant margin.

Still, most financial advisors and their investor clients ignore all this and continue to pursue active management strategies.

Why?

Apparently, many still believe that most active managers can beat the market. Mutual fund companies and the financial media fuel the myth that beating the market is easy by touting the handful of winners while ignoring the plethora of losing managers.

Whether you believe markets are efficient or inefficient, **the biggest advantage of passive funds is cost.**

Investors earn the market return minus their costs. Some profit, others don’t. Passive investors earn the market return minus low costs, while active investors earn the market return minus significantly higher costs. Thus, the average return of the passive investor is higher.

Because active managers employ large, expensive research teams and trade much more heavily, their costs are much higher than those of passive funds. The total cost of a passive fund is roughly 0.25%³, while that of an active portfolio can be 2% or even 3%⁴. Active managers need to outperform their benchmarks by 2 or 3% just to match the market return!

So, in the lifetime investment marathon, the active runners

may be faster and stronger than the passive runners. But the passive runners run with a 10-pound vest, while the active runners are loaded down with 100-pound vests.

Taxes are another cost that is often ignored. The average portfolio turnover in the actively managed mutual fund industry is more than 100%⁵; meaning that, on average, positions are held for less than a year and taxed as short-term capital gains.

With whom would you rather invest: an active manager averaging a 12% annual return or a passive fund that averages 9% annually? The answer might seem obvious, but the active manager’s highly appealing 12% pre-tax return leaves us with only 7.2% after short-term capital gain taxes at a combined federal, state, and local income tax rate of 40%. However, if we invested in a low turnover passive fund that averaged a 9% return, we would be left with 7.7% return if all gains were taxed at the long-term capital gain and qualified dividend rate of 15%. In this case, even though the passive fund lags behind the active fund by 3% pre-tax, it outperforms by 0.5% annually after taxes.

There is one more factor that few active management proponents consider—the odds of designing an **entire portfolio** that beats the market. If the odds of picking one fund that will beat the market were conservatively 1 in 4, then the odds of picking a portfolio of 5 funds that beat the market would be 1 in 1024, or less than one tenth of 1%. I don’t like those odds!

The frustrating reality is that there will always be active managers who beat the market by large margins.

But there is no reliable way of picking these managers in advance. With all the work that goes into picking managers, cost is still the best predictor of manager performance, according to a recent Morningstar study.

I believe strongly that investors put the odds overwhelmingly in their favor by favoring passively managed funds over active managers. **FA**

¹ Lipper Inc., 2009.

² Bogle Financial Markets Research Center, 2009

³ Lipper Inc., 2009.

⁴ “Scale Effects in Mutual Fund Performance: The Role of Trading Costs” (March 2007)

⁵ Morningstar, 2010.

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