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Active vs. Passive Management

Active management refers to the investment approach in which a manager picks the right stocks at the right time in an attempt to “beat the market.” Passive management refers to a buy-and-hold, index approach that simply seeks to achieve the “market return.” Much debate in the investment community is centered on which approach is best. Vista believes that while neither style is perfect, a passive approach that relies on index investments is preferred because of its low-cost structure, inherent tax advantages, and superior long-term returns.

An index is a diversified group of securities representing an entire market or market segment. Index funds seek to replicate the performance of a chosen index by assembling a portfolio that invests in the same group of securities that comprise the index. A well-known example is the Vanguard 500 Index Fund, which tracks the S&P 500 Index.

The common belief is that a professional mutual fund manager should be able to outperform the market. Numerous studies, however, show this not to be true. One study looked at the ten-year performance of actively-managed US equity mutual funds. Of the 1,033 U.S equity funds analyzed in the study, 71% delivered less than the 10.6% annualized return of the broad U.S. stock market. A common characteristic among the 733 funds that failed to match the market return was their high cost structure. The funds that managed to beat the market had lower fees and expenses.

The costs associated with attempting to outperform the market do matter – these costs can be significant. A study of mutual fund performance from 1975-1994, summarized in the August 2000 Journal of Finance, concluded that while the average stock bought by a fund manager outperformed the market by 1.5%, the average fund delivered annual returns that were .80% below the market’s over that period. The primary culprit? Excessive costs. The average fund frittered away that 2.3% per year on a combination of expenses (1.1%), holding cash to meet redemptions and/or to time the market (.7%) and trading costs (.5%). Index funds, by contrast, have very low expense ratios and minimal turnover. This means index investors won’t have a 2.3% hurdle to overcome simply to capture the market’s return.

Index strategies also have an inherent tax advantage over actively-managed funds. Because of their low turnover (trading), index funds and exchange traded funds (ETFs), distribute few, if any, capital gains. While typical actively-managed funds distribute close to 50% of their annual return in the form of capital gains, index investments distribute less than 0.5%. This maximizes after-tax return, keeping more of the fund’s performance in an investor’s pocket.

By now, you may agree that poor-performing funds do exist. “But what about the great stock-pickers, the managers that are above average,” you ask? Surely, a savvy investor will avoid the average fund and only pick those with excellent performance records. Unfortunately, empirical data does not support such a strategy. Consider, for example, the record of the best-performing domestic equity funds over the period from 1983 to 1993. Out of the twenty best-performing funds over those ten years, sixteen (80%) failed to even match the market return in the subsequent decade! The message is powerful: while there may be funds that outperform the market in any given year, consistent outperformance is rare.

Numerous studies show that the average actively-managed mutual fund underperforms the market. While somewhat sobering, this seems intuitive: as a group, investors are the market and achieve the market return. One would, therefore, expect investors to collectively underperform the market after management fees and transaction costs. By minimizing these costs, passive index strategies closely track the market return, thus outperforming a majority of actively-managed funds.