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Active Managers' Scorecard

There are, broadly speaking, two competing investment strategies and there continues to be an ongoing debate between their proponents. The oldest and most common strategy is called active management. Active fund managers attempt to identify stocks that will outperform the market and avoid those that they believe will underperform. In an effort to avoid market declines, active managers often employ market timing strategies. The other strategy, one that has gained in popularity over the last two decades, is known as passive management. Passive investors use index funds that match the return of a particular asset class by owning most or all of the securities in that asset class. Passive investors make no attempt to beat the market via stock selection or market timing.

S&P's Indexes Versus Active (SPIVA) Scorecard is a semiannual report that compares the performance of actively managed mutual funds to their S&P benchmark index. It provides ongoing evidence that few active managers have outperformed their benchmark index over the long term. The latest SPIVA Scorecard covers the 15 years ending December 2018 and notes that 2018 was the ninth consecutive year in which most large-cap domestic fund managers underperformed the S&P 500 Index. Additionally, 69% of all actively managed stock funds underperformed the S&P 1500 Total Market Index last year - the fourth-worst annual performance for active managers since 2001.

Proponents of active management admit that it is difficult for large-cap fund managers to outperform the S&P 500 Index because the stock market efficiently prices large company stocks. But they assert that in less efficient markets, such as small-cap stocks and emerging market stocks, active managers have an edge. But this assertion is not supported by the evidence. For the past 15 years, 96% of actively managed emerging market stock funds underperformed their benchmark S&P index and more than 94% of actively managed domestic small-cap funds underperformed the S&P 600 Small Cap Index. It doesn't matter whether markets are efficient or inefficient, investors, as a group, must fall short of the market's return by the costs they incur. Index funds are less expensive than actively managed funds. By eliminating manager risk, minimizing taxes and keeping management fees and transaction costs low, index funds have provided investors with superior results over the long haul - even in asset classes in which markets are less efficient at setting prices.

Fund Asset Class	1 YR	3 YRS	5 YRS	10 YRS	15 YRS
Large-Cap Growth	F	F	F	F	F 5%
Large-Cap Value	P	F	F	F	F 21%
Mid-Cap Growth	P	F	F	F	F 9%
Mid-Cap Value	F	F	F	F	F 8%
Small-Cap Growth	F	F	F	F	F 2%
Small-Cap Value	F	F	F	F	F 6%
Domestic REITs	F	F	F	F	F 14%
Int'l Large Stocks	F	F	F	F	F 10%
Int'l Small Stocks	F	F	F	F	F 24%
Emerging Market Stocks	F	F	F	F	F 4%

Data as of December 31, 2018

This chart displays the SPIVA report card of active managers. The far-left column lists ten popular stock asset classes. The next five columns give a pass or fail grade to active managers in each asset class for the past 1, 3, 5,10 and 15 years. If more than 50% of actively managed funds in an asset class outperformed their benchmark S&P index, they get a passing grade of **P** for that time period. If the majority underperformed, they get a failing grade of **F**. The 15 YRS column includes the percentage of actively managed funds in the asset class that outperformed their benchmark index over the past 15 years.

The reason that long-term performance results are so poor, and bound to remain so, is due to the compounding effect of the ongoing performance shortfalls as the years go by.

Each day the global financial markets process millions of trades that aggregate vast amounts of information. It yields consensus pricing that is difficult to outsmart. This works to the benefit of passive, index investors who accept market pricing as the best estimate of fair value. It hinders active managers who must identify mispriced securities ahead of their competitors. Most are unable to do so consistently for the same reason that the best major league players fail to get a hit in 70% of their at-bats – talented opposition. To outperform, a fund manager must outsmart the collective asset pricing wisdom of all other investors in the global stock market.

The Scorecard also tracks the longevity of mutual funds. There were 1,923 domestic stock funds available to investors on January 1, 2004. By January 1st of this year, only 829 (43%) were still in business. Funds that went missing in action were poor performers that were either merged into other funds or liquidated. So, if you had five actively managed stock funds in your portfolio 15 years ago, it's likely that only two of them still exist.

Finding and profiting from mispriced securities is a difficult task even for professional money managers. Charlie Munger, Warren Buffett's business partner, recently made this comment –

"These index funds have come along and basically beaten everybody. The amount by which they beat everybody is roughly the cost of running an (active fund) *operation. So, we've got a whole profession that is being paid for accomplishing practically nothing."*

Academic studies and reports from research firms like Morningstar and S&P confirm the validity of Munger's remark. Only a small fraction of actively managed funds beat the market on a risk-adjusted basis. It's doubtful that by doing your own research or by following the recommendations of your financial advisor you can find those few funds that will outperform.

The latest SPIVA Scorecard provides evidence of the ongoing failure of active managers to outperform their benchmark index, even in inefficient markets. Each new Scorecard brings out spokespersons for active fund companies who repeat the same tired excuses and empty promises. Fidelity Investments has just published an analysis of mutual fund performance for investment professionals and retirement plan sponsors that contained a chart with the title: "Dramatic Misperception of Passive Outperformance". The chart "reveals" that actively managed mutual funds have outperformed their index competitors in 8 of 15 popular asset classes. In the tiny writing at the end of the report Fidelity notes that its analysis shows only one-year performance, recalculated monthly. It excluded funds with the highest (top 25%) annual management fees and funds with a 1-star or 2-star Morningstar rating. Since index funds have similar fees and yield average performance, this filter eliminated mostly actively managed funds with the highest management fees and the worst performance. Even so, the remaining funds were able to outperform index funds in barely half of the asset classes in the study. Unfortunately for their clients, Fidelity's advisors now have new "evidence" to promote actively managed funds and can add it to these currently popular active management myths –

- **Competition from index funds has led many active managers to lower their fees, making their services more affordable.** True, but index funds have also lowered their fees and still possess a significant cost advantage.
- **Active managers can provide wealth protection in down markets.** This claim is a classic example of hope triumphing over experience. Active managers don't suddenly become more intelligent when markets are declining nor do their competitors suddenly become fools. The rapid decline in stocks in last year's fourth quarter gave active managers a perfect opportunity to outperform, yet 69% underperformed the S&P 1500 Total Market Index. The Vanguard 500 Index Fund (VFINX) has yielded negative returns in 10 of the past 40 years. The majority of actively managed large-cap domestic stock funds outperformed VFINX in five of those years – nothing to brag about. The last two losing years were 2008 and 2018. In 2008, the Vanguard fund lost 37% but outperformed 62% of its actively managed competitors. Last year, the fund lost 4.5% and outperformed 71% of its active competitors.
- **Index funds purchase stocks regardless of price. This causes pricing inefficiencies in the market because the highest priced stocks receive the largest amount of newly invested dollars.** Stock prices are determined by active participants, not index funds. Only about 15% of the total US stock market capitalization is in index mutual funds and ETFs. A recent Vanguard study noted that most of these funds have low turnover and their trading activity makes up less than 5% of all daily trades in the US stock market. It is the relentless trading of pension funds, hedge funds, active mutual funds, insurance companies and high frequency traders that dominate trading activity and determine stock prices. If uninformed, active amateur investors become index investors, as many have done in recent years, the market's pricing efficiency just might be increasing because the "dumb money" is leaving the market.
- **With so many actively managed funds closing over the past decade, we are left with fewer active managers and the greater likelihood of outperformance.** There are still thousands of active managers of all flavors trading in the global stock markets. If the rising popularity of indexing over the past two decades has made it easier for active managers to find mispriced securities, we should have seen a corresponding increase in the number of active funds outperforming their benchmark index. But as the SPIVA Scorecard clearly shows, there is no evidence of this. Most active mutual fund managers continue to underperform, suggesting that the rise of indexing has not made it any easier for them to find mispriced securities.

There will always be active funds that outperform over any time period, especially short periods such as one year. With 20/20 hindsight, it's easy to imagine the fortune that could have been made by buying just the right fund at just the right time. Unfortunately for investors, these funds are unknowable in advance and the winning funds usually change from one year to the next. Historically, average market returns have been sufficient for most investors to achieve their financial goals, eliminating the need to seek above average returns by employing active management strategies.

In the News

Franklin Templeton Investments has agreed to pay $14 million to settle a class-action lawsuit alleging that the firm violated its fiduciary duty under the Employment Retirement Income Security Act of 1974 by selecting high cost, in-house funds for its 401(k) when better, lower-cost funds were available. Franklin Templeton is just one of many financial services firms that have been sued by their employees for self-dealing in their 401(k) plan. Allianz, Wadell and Reed, Jackson National, Citigroup, Fidelity Investments and Deutsche Bank have paid millions of dollars to settle similar employee class action lawsuits. Late last year, Fidelity Investments was again sued by its employees for alleged self-dealing in its $15 billion 401(k) plan. The plaintiffs claim that despite settling a similar lawsuit in 2014 for $12 million, Fidelity still offers 234 proprietary funds and no non-proprietary funds in its 401(k) plan. It's a sad commentary on the financial services industry when employees sue their company for forcing them to own the same funds in their 401(k) that they sell to clients.

In a recent study by the Brookings Institution, it was noted that in 2018, for the first time, just over 50% of the world's population lived in households considered to be middle-class or rich. The report noted that "middle class" does not have a precise definition that can be globally applied: *"The threshold we use in this work has the following characteristics: those who have some discretionary income that can be used to buy consumer durables like motorcycles, refrigerators and washing machines. They can afford to go to movies or indulge in other forms of entertainment. They may take vacations. And they are reasonably confident that they and their family can weather an economic shock – like illness or a spell of unemployment – without falling back into extreme poverty…September 2018 marks a global tipping point. After this, for the first time ever, the poor and vulnerable will no longer be a majority in the world. Barring some unfortunate global economic setback, this marks the start of a new era of middle-class majority."* This is good news that should have been widely reported, yet somehow wasn't.

In a Federal Reserve Bank of New York study, researchers evaluated how employee earnings tend to change throughout a working career. The study revealed that the conventional financial planning view that earnings rise steadily throughout our working years is not accurate. The growth in real (inflation-adjusted) earnings is not evenly distributed throughout the years. Real wage growth is concentrated in early working years, leveling off at mid-career, peaking for the average worker in their early 50s and declining in the final decade before retirement. A Labor Department study tracked the income of 10,000 baby boomers from 1979 through 2012 and found similar results – that the largest income increases came in the 20s through the 40s. Unfortunately, the greatest increases in income tend to come when most people have little or no experience in properly managing money, spending responsibly or saving for the future. These studies show the importance of avoiding lifestyle creep and why it's important to establish good spending habits early.

Dalbar has been studying the investment performance of individual investors since 1994 and notes that, due primarily to predictable behavioral mistakes, the average stock fund investor underperforms the stock market. In its analysis of investor behavior in 2018, Dalbar reports that while the S&P 500 Index lost 4.4%, the average stock fund investor lost 9.4%. As so often happens, many investors decreased their stock fund holdings during months in which prices declined and many were still on the sidelines during the subsequent recovery months.

Are professional money managers subject to similar behavioral mistakes? Essentia Analytics tracked more than 250,000 trades and portfolio data of 29 active stock fund managers in 21 different firms over a ten-year period to discover if portfolio managers on a losing streak changed their investing behavior and what the impact those changes had on future performance. A streak was defined as a sequence of five days in which a fund lost money each day. If a fund had a specified benchmark, the loss was considered relative to that benchmark. Their research found that 35% of managers changed their investing behavior during a losing streak; typically trading more and in larger amounts. Those decisions tended to destroy even more value. These managers displayed the behavioral flaw of the "illusion of control". When things aren't going as hoped, investors often feel compelled to do something to regain control and reverse the trend, ignoring John Bogle's advice: *"Don't just do something, stand there."* It should come as no surprise to any observer of the human condition that all investors, amateur and professional, are susceptible to making the same behavioral mistakes.