On Course Financial Planning

Facing the Future with Optimism and Courage

April 2021 Vectors

geo@oncoursefp.com

425-861-9997

Active Managers' Scorecard

There are, broadly speaking, two competing investment strategies and there is an ongoing contentious debate between their proponents. The older, more 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. Active managers' strategies include stock picking, market timing, technical analysis and stock shorting. The other strategy, that has gained in popularity over the last two decades, is known as passive management. Passive investing was birthed in 1976, when John Bogle, then the CEO of Vanguard, launched the first retail index fund. Index funds match the return of an asset class by owning most or all the securities in that asset class. Passive investors make no attempt to outperform the market. They believe that by using index funds, they will reap market returns which should be sufficient for them to achieve their financial goals. By capturing the market's return, they are likely to outperform most active investors. While the performance advantage might be modest in any given year, it compounds over time and becomes more evident as the years go by.

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. The latest SPIVA Scorecard, covering the 20 years ending December 2020, noted that 2020 was the 11th consecutive year in which the majority (60%) of large-cap domestic stock funds underperformed the S&P 500 Index.

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-cap 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 20 years, 92% of actively managed emerging market stock funds underperformed their benchmark S&P index and more than 80% of actively managed domestic small-cap funds underperformed the S&P 600 Small Cap Index. 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	20 YRS
Large-Cap Growth	P	P	F	F	F 4%
Large-Cap Value	P	F	F	F	F 23%
Mid-Cap Growth	P	P	P	F	F 10%
Mid-Cap Value	F	F	F	F	F 15%
Small-Cap Growth	P	P	P	F	F 6%
Small-Cap Value	P	F	F	F	F 24%
Domestic REITs	P	P	F	F	F 12%
Int'l Large Stocks	F	F	F	F	F 9%
Int'l Small Stocks	F	F	F	F	F 12%
Emerging Market Stocks	F	F	F	F	F 8%

Data as of December 31, 2020

This chart displays the year-end 2020 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 20 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 20 YRS column includes the percentage of actively managed funds in the asset class that outperformed their benchmark index over the past 20 years.

The SPIVA Scorecard reveals that few active managers have outperformed their benchmark index over the long term. 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.

Active managers do not suddenly become more intelligent when markets are declining. The rapid decline in stocks last March gave active managers a perfect opportunity to provide value, yet 57% of actively managed domestic stock funds underperformed the S&P 1500 Total Market Index last year.

The Scorecard also tracks the longevity of mutual funds. There were 2,044 domestic stock funds available to investors on January 1, 2001. By January 1st of this year, only 647 (32%) were still in business. Funds that expired were poor performers that were merged into other funds or liquidated. So, for every three actively managed stock funds available to investors in January 2001, only one still exists today.

Managers employed by mutual funds, pensions, endowments and hedge funds are skilled professionals who conduct extensive research in their quest to find mispriced securities. The technological revolution of the past few decades has leveled the playing field, increasing the number of informed, active investors and making it difficult for any manager to have an information edge over the competition. Each day the global financial markets process millions of trades that aggregate vast amounts of information, yielding consensus pricing that is difficult to outsmart. This works to the benefit of passive, index investors who accept current prices as the best estimate of fair value. To outperform, a fund manager must outsmart the collective pricing wisdom of all other investors, know how the future will be different from what other investors expect and how prices will react to the unexpected news. Another way of describing this is to say that thousands of active investors make the market smarter than any one participant. So, a tip of the cap to active managers of all stripes. Because of their tireless activity, index investors receive their fair share of what the capital markets freely offer at virtually no cost.

Adopting a passive investment strategy and growing wealth slowly is boring. Investors love excitement – a story they can invest in. Every active manager has an exciting story about why his fund or strategy will produce exceptional results. A select few will succeed, and performance chasing investors will flock to them. But as the SPIVA Scorecard shows, outperformance rarely persists and investors who arrive late to the party are likely to get a first-hand education in reversion to the mean. The evidence is overwhelming that attempting to outperform the market adds costs, is tax inefficient and is more likely to subtract, rather than add value.

There are fewer actively managed funds today than 20 years ago. We can assume that the surviving funds have the most talented managers. The elimination of less talented competitors has made it even more difficult for the surviving managers to outperform. The reason for this is the same reason why the best major league players fail to get a hit in 70% of their at-bats – talented opposition. Some proponents of active management claim that the rising popularity of indexing over the past 20 years has made it easier for active fund managers to outperform. But the SPIVA Scorecard shows no evidence that the growth of index investing has made life any easier for active fund managers.

No one can predict the future and 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 both survive and outperform. There will always be active funds that outperform, especially over short periods such as one, three or five years. With 20/20 hindsight, it is easy to imagine the fortune that could have been made by buying the right fund at just the right time. Unfortunately, outperforming funds are unidentifiable in advance and the winning funds usually change from one year to the next.

Once again in 2020, investors favored index funds over actively managed funds. According to Morningstar, active mutual funds and ETFs experienced a net outflow of $188 billion, while estimated net flows into index funds and ETFs totaled $401 billion.

In the News

There appears to be a revival of mindless speculation by investors with stimulus check money, an internet connection and nothing else to do. Social media bloggers are singing the praises of investing in everything from bankrupt companies, options, cryptocurrencies, SPACs and NFTs. (If you haven't heard of SPACs or NFTs count yourself lucky). But there is nothing new under the sun. Consider this passage from *The Life and Adventures of Nicholas Nickleby*, written in 1838 by Charles Dickens –

Mr. Nickleby looked about him for the means of repairing his capital, now sadly reduced by this increase in his family and the expenses of their education. 'Speculate with it,' said Mrs. Nickleby. 'Spec--u--late, my dear?' said Mr. Nickleby, as though in doubt. 'Why not?' asked Mrs. Nickleby. 'Because my dear, if we should lose it,' rejoined Mr. Nickleby, who was a slow and time-taking speaker, 'if we should lose it, we shall no longer be able to live, my dear.' 'Fiddle,' said Mrs. Nickleby. Think of your brother! Would he be what he is if he hadn't speculated?" That's true,' replied Mr. Nickleby. 'Very good, my dear. Yes. I will speculate, my dear.'

Speculation is a round game; the players see little or nothing of their cards at first starting; gains may be great--and so may losses. The run of luck went against Mr. Nickleby. A mania prevailed, a bubble burst, four stockbrokers took villa residences at Florence, four hundred nobodies were ruined, and among them Mr. Nickleby.

This might be a good time to ask the question "Is there anyone with whom I have a financial relationship who thinks of me as a nobody?"

This chart shows the performance of the S&P 500 since the low point during the Financial Crisis. Over the past 12 years, there have been eight drawdowns of 9% or more, eight reasons to flee to cash and miss the five-fold increase in the index since March 2009.

Stocks go up or down until they reverse course, usually for no apparent reason. The financial media presents a story for every day's market activity because their audience seeks a cause-and-effect explanation. Once you understand that there is not always a reason for every move in the market, you will free yourself from the temptation to follow the stock market every day.

Most investors imagine that there are two distinct investing environments; times when the future is clear and investing in stocks is safe and times when the future is unclear and investing in stocks is risky. But perceived clarity regarding the future is illusory. Uncertainty is the only investing environment. We are bombarded 24/7 by more bad news than any generation in history and there will always be reasonable sounding excuses to avoid investing in stocks. Economic uncertainty, political disfunction, and the apocalypse du jour provide ongoing reasons to be worried. The solution isn't to flee stocks. The solution is to have a properly constructed, diversified portfolio that accounts for these realities.

There has been a lot of media attention to the first anniversary of the Covid bear market when the S&P 500 fell 34% over the course of four weeks last March and April. During the monthlong decline, there were six days in which the S&P 500 rose at least 4.9%, including a 9.3% jump on March 13th and a 9.4% gain on March 24th - the ninth and tenth best daily gains since 1926. There were also five days with losses of at least 4.9% (the worst decline was 12.0% on March 16th). There was a three-day period in March when the S&P 500 rose 9.3%, fell 12.0% and then rose 6.0%. This is the latest example of how the best and worst days of stock market performance are usually near each other, during times of extreme volatility and why attempting to time your way in and out of stocks is a fool's errand.

Too many media talking heads pretend to know the unknowable— such as the near-term direction of the stock market or interest rates, or which stocks and mutual funds will outperform this year. Last year, financial pundits regaled us with their confident, ever-changing predictions about what would happen next. But since most just extrapolated recent trends with minor tinkering, they provided no value. None predicted that stocks would fall 34% and then reach new highs before year-end. The near to intermediate term course of the economy and stock market is not only unknowable, but for the long-term investor it is irrelevant. That is why wise investors develop a financial plan containing a diversified portfolio, stick with it come what may, rebalance annually and get on with their lives.

There are far too many people in the investment advice business who make a good living by scaring people into making poor investment decisions. Thus, billions of dollars wind up in complex "alternative" funds and new investment ideas that will remain popular for about as long as the shelf life of a bag of potato chips. These days, people are beginning to worry about inflation and inflation protection is a hot topic. Be on your guard. Wall Street would sell you Ziploc bags filled with rocks if they could convince you that they are a great inflation hedge.

Vinyl records dominated recorded music sales until 1984 when cassette tapes became the most popular format for recorded music. CDs entered the scene in 1983 when they were only 0.5% of recorded music sales. By 1987 they had surpassed LP sales and by 1991 surpassed cassette sales - reaching a peak market share of 96% in 2002. Today, streaming music accounts for 83% of recorded music sales, digital downloads account for 6%, vinyl records 5% and CDs 4%. In 2002, who would have believed that CDs would someday have a smaller market share of recorded music sales than vinyl records? This is a classic example of "creative destruction". Austrian born economist Joseph Schumpeter coined the phrase to describe how new technologies create disequilibrium by creating new profit opportunities and businesses that replace companies committed to older technology. Today, streaming music has "destroyed" the old format technologies of LPs, 8-track tapes, cassettes and CDs because it is cheaper, more readily available, more convenient to use and higher quality than older music recording technologies.