

## **The Folly of Active Investment Management**

The investment world can be divided into two strategic camps: active management and passive management.

Active management can be defined as:

The attempt to uncover securities the market has either under- or overvalued; also the attempt to time investment decisions in order to be more heavily invested when the market is rising and less so when the market is falling<sup>1</sup>

Passive management is the exact opposite of active management and primarily involves a buy-and-hold approach to investing. (It does not mean you NEVER make changes to your portfolio though!)

Why have we used the term ‘folly’ to describe active management? There is a ton of evidence from studies done over the years that managers of actively-managed mutual funds are unable to outperform the market as a whole. Let’s look at a recent study performed by Thomas McGuigan and published in the February 2006 issue of the Journal of Financial Planning.

The study looked at actively-managed mutual funds that focused on large capitalization US stocks. The benchmark that these managers used to compare their returns was the S&P 500 index which is widely reported in the financial press on a daily basis. The time period studied was 1983-2003. The author found that 171 funds ‘survived’ this 20-year period. (Many funds that existed during this time period were either closed or merged into other funds- almost always due to poor performance. Hence, the results of this study actually overstate the ‘successes’ of actively-managed funds.)

During the first five years of the study, 55% of the active funds beat the index. At this point, some may think that active management is the winning strategy. Unfortunately, most investors have a time horizon greater than five years. When extended to 10 years, less than 25% of the funds were able to beat its benchmark. Extended to the full 20 years of the study, only 10.59% of the funds were able to beat its benchmark! Hence, investors had about a one in ten chance to beat the S&P 500 index over this time period by selecting an actively-managed fund. Of course, if we include the funds that no longer existed the actual chances of success were much lower than one in ten. Not a particularly attractive strategy for investment success.

Next, the author looked at those few that did outperform and wanted to see what the potential upside was for those funds that were successful in beating the benchmark. Of the 18 funds that did outperform 12 of those funds provided a return that was less than 1% above the benchmark. Only 6 funds (or less than 4% of all funds) were able to provide investors with a return more than 1% above the benchmark. Again, not an attractive strategy for investment success.

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<sup>1</sup> Larry Swedroe, Rational Investing in Irrational Times, page 299

Finally, the author wanted to see if there was any persistence in fund success, so he looked at the funds that were successful in the first 10 years of the study and looked at how they did in the next 10 years. Average return of the 'winners' in the 2<sup>nd</sup> half of the study was 9.85% compared with a return of 10.56% for the S&P 500 Index or an underperformance of .71%. If we compare the after-tax return, the underperformance of the so-called 'winners' increases to more than 1.5% below the after-tax return of the index. Hence, even if one is able to find a 'winner' it seems unlikely that fund will be able to keep it up for very long.

The author looked at mid-cap funds and found the results even more compelling. There were not enough survivors in the small-cap area to make up a large enough study.

Active management is a losing investment strategy. The above example is one of many in a long line of academic research. Passive investment management is a strategy that will provide you the best opportunity to achieve your long-term goals. If you would like to learn more about how to implement a passive investment strategy, please contact us at 609-620-1770.

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