Is Performance worth the Price?

At the end of 2006, less than 1% of the funds in the population are able to outperform their passive benchmarks, after deducting transaction costs and expenses. Fotolia

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How many mutual funds can consistently outperform the broad stock market? And does it make sense to try to identify these successful funds?

These are essential questions that individual investors or pension funds face when they make investment decisions.

Unfortunately, addressing these issues is difficult, as one can only rely on past returns to determine future performance among several thousand funds. In particular, investors must distinguish between true skill and pure luck, as managers that were lucky in the past are unlikely to reproduce the same performance in the future.

In a recent study published in the Journal of Finance (available on www.ssrn.com),Prof. Olivier Scaillet (Swiss Finance Institute-University of Geneva), Russ Wermers (University of Maryland) and I apply a new technique that separates skill from luck in order to precisely measure performance in the U.S. industry of actively managed mutual funds (equity only). Our study comes to a rather sad conclusion: At the end of 2006, less than 1% of the funds in the population are able to outperform their passive benchmarks, after deducting transaction costs and expenses.

Even worse, we find that 24% of the funds actually destroy value, since their benchmark-adjusted performance is negative.

Of course, these results do not imply that fund managers have no stock-picking skill -- some of them do, but the price investors have to pay for it is simply too high.

This poor performance contrasts with the early '90s when the proportion of outperforming funds was close to 15%. This downward trend is striking and leaves little hope for recovery.

Several factors have contributed to this decline. First, the mutual fund industry has witnessed a substantial growth in the number of funds and an improvement in information systems.

These changes have certainly made markets more efficient and superior performance more difficult to achieve. In addition, many talented fund managers have migrated to the hedge fund industry for its more generous compensation schemes.

If actively managed funds have progressively lost their ability to generate superior returns, they should have charged lower fees to their clients.

However, this has not been the case: While the value of the assets managed by the U.S. mutual fund industry has skyrocketed from US$3-trillion to near US$10-trillion between 1995 and 2006, the average fund expense ratio has remained roughly constant at 1.5%

per year.

Stated differently, investors have not benefited at all from the economies of scale generated by the increasing value of assets under management.

Unsurprisingly, some investors are disappointed with active management because they are not getting the performance they are paying for.

As a result, they tend to focus on passive strategies that simply combine diversification and cost reduction. A striking illustration of this change is the success encountered by Exchange Traded Funds (ETFs): Between 2002 and 2006, the money invested in ETFs has increased by 50% per year.

Investors can use the wide range of ETF products to diversify across investment styles, such as "value" or "small cap", for an expense ratio as low as 0.2% per year. Investing in ETFs also represents a simple way to diversify internationally.

Another advantage is liquidity, since ETF shares are traded on stock exchanges, just like shares of large companies.

The recent development of passive investing is likely to affect mutual funds. Although they have been reluctant to reduce commission fees and operating costs, competitive pressures may force them to do so. From this perspective, the future is looking brighter for investors.

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