INVESTING QUARTERLY

Actively managed mutual funds fall short again — and investors notice

Most stock mutual fund managers keep failing to beat 'passive' investing. That's fueling a rush into low-cost index funds.

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In the last five years, stock mutual fund managers had two big opportunities to show how much they deserved your money — and trust.

First, they could have limited your losses in the harrowing 2008-09 market crash. Second, they could have anticipated the market's powerful rebound and loaded up on the shares that would end up performing best.

But instead of demonstrating their brilliance, the majority of fund managers came up short: In most major categories of stock mutual funds, investors would have been better off just owning the market as a whole instead of trying to beat it, data show.

If this sounds familiar, it's because the debate over "passive" versus "active" investing has been going on for about 40 years.

Proponents of passive, or index, investing say the odds of finding a money manager who will trump the market return over time are too low to justify the search — let alone justify the management fees you'd pay. They note that much of the historical evidence favors their camp.

Now, get ready for a new chapter in the debate. With U.S. share prices already up 150% or more since 2009, actively managed equity funds argue that adept stock picking will be crucial for future gains. Stick with them, they say.

The normally publicity-shy American Funds group in Los Angeles, the biggest U.S. operator of actively managed funds, last month began touting a new research report stressing the "active advantage" of the firm's funds.

In the bond market, meanwhile, actively managed funds pitch themselves as the solution to negotiating what could be a wild period ahead as the Federal Reserve wrangles over what to do with interest rates.

The active versus passive question isn't simply an academic exercise for investors. Many Americans who have saved too little for retirement are desperate to boost their nest eggs. The fund choices people make in their 401(k) plans or with other investment options will determine how much ground they can make up.

Consider: In the 10 years that ended June 30, $10,000 invested in the average fund that owns a diversified mix of large-capitalization, or blue-chip, U.S. stocks grew to $18,840. But the same amount invested in the Vanguard 500

Index fund, which tracks the Standard & Poor's 500 index, grew to $20,002 — $1,162 more than the average fund, according to data from financial research firm Morningstar Inc.

Over 25 years the numbers are more striking. A $10,000 investment in the Vanguard 500 fund grew to $99,503, or nearly $24,000 more than the value of the average large-cap fund in that period. How many retirees could do with an extra $24,000?

For many veteran financial advisors, there's no contest. Dale Yahnke, a principal at wealth manager Dowling & Yahnke in San Diego, said his firm has been using low-cost index funds as clients' core portfolio holdings since he co-founded the business 22 years ago.

The performance numbers don't lie, said Yahnke, who oversees $2.1 billion in client wealth. Neither is he persuaded by the argument that an aging bull market gives active managers a better chance to beat index portfolios.

"If I had a buck for every time someone said, 'It's a stock picker's market,' I wouldn't have to work anymore," he said.

But even some die-hard fans of indexing advise investors against a blanket condemnation of active funds. John Rekenthaler, vice president of research at Morningstar in Chicago, said the discussion increasingly "has been a very one-way debate" that obscures the value of many active portfolios.

Not surprisingly, some of the actively managed funds that have become most popular with investors have racked up market-beating returns over time: the $49-billion Dodge & Cox Stock fund, for example, and the Pimco Total Return Bond fund, the $250-billion behemoth managed by bond guru Bill Gross in Newport Beach.

American Funds, which has been managing money since the 1930s, also boasts impressive long-term track records in many of its stock funds. The return on the company's $123-billion Growth Fund of America edged the Vanguard 500 fund in the 10 years through June, even allowing for the upfront sales fee that brokers may charge to buy the fund. (Except for retirement savings plans, American Funds sells its funds exclusively via brokers and financial advisors.)

Yet many investors, or their advisors, have pulled the plug on American Funds over the last five years. The company's stock and bond funds have suffered total net cash outflows of $263 billion since September 2008, Morningstar estimates. The funds' assets now total about $1 trillion.

The heavy cash outflows set the scene for the data-laden study American Funds published last month. The company's research-driven stock picking has generated "clear advantages over index investing during every meaningful period of time for decades," the study declares.

"We wanted to raise our voice in the debate" between passive and active investing, said Steve Deschenes, co-author of the report and a senior vice president at American Funds. The firm's track record, he said, "isn't luck."

ome fund industry analysts say American Funds' offensive is overdue. "They're the only managers who could talk about active management" with authority, Rekenthaler said.

A key factor in the performance of the firm's funds, he said, is that they share two traits also common to successful index funds: relatively low management fees and a long-term investing horizon that keeps trading costs down.

Those are the strategies that helped build Vanguard Group into the best-known index-fund manager, with $2.3 trillion in total assets. Yet, unknown to some investors is that the Malvern, Pa., company also is a big player in the active-fund business. About 40% of its assets are in actively managed funds, including the popular Primecap stock funds managed from Pasadena.

"We sit in the middle" of the two investing disciplines, said Francis Kinniry, a principal in Vanguard Group's investment strategy group.

Active management, Kinniry said, clearly can pay off when it's in the hands of a knowledgeable, disciplined, cost-conscious money manager. "There are always going to be the Warren Buffetts of the world," he said.

Still, he notes the enormous challenge of active management over time in getting both buy and sell decisions right — as opposed to accepting average market returns via passive, long-term investing.

That message has resonated with individual investors, and their advisors, over the last five years. They have been voting with their feet for passive in droves.

Since September 2008, assets of passively managed U.S. and foreign stock mutual funds have doubled to $1.31 trillion, according to Morningstar. By contrast, assets in actively managed mutual funds are up 28% in the same period to $4.58 trillion.

Demand for exchange-traded funds, or ETFs, also has exploded since 2008. They now hold $1.5 trillion. ETFs, which trade on stock exchanges, are designed to replicate broad or narrow market indexes.

"I think we're in the very early stages of a secular shift" toward passive funds, Kinniry said.

But millions of people haven't yet been convinced. Actively managed funds still hold about 78% of total stock mutual fund assets.

In part, the dominance of actively managed funds reflects the nature of the brokerage industry, Yahnke said. "It's a business predicated on selling people stuff," he said. Whether that stuff is good for investors is another question.

Psychology also plays a role. People may go to Las Vegas expecting to lose, but there's still an element of believing you might make some bets that will pay off hugely.

"For the more sophisticated investor, there is a gambling aspect" to picking actively managed funds, Yahnke said.

For investors trying to rationally approach how best to structure — or restructure — their own portfolio, here are some thoughts:

•**Worry less about active versus passive than your overall asset allocation.** Your long-term returns — and risk of short-term loss — are likely to be far more dependent on how you allocate savings among stocks, bonds and cash than whether you choose active or passive funds.

"Allocation is everything," said Jeff Tjornehoj, senior analyst at fund tracker Lipper Inc. in Denver. "It's more important than beating a benchmark index" in any one asset category.

•**Focus on fund management fees.** Fund companies take their fees off the top — meaning they come directly from fund assets, reducing your net return. If you don't know what your fund costs, and how that fee compares with the fees of other funds in its asset category, you can easily check it athttp://www.morningstar.com by plugging in the ticker symbol.

The difference between a 1% annual management fee and a 0.5% fee may not seem like much, but over time it can become enormous.

And don't assume that just because a fund is passive it's cheap. Check the fees.

"There are a lot of foolish index funds out there," warns Don Phillips, head of Morningstar's investment research unit. Be wary, he said, of the index funds that promise some twist on the basic theme. What's the cost versus the expected benefit?

•**Consider active funds in asset categories where managers historically have had a better chance of outperforming the index.** In the five years that ended in June, 43% of emerging-market stock funds beat their index. Among U.S. large-stock funds, by contrast, just 23% beat their index.

That's a sign of how much tougher it is for funds that own the best-known stocks to gain an advantage over the market.

In the bond market, actively managed funds in the widely owned intermediate-term bond category also fared well over the last five years, with 63% of all funds beating the 5.2% average annual return of the sector index.

But how will those funds fare if interest rates continue to rise? Financial advisors say it's now crucial for bond fund investors to understand how their fund manager is betting, particularly in the mix of longer-term and shorter-term securities. Funds tilted toward longer-term bonds could suffer the most if rates surge — but also could benefit the most if rates start falling again.

For two opposing views on bond fund indexing, go here and here.

•**Remember: All investing is active on some level.** Making a decision to buy passive funds is an action. And if you own nothing but index funds, but trade in and out of them regularly, you are actively playing the market rather than just going with it.

The point is, experts say, if you want the benefits of passive investing, don't use those funds in a strategy that defeats their purpose.

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