Stock Market Perspective: Active Management vs. Indices

Most writers and commentators about the best way to invest in mutual funds say that due to their lower costs, it is better to buy index funds rather than actively managed funds with holdings of the same type as their benchmark indices. Not surprisingly, the managers of those funds say that they add value that more than makes up for their funds' higher expenses. I will discuss a recently released report by S&P, which has quite a few indices, and some of my own analysis.

Are passive index funds a "better buy" due to lower expenses? That is true in some cases, but many exceptions exist.

Before going further, I need to point out that I am a long-term member of the National Association of Active Managers (NAAIM), but "active" in that context does not have the same meaning as what follows. Just about all of those comparing actively managed funds, regular mutual funds or exchange traded funds (ETFs), with index funds are assuming and recommending that the funds purchased, of either type, be bought and held except for possible periodic rebalancing. NAAIM-types, including me, believe that approach is far too risky for just about all investors. Rip Van Winkle with a 20-year holding period that he slept through would be an exception.

S&P Dow Jones Indices issues periodic studies analyzing the performance of mutual funds. Since it is a purveyor of numerous indices and receives licensing fees from the funds that say their objective is to replicate one of the indices, it can't be considered as an impartial observer. However, the researchers takes steps to make sure it is of high quality. In particular, they make sure there is no survivorship bias by considering all the funds, including the ones that ceased to exist, at the beginning of each period in the analysis. There are other steps taken to reduce the chances of conclusions that are not meaningful. Nonetheless, one can wonder if S&P would publish a study that did not show its products in a favorable light.

One of my specialties is trading sector funds. When I started as an investment advisor almost twenty years ago, the only ones available were the Fidelity Select portfolios. Those funds still are by far the most numerous in any fund family and have some more specialized ones that are not available elsewhere. In 1999, Rydex (now part of Guggenheim Investments, although I will still call it Rydex) introduced sector funds. It currently has 18 while Fidelity has 39. ProFunds also has some sector funds that employ 1.5 times leverage, but I will not consider them here. The Selects are actively managed and are often a training ground for those wanting to manage Fidelity's larger funds. In contrast, the Rydex funds are essentially indices developed by the firm and are passively managed. Once the percentage allocations for the stocks owned are established, those percentages are maintained until possible periodic revisions due to changes in the factors behind the allocations. A dozen of the Select Funds have the same names and invest in the same industries as the corresponding Rydex funds. Comparing the performance of the matched funds will provide a different look at active fund management vs. passive index investing.

▶**The S&P (Standard & Poors) report** is SPIVA (acronym for S&P Indices Versus Active Funds) U.S. Scorecard. It is a 28 page study and can be downloaded from http://us.spindices.com/resource-center/thought-leadership/spiva/. (Under latest SPIVA Scorecards, choose U.S. from the drop down menu). I will e-mail it to you if you wish.

Its main table shows the percent of actively managed funds that were outperformed by the corresponding S&P benchmark index for each of the ten years, 2004-2013 and the average of the ten years. There are comparisons of all domestic funds to the S&P Composite 1500, but since most funds have benchmarks that are a

subset of that very broad market measure, the comparison may not be the most meaningful one. The table also shows how large-cap funds compare to the S&P 500, mid-cap funds to the S&P MidCap 400, and small-cap funds to the S&P SmallCap 600. Each of the three capitalization groups is further broken down into core, which is compared to the S&P indices listed above, and growth or value, which are compared to the corresponding subindices for the cap size.

Then ten-year averages show that fewer than half of the actively managed funds did better than their corresponding benchmark indices. The smaller the capitalization group, the greater the amount of underperformance: for large-cap 58.7% underperformed the S&P 500, 62.8% of the mid-cap funds on average did worse than the MidCap 400, and 65.3% of the small-cap funds trailed the SmallCap 600 index. The "value" funds tended to underperform by a little less than the core and "growth" funds.

There is quite a bit of variability in the table for both worse and better performance than the benchmarks. In 2004, 2008, and 2011, over 93% of the small-cap growth funds did worse than the SmallCap 600 Growth index. In 2005 and 2007 more than two-thirds of the large-cap growth funds did better than the S&P 500 Growth benchmark. In general, the actively managed funds averaged beating their benchmarks in 2005, 2007, 2009, and 2013, four of the ten years in the period. So the comparisons are hardly consistent or one-sided.

Keep in mind that the above does not say anything about the amount of underperformance as it is essentially a win-loss measure. Later on the report does delve into average returns sliced and diced in various ways.

In addition to the domestic stock funds, the report shows similar data for international stock funds and fixed income funds, but not with as fine divisions and for only the past five years. It can be a useful tool for those wanting to buy and hold various types of funds. It makes a general case that index funds, assuming they have very low expense ratios, are often better than actively managed funds as a group, but there is a significant percentage of exceptions, particularly with the fixed income funds.

▶**Fidelity Select and Rydex sector funds** provide another way of comparing actively managed funds with an index although differently from the SPIVA report in several ways. One is that sector funds often behave quite a bit differently from broad market funds. Another is that the S&P indices used in the SPIVA report do not include any expenses. In some cases such as the S&P 500, fund expenses can be trivial, as low as 0.05%. The Rydex funds have their expenses built into their prices. Those funds often have higher expenses than the corresponding Fidelity funds. One reason is the Rydex funds have no restrictions on trading as they can bought one day and sold the next. In contrast, the Selects charge 0.75% if sold before being owned for 30 days. Nonetheless, one wanting to buy and hold a fund for a particular sector might have a choice between a Select fund, say Electronics, and a Rydex fund for the same sector. So comparing the performance of corresponding sector funds is reasonable.

Comparing the holdings of Select Electronics with the Rydex fund illustrates the differences due to active management. The Rydex fund's top holding is, not surprisingly, Intel at 8.4% of assets; Texas Instruments is 5.2%, and the top five are rounded out by Applied Materials (3.6%), Micron Technology (3.5%), and Broadcom (3.1%). The top ten holdings are about 33% of the portfolio. These percentages do not vary much over time.

While Rydex's web site shows the complete essentially current portfolio, Fidelity's shows the top ten holdings (as of 12/31/2013 as I write this). Intel is the top holding of the Select fund, and Broadcom is the second largest. Only one other of Fidelity's top ten in the Rydex top ten, Xilinx is the #5 Select fund and #7 at 2.8% for Rydex. Fidelity does not show the percentages for the individual issues, but it does say the top

ten holdings are 52.4% of the portfolio. The Selects Electronics fund is more concentrated and focuses more on smaller companies due to its active management.

I decided to compare funds for twelve sectors. Some Fidelity funds now have names that are the same as or similar to the Rydex funds, but have changed their names and presumably their objectives since 2000. The Rydex sector funds were introduced in April 1999, so looking at returns for 2000 through 2013 is possible. That period also has the nice property that at the beginning stocks were well into a period of strong gains as is also the case at the end of 2013.

The twelve funds for comparison are Banking, Biotechnology, Electronics, Energy, Energy Services, Financial Services, Healthcare, Leisure, Retailing, Technology, Telecommunications, and Transport. They comprise a broad, but not comprehensive, cross-section of the economy.

Looking at the annualized compound rates of return for the fourteen year period, 2000-2013, all twelve of the Select funds had higher rates than the corresponding Rydex funds. The differences ranged from a high of 7.2% for Telecommunications to a low of 0.6% for Biotechnology. Nine of the twelve Select funds beat the Rydex fund in at least ten of the fourteen years, and only one, Leisure, which was better in seven of the fourteen, did not outperform in more than half of the years.

In only two of the years, 2003 and 2008, did the average Rydex fund outperform the average Fidelity fund. The margins were quite small, 1.0% and 0.6%, respectively. Those are both smaller than the year of the lowest Selects outperformance, 1.3% in 2006. In 2009, the Select fund average was 8.6% higher than that of the Rydex funds. The fourteen year average margin of the Fidelity funds was 3.3%. This is far larger than the less than one percent advantage that may be due to lower expenses ratios of the Selects.

These data indicate that active management of sector funds is worth paying for provided trading will not be too frequent. However, during the current secular bear market, I have determined that the methods I use to trade sector funds work better over time if I am able to trade them somewhat frequently. Trading the Selects funds too often and incurring the 0.75% charge for selling one before owning it for at least 30 days eliminates the advantages those funds have in comparison to the Rydex funds, which have no trading restrictions or short-term charges. For those reasons, for several years I have recommended that sector fund investing using Rydex funds rather than the Fidelity Selects.