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 Buttonwood's notebook  
**Financial markets**


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**Mutual fund investing**  
**A 25% chance of success**

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BETTING on red gives the punter an 18-in-37 chance (in Europe) or 18-in-38 chance (in America) of success in roulette. Parcel out your money carefully and you might have a diverting 20 minutes or so until it's all gone, with a few wins along the way. If the odds were just one-in-four, then the whole game would be much more discouraging.



But those have been the chances, over the last 20 years, of largecap US mutual funds beating the market. It has happened in just five calendar years. In one sense, this is hardly surprising; professional fund managers own the bulk of stocks, so the average fund manager performance should match the index. But the index doesn't have costs and the fund managers do. Those costs doom the fund managers to underperform. One does not have to believe in the efficient market hypothesis to understand this outcome. But to the extent that any market *is* efficient, largecap US stocks is the one; dozens of analysts cover every stock and their business models are well known and understood. The chance that any investor has a unique insight into a particular company is very small.

Here are the figures from Morningstar for each of the last 20 years.

Year	% of outperforming funds	ave fund return	S&P return
1995	11.2	31.4	37.6
1996	21.4	19.5	23.0
1997	9.8	26.1	33.4
1998	24.3	20.5	28.9

1999	43.7	22.1	21.0
2000	63.6	-3.6	-9.1
2001	42.6	-13.8	-11.9
2002	39.8	-23.3	-22.1
2003	38.2	28.0	28.7
2004	43.0	10.2	10.9
2005	58.6	6.2	4.9
2006	32.8	12.5	15.8
2007	55.0	7.5	5.5
2008	37.4	-38.6	-37.0
2009	59.4	30.0	26.5
2010	37.8	14.4	15.1
2011	18.7	-1.6	2.1
2012	36.8	14.9	16.0
2013	51.8	32.6	32.4
2014	13.4	10.3	13.7

Note that 2014 was actually the third worst year in terms of the proportion of funds that managed to outperform; fewer than one-in-seven managers did so. On average, active funds underperformed by around 1.6 percentage points a year, a big handicap for clients. There was one year, 1999, when most funds underperformed but the average return was slightly higher than the market. Still, the average return only beat the market 6 times out of 20. (To be fair, if one takes the average of each of the 20 years, active funds have outperformed 37% of the time. But that's still very low.)

To those who would say that passive funds are also doomed to underperform the market after costs, that is true, but their costs are a lot lower. A shrewd gambler would consider them a much better bet.

GMO has an interesting paper "Is skill dead?" on its [website](http://www.gmo.com/America/) (http://www.gmo.com/America/) which explains the poor performance of active managers in the largecap sector. It says three

factors are at work. Managers do not keep 100% of their portfolio in largecap stocks; they tend to have holdings of cash, foreign stocks and smallcaps. To the extent that these assets underperform the largecap index, the managers will underperform (and outperform when things go well). Last year, for example, the S&P 500 did much better than cash, international stocks or smallcaps, so it is hardly surprising that nearly six out of seven managers underperformed.

Well, it is an excuse, but is it a good one? Surely investors buy a US largecap fund to get exposure to largecaps, not the other stuff. To the extent that managers go off piste, that can only be justified if they reliably outperform. They clearly don't.

This explanation only makes the lesson clearer; if you want an exposure to US large caps, buy a US largecap index fund with low fees.

Of course, many people will ignore this advice. They see an index fund as a boring commodity product; they want the best in class, a manager that can outperform. And no active manager will admit that he (or she) is likely to underperform. But it is remarkable how few will put their money where their mouth is.

So kudos to one British manager who is doing so. Neil Woodford, a successful income fund manager, is launching the [Patient Trust](http://www.telegraph.co.uk/finance/personalfinance/investing/11394456/Woodford-to-launch-200m-investment-trust-backing-start-ups.html) (<http://www.telegraph.co.uk/finance/personalfinance/investing/11394456/Woodford-to-launch-200m-investment-trust-backing-start-ups.html>) , which will hold stakes in start-up companies with a focus on medical and biotech firms. Mr Woodford will charge no annual management fee, just a performance fee, which will take the form of shares in the trust itself. Thus he will only prosper if the fund goes well. If active managers really believed their own hype, more would adopt this arrangement. It is telling that this is such an innovative deal.