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Put indexing in your stocking

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Many leading U.S. financial advisors use index funds and ETFs to construct clients' core portfolios.

This year when you line up to return pricey, outmoded gifts, you might consider doing the same with many of your mutual funds. That's what serious investors should do based on sweeping new research on Canadian mutual fund performance released by The Vanguard Group Inc.

Vanguard compared the returns of actively managed stock and bond funds against their respective MSCI market indexes to evaluate their performance over both five-and 10-year periods. Their study is laudable in two respects. First, it accounted for mutual funds that merged or liquidated during the study period. These are typically underperforming funds and failing to consider these "losers" gives a falsely optimistic lift to the performance of actively managed funds.

Second, it didn't simply compare the returns of actively managed funds to the entire Canadian stock market as represented by an index such as the S&P/TSX composite. Instead, the study divided the market into categories based on the size of the company -- large, mid and small -- as well as the type of stock -- growth, blend and value -- and then compared funds against the most appropriate category benchmark. This eliminates the only too frequent problem of giving a manager credit for outperforming the overall market when it is simply the category of stocks that is hot.

Across the board for every asset group, category and time frame, actively managed funds underperformed their comparable indices. Of particular note is the fact that the majority of funds focused on mid and small companies underperformed their indexes. And the magnitude of the shortfall was not trivial. For example, small-company growth funds underperformed by 6.1% annually. So much for the myth that pricing inefficiencies among small company stocks can be readily exploited by active managers.

Not every actively managed fund underperformed its comparable index; there was a group of winners in every category. However, anybody with Grade 6 math and a historic fund-return table can identify the winners with hindsight.

The key question is -- how persistent is that outperformance? Unfortunately, it isn't. Only 21% of funds that were in the top one-fifth of funds in their categories for the five-year period ending Dec. 31, 2004 remained in the top one-fifth of funds in the next five years. Outperformance was almost random. Luck trumps skill in the active-management game.

Why do actively managed funds underperform? The high cost of running and marketing mutual funds creates such a drag that even if a manager is skillful, it is difficult to deliver superior returns net of expenses to an investor. Also, actively managed funds often trade frequently piling up commissions and other costs.

A decade ago, investors seeking global asset class diversification had little choice but to use pricey, actively managed mutual funds. Now, however, there is a range of index mutual funds available at a significant cost advantage. Vanguard found that the management expense ratios (MER) of stock and bond index mutual funds in Canada are on average 1.42% and 0.60% lower, respectively, than their actively managed peers.

An even better bargain can be had in the raft of exchange-traded funds (ETFs) that replicate various stock and bond indices and trade on the Canadian and U.S. stock exchanges.

According to ETF Guide, the median MER for ETFs in the United States is 0.49%. It's no wonder that when I talk to leading U.S. advisors, they almost uniformly report that they use index mutual funds and ETFs to construct the core of their portfolios.

Give yourself a present this holiday season. Return those pricey, actively managed mutual funds for the new low-cost, index model.

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