FINANCIAL POST

Tuesday, May 29th, 2012

The lopsided bet

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Bloomberg News

Any decision to use an active manager is a bet.

Are you a betting person? Well, if you are, I have a wager about skillfulness that you might consider. First, let me lay out the odds. Your chance of winning this bet is only about one in seven — clearly a long shot. In this wager you stand to lose about 86% of the time.

Being an astute gamester, you ask a vital question, “What’s the payoff?” Simple. If you win, you will get $128, but if you lose, you have to pay $319. Ridiculous you say — no sensible person would enter into a wager with these horrendous odds and an unrewarding payoff.

Yet, everyday millions of taxable investors enter into this kind of lopsided bet by deciding to use active managers that pick stocks instead of broad-market index funds. Let me explain where the numbers underlying the wager originate.

In 2000, a groundbreaking study was published in the Journal of Portfolio Management that looked at the relative performance of active versus index investing in the U.S. This study was original in three ways. First, it looked at post-tax performance; a critical view for the taxable high net worth investor. Second, unlike most studies that compare active managers' returns to those of an index, this study compared actively managed large US equity fund returns to those of the Vanguard Index 500 Fund. This is an actual index fund that charges fees, incurs transaction costs and distributes taxable dividends and gains. Finally, encompassing the years 1979-1998, its results are of great import for the long-term investor. It was the ultimate "active versus index" challenge.

The results are illuminating. A sobering 86% of actively managed funds had returns, net of capital gains and dividend taxes, which trailed that of the Vanguard 500 Index Fund. Only about one out of seven actively-managed funds beat the Vanguard 500 index fund. The handful that did only managed to do so by an average of 1.28% a year. The laggards, which were the overwhelming majority, had returns that averaged a shocking 3.19% a year less than that of the Vanguard 500 index fund.

In essence, any decision to use an active manager is a bet — an investor is betting that he or she can pick the winning manager whose skill can earn a return, net of fees, that is better than a comparable index fund. Affluent taxable investors have to add potential incremental taxes into the wager. What this study so uniquely profiles is just how lopsided that bet is. Not only are the odds stacked hugely against an investor picking a winner but the magnitude of the gain is far less than the penalty in underperformance from being wrong.

In Canada, we don't have anything like the Vanguard 500 Index Fund. Founded in 1976, it was the first index fund that catered to retail investors. However, the Vanguard Group, which recently launched a number of exchange-traded funds in Canada, has conducted studies on the Canadian fund industry that provide insight into the odds of picking a winning manager here.

In one study that compared the performance of Canadian equity funds to the MSCI Canada IMI index over 15 years ended December 31, 2010, only 6.5% of the original funds bested the Index. Most active funds didn't even finish the race; 62% of actively managed funds merged or were liquidated along the way.

Another study which looked at performance by equity fund type — large, medium and small cap segmented into value, core and growth styles — found that, on average, over 90% of funds underperformed their comparable benchmark for the five years ended 2010. The magnitude of underperformance by the surviving funds was substantial. It ranged from 1.21% for large cap value funds to a staggering 8.16% for mid cap value funds.

Lopsided bets might be exciting at the Friday night poker game. But it's a mug's game to make them with your entire investment portfolio.

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