FINANCIAL POST

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# Toting up the score: indexing vs. active investing

**Michael Nairne, Serious Money**

Brendan McDermid/Reuters files

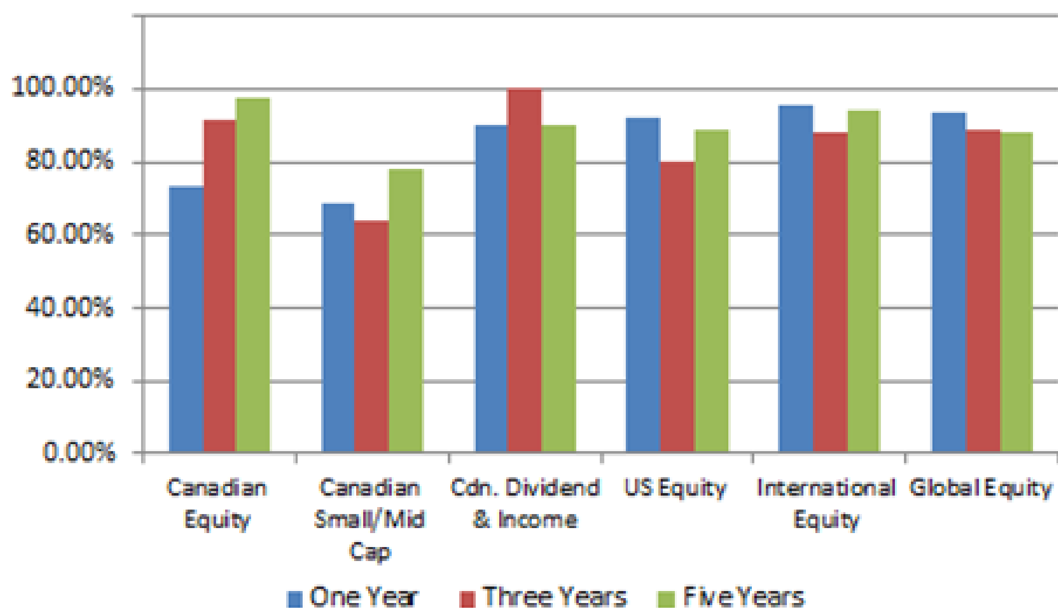
The recently released 2011 SPIVA scorecard for Canada highlights a recurrent and important finding from these reports — the overwhelming majority of actively managed funds cannot outperform their benchmarks.

Keeping score is how winners are separated from losers. So it's not surprising that a decade ago, analysts at Standard & Poor's decided to do just that by pitting the performance of S&P indexes such as the S&P 500 against the returns of actively managed mutual funds.

To keep the scorecard honest, their work incorporated three key features missing in many studies.

First, they used data that were free of survivorship bias — the distortion that arises from excluding the returns of funds that have closed or merged. Since these funds tend to be the poorer performers, using only the results of survivors overestimates returns. This is not a trivial matter. Imagine report card averages if students were allowed to drop their D's and F's. In fact, one major study found that looking at only the surviving funds' performance overstated returns by 0.9% annually.
Second, they ensured an apples-to-apples comparison by properly classifying mutual funds by their style of investing (e.g. value versus growth) and the size of companies in which they invested (e.g. small-cap versus large-cap) and comparing the results to appropriate S&P indexes. Finally, they weighted fund results by asset size to get a proper representation of how actively managed fund investors as a group really fared.

Thus, the S&P Indices Versus Active Funds (SPIVA) scorecard was born. It has since become the de facto scorecard for measuring how active managers are performing against comparable indexes. SPIVA Scorecards are now published for Canada, Australia and India as well as the United States.




Source: 2011 SPIVA Canada Scorecard

The recently released 2011 SPIVA scorecard for Canada highlights a recurrent and important finding from these reports — the overwhelming majority of actively managed funds cannot outperform their benchmarks. Across all major equity categories, the vast percentage of actively managed funds in Canada

underperformed their indexes. The dead weight of fees and expenses on returns is simply too great a burden in today's highly competitive capital markets.

Over shorter periods such as one or even three years, actively managed funds can post better relative results. However, the longer the period, the more oppressive the cost burden becomes. Hence, the five-year results tend to have a higher percentage of underperformance in each category than one or both of the shorter periods. Costs are certain, performance isn't.

The SPIVA scorecards have shattered two myths of active investing. Myth one is that active managers outperform indexes in bear markets because of their ability to act defensively. In contrast, by definition, indexes and the index funds that replicate their holdings stay 100% invested at all times. In a special SPIVA report, analysts looked at U.S. mutual fund performance in the 2000-2002 and 2008 bear markets. In both instances, the major S&P indexes — the S&P 500, the S&P MidCap 400 and the S&P SmallCap 600 — outperformed the majority of actively managed funds. Another SPIVA report reached the same conclusion for the Canadian market in 2000-2002.

The second myth is that active small-cap managers, on average, outperform the indexes due to the heightened inefficiencies at this end of the market. There are actually good reasons to believe this end of the market is less efficient but again, only a minority of active managers can surmount the burden of costs to beat their benchmarks. Only a little over a quarter of the active small-cap managers in the U.S. beat their benchmarks over the past five years. In Canada, even fewer succeeded.

Fortunately, the SPIVA scorecards are not simply an academic exercise. The explosion in exchange-traded funds that replicate the holdings of the S&P indexes, among others, has made low-cost indexed solutions available to investors. Savvy investors have toted up the score and are acting accordingly.

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