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EVENSKY TAKES ON ACTIVE MANAGERS; OFFERS NEW RESEARCH

By Maureen Nevin Duffy

When markets are booming, vitriol often flies at active fund managers. Critics charge that “any monkey with a few darts could do as well in a great market.” And active fund managers retort that they come through for investors in turbulent or down markets. Active managers have the flexibility to make tough decisions as markets move, drawing on their experience and wits, while index-bound funds are stuck banging on the same door.

In the current issue of Journal of Investing, two researchers shred that theory. They argue that active portfolio management is not superior to passive investment strategy in either expansions or recessions. Based on the 20-year period they studied, they conclude that “active portfolio management, in aggregate, fails to provide positive alpha in any economic environment.”

Authors Harold R. Evensky, president of Evensky & Katz, a financial advisory firm in Coral Gables, Fla., and an adjunct graduate professor at Texas Tech University's Division of Personal Financial Planning in Lubbock, and Shaun A. Pfeiffer, an associate professor of financial services in the Department of Business & Economics at Edinboro University in Pennsylvania, depart from earlier work by Tobias Moskowitz and Robert Kosowski that showed active management did produce better returns during recessions than at other times. Evensky and Pfeiffer say active managers' superior returns during recessions do little more than pay back their fees. And, the authors claim that active portfolio management cost investors roughly 1 percent a year during expansions and across time, from July of 1990 to March of 2010.

Even among outperforming active managers, they say, under 20 percent of prior business cycle “winners” repeat those performance levels in subsequent cycles. Fortunately, the researchers say the same inconsistency is found among poor performers.

“The challenge is that not all funds are structured the same way,” says Todd Rosenbluth, a senior equity analyst with Standard & Poor's Capital IQ, which also has done research on the subject. “Actively managed funds tend to take on more risk,” says Rosenbluth.

To be fair, he says, the authors' use of 140 basis points or 1.4 percent as the average expense fee may be unrealistic. “No one owns a thousand active mutual funds. A number of T. Rowe Price and Fidelity active funds cost less than half that. You can find much lower active fund fees.” But Rosenbluth agrees with the authors' basic premise that it is very hard for actively managed funds to outperform, partly due to the expense ratio and the costs of actively managed funds.

FA invited Fidelity and other funds to weigh in. Although Fidelity declined to be interviewed, a spokesman wrote back, “We can say, as a company that has been managing money for 65 years and has one of the largest global teams of portfolio managers, we firmly believe active investment strategies can add value on behalf of clients and shareholders over the long-term.”

Neither Alliance Bernstein or T. Rowe Price had a comment.

Investors can also try to beat the odds by seeking out funds that have outperformed and taken lower risk, insists Rosenbluth. “That can increase the likelihood of your portfolio outperforming because you've weeded out some of the bad apples.”

Another research team will soon release similar conclusions. Vanguard's Investment Strategy Group plans to publish a paper at the end of this year. The fund group offers both active and passive funds. “I don't think I would disagree with the premise of this academic article,” says Daniel Wallick, principal of the group, based in Malverne, Pa. His group examined excess return among active managers and third-party subadvisors industry wide, including Vanguard funds. “The challenge with active management is that the costs are too high,” he says. “We would certainly agree with that.”

The team deconstructed and compared Vanguard active funds against all other active funds and found a distinct difference. On average over 15-year periods, the Vanguard active funds had a median cost of 37 basis points, more than 40 percent cheaper than the indexed or passive funds out there, says Wallick.

“But not all low-cost investments are indexes and not all high-cost funds are active,” he says. In analyzing funds from both the expense ratio and after-tax cost perspective, Wallick found, the distribution of costs within the active and passive management space is what really counts. The distribution of returns for index funds is much tighter than for active funds, so the possibilities for passive funds will be narrower, he says, hinting at where his team's paper will go.

The question for investors to ask themselves is can the fund in question attract top talent at low cost? And can they live with the variability of returns? The issue seems to turn back to the wisdom an investor exercises in choosing which fund, rather than the easy bet that an active manager can and may break out and race ahead of the pack.